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The Politics of Monetary Leadership and Followership: Stability in the European Monetary System since the Currency Crisis of 1992

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Despite widespread scepticism, there is a fundamental continuity in the stability of the European Monetary System (EMS) before and after the 1992 crisis. Although speculative pressures provoked European leaders to widen the fluctuation bands of the Exchange Rate Mechanism (ERM), thus altering substantially the official commitment of member governments to coordinate monetary policies and exchange rates, the values of currencies in the hardcore of the EMS have remained close to their pre-crisis parities with limited fluctuations. European monetary cooperation continues informally, achieving much more stability than the wide bands suggest. The task of the article is to explain the puzzling continued success of the EMS. First, this article re-specifies the problem of international monetary cooperation as a leader–follower interaction with inherently hierarchical attributes. Second, the article outlines the causes of exchange-rate stability in Europe. Finally, the article emphasizes that French monetary followership is the key to the stability of the post-crisis arrangement and offers a preliminary interpretation of the sources of French behaviour.

Despite a turbulent beginning and nearly universal scepticism, the European Monetary System (EMS) gradually evolved into an effective arrangement for coordinating exchange-rate stability in Europe. Frequent exchange-rate realignments had characterized the unstable early years of the EMS, but between 1987 and 1992 there were no exchange-rate realignments. Members of the EMS increasingly believed that the system's stability would provide a sound basis for a quick transition to a common currency, while an academic cottage industry arose to explain the politics and economics of stable European exchange rates in the context of an unstable world monetary system. The Maastricht Treaty laid out the plans for monetary unification, and Europe expected continued stability. However, in September 1992 a currency crisis wreaked havoc on the EMS. International financial markets seemed to prove Europe's expectations wrong.

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The crisis shattered perceptions of the stability of the EMS. For the first time since the creation of the EMS in the late 1970s, two currencies, the British pound sterling and Italian lira, left the system. Additionally, the Portuguese escudo and Spanish peseta were pressured to devalue involuntarily. Continued speculative pressures against EMS currencies through the end of 1992 and into 1993 eventually provoked European leaders to widen the fluctuation bands of the Exchange Rate Mechanism (ERM) of the EMS from 4.5% to 30%. These new, wider fluctuation bands significantly altered the *official* commitment of member countries to maintain strict adhesion to their pre-crisis parities. In effect, the official commitment to coordinate monetary policies and exchange-rates within narrow bounds was now gone. Most American and British financial journalists and scholars perceived this as the end of monetary cooperation in Europe and, therefore, the end of the dream of European Monetary Unification (EMU). The academic cottage industry on the EMS rapidly turned from explaining the success of the EMS to explaining its failure.[1] Most observers expected the widening of the bands to mean the end of coordinated exchange-rate stability in Europe, despite statements from the Commission and member countries to the contrary. Because it was acknowledged widely that the rigors of following tight German monetary policy had helped push Europe deeper into recession, many economists assumed that the remaining EMS countries would use their new freedom to reflate their economies.[2]

Europe has been proving the expectations of markets and sceptics wrong. The conventional wisdom regarding the state of monetary cooperation in Europe is quite inadequate. Since the fluctuation bands of the EMS were widened in 1993, the countries still in the EMS, especially those in its hardcore, have maintained the values of their currencies very close to their pre-crisis parities, as seen in Figures 1–4.[3] Although the official fluctuation margins of the EMS are dramatically larger, the exchange rate stability within the hardcore of the EMS suggests that monetary coordination continues, albeit on a more informal level.[4] In fact, Labhard and Wyplosz present statistical evidence indicating that there are much narrower *implicit* fluctuation bands within the wider *official* bands of the EMS. These narrower bands generally are centred around a parity that is slightly weaker than the official parity and have an average estimated band-width of approximately $\pm 6\%$.[5] Clearly there is much more to be told about the EMS story as it has developed since 1992. The crisis has been ably explained

[1] An example of the American reaction to the perceived death of the EMS is O. Blanchard, R. Dornbusch, S. Fischer, P. Krugman, P. Samuelson, and R. Solow, 'No reason to mourn', *Financial Times*, (6 August 1993).

[2] See in particular the expectations outlined in International Monetary Fund, *World Economic Outlook: October 1993* (Washington DC, International Monetary Fund, 1993), pp. 29–41.

[3] The group of countries included in this stable arrangement includes Belgium, Denmark, France, Germany, Luxembourg, and the Netherlands. Spain and Portugal are peripheral members of this group, while Ireland is increasingly a stable member. Austria has recently joined the system but has been shadowing German monetary policy for some time. Note that Luxembourg and Belgium are in a currency union. Germany and the Netherlands have a bilateral agreement to maintain the pre-crisis fluctuation bands. For criticism of the argument that the EMS has disintegrated, see D. Cobham, 'Introduction: Diversion or Dead End?', in D. Cobham (ed.), *European Monetary Upheavals* (Manchester, Manchester University Press, 1994).

[4] H. Matthes, '"Damocles shadowing": An innovation in the second phase of EMU', *Intereconomics*, 29,2 (1994), 75–7.

[5] V. Labhard and C. Wyplosz, 'The new EMS: narrow bands inside deep bands', *American Economic Review*, 86,2 (1996), 143–6.

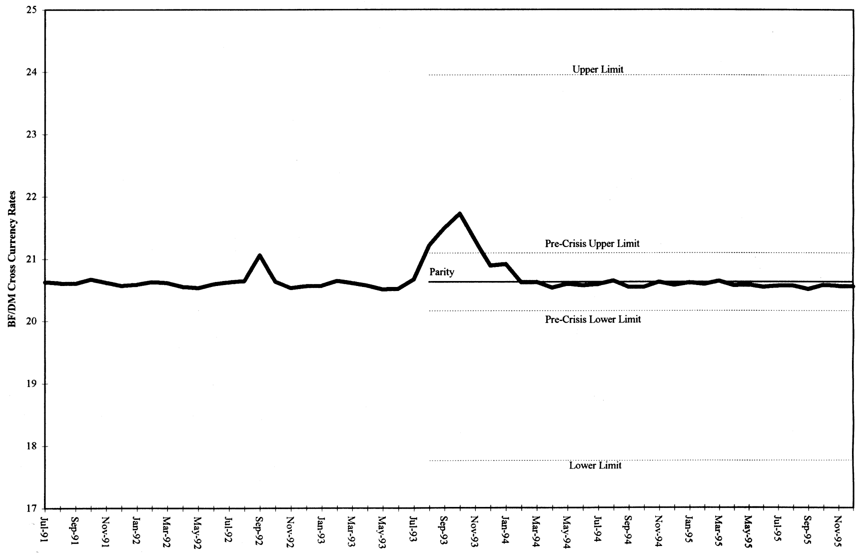

Figure 1. Belgian Franc vs. Deutsche Mark

Sources: IMF, *International Financial Statistics*, various; Eurostat, *ECUSTAT*, various; Banque Nationale de Belgique, *Bulletin Statistique*, various; Danmarks Nationalbank, *Report*, various; Banque de France, *Rapport*, various; De Nederlandsche Bank, *Quarterly Bulletin*, various. Values are mean monthly exchange rates.

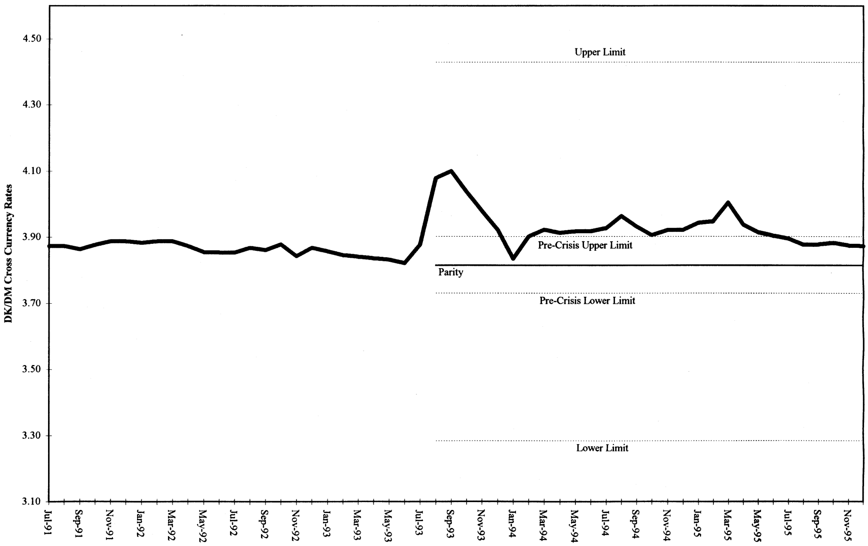

Figure 2. Danish Krone vs. Deutsche Mark

Sources: IMF, *International Financial Statistics*, various; Eurostat, *ECUSTAT*, various; Banque Nationale de Belgique, *Bulletin Statistique*, various; Danmarks Nationalbank, *Report*, various; Banque de France, *Rapport*, various; De Nederlandsche Bank, *Quarterly Bulletin*, various. Values are mean monthly exchange rates.

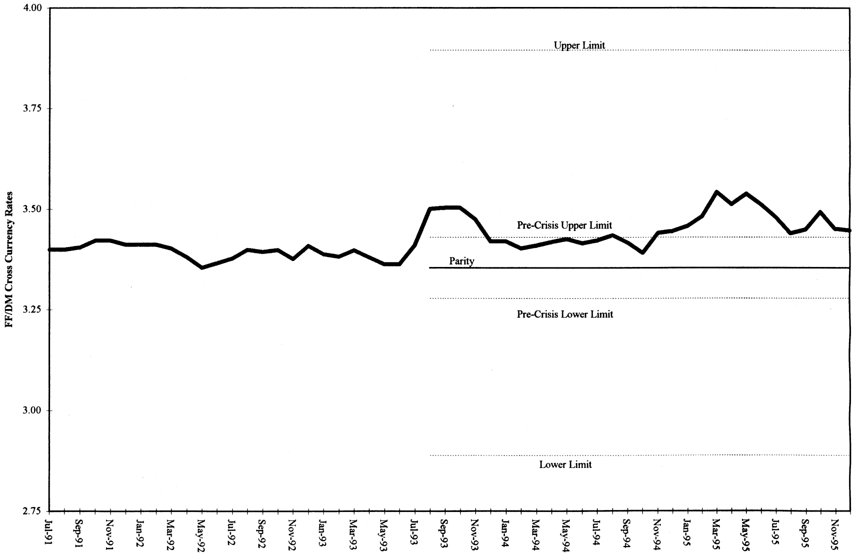

Figure 3. French Franc vs. Deutsche Mark

Sources: IMF, *International Financial Statistics*, various; Eurostat, *ECUSTAT*, various; Banque Nationale de Belgique, *Bulletin Statistique*, various; Danmarks Nationalbank, *Report*, various; Banque de France, *Rapport*, various; De Nederlandsche Bank, *Quarterly Bulletin*, various. Values are mean monthly exchange rates.

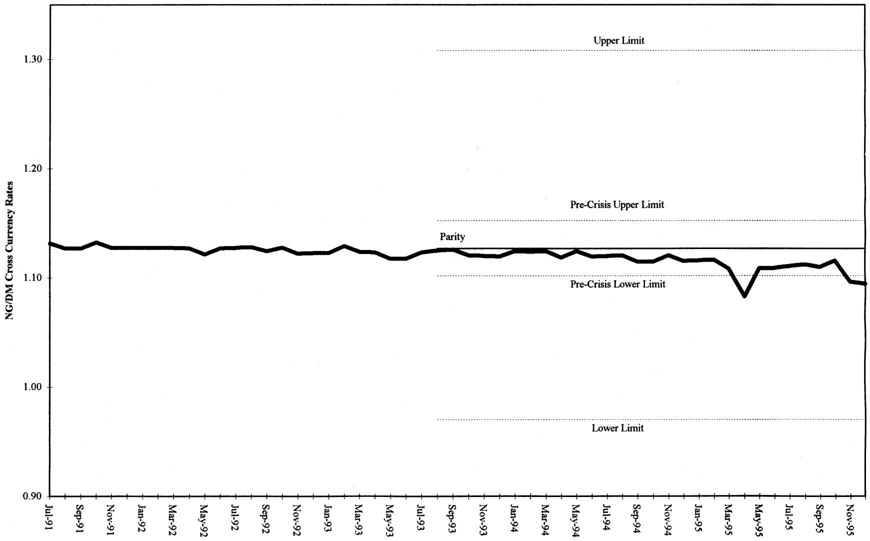

Figure 4. Netherlands Guilder vs. Deutsche Mark

Sources: IMF, *International Financial Statistics*, various; Eurostat, *ECUSTAT*, various; Banque Nationale de Belgique, *Bulletin Statistique*, various; Danmarks Nationalbank, *Report*, various; Banque de France, *Rapport*, various; De Nederlandsche Bank, *Quarterly Bulletin*, various. Values are mean monthly exchange rates.

elsewhere.[6] But what are the politics and economics of the new EMS with its informal narrow bands and exchange-rate stability? This article is an attempt to understand and explain *not* the early death of the EMS, but rather its continuing and curious life.

This continuity raises a theoretical and empirical puzzle for scholars of monetary relations and international political economy more generally. Why have exchange rates in Europe remained stable? The formal institutionalization of cooperation has broken down, a weak dollar has increased international pressures to devalue in Europe, and a global and European recession has increased domestic pressures for reflation. Yet coordination continues.

Scholars, markets, and analysts are recognizing more widely that the countries of the EMS have not taken the opportunity to reflate their economies but have instead continued to maintain exchange-rate stability in Europe. But from the perspectives of theories of international cooperation, the expertise and knowledge underlying the expectations and advice of markets and economists in 1993, and the range of domestic and international incentives for reflation, this behaviour remains a surprise. Two empirical questions motivate this article. First, what are the policy mechanisms that underlie continued exchange-rate stability in Europe? Second, what are the political sources of this behaviour?

To answer these questions the article briefly offers a framework within which to evaluate the history of the EMS. This framework re-specifies the problem of international monetary cooperation as a leader–follower interaction with inherently hierarchical attributes. Then the article applies monetary leadership and followership to the European case, with emphasis on the period since the crisis. The conclusion relates the theoretical and empirical discussion to the future of European monetary unification.

Most important are the empirical claims about the politics of monetary cooperation in Europe since the crisis.[7] First, monetary coordination in Europe continues on a more informal level but within the existing EMS structure. This continued coordination cannot be understood outside of the context of the continued movement of Europe toward the EMU goal. Second, interest rate policy rather than foreign exchange intervention is the primary mechanism for the maintenance of the current stability. Third, the ERM infrastructure of policy communication and monthly European Monetary Institute (EMI) meetings are the primary arenas for the expression and discussion of national monetary preferences. However, although the EMS as a regime certainly has important effects on multilateral decision making,[8] the institutionalization of

[6] See M. D. Harmon and D. Heisenberg, 'Explaining the European currency crisis of 1992', *German Politics and Society*, 29 (1993), 19–51; C. Johnson and S. Collignon (eds), *The Monetary Economics of Europe: Causes of the EMS Crisis* (Rutherford, Fairleigh Dickinson University Press, 1994); and, D. Cobham (ed.), *European Monetary Upheavals* (Manchester, Manchester University Press, 1994).

[7] Much of the original research to support these claims was undertaken through interviews of participants and observers of contemporary European monetary politics. These included analysts at the Deutsche Bundesbank, Banque de France, and Bank of England. I also interviewed economic and political researchers at international banks and European research institutes in Germany, Belgium, France, and Britain. Additionally, I interviewed members of the EU Commission's Directorate-General for Economic and Financial Affairs (DGII) in Brussels. All attributes are made with the permission of the interviewees. Some interviewees have requested anonymity.

[8] See M. Kahler, 'Organization and cooperation: international institutions and policy coordination', *Journal of Public Policy*, 8,3/4 (1988), 375–401.

European monetary cooperation is not central to the current politics underlying exchange-rate stability in Europe. Instead, the informal nature of the current arrangement strongly enhances the importance of domestic rather than international sources of government commitment to the EMS. The institutionalization of cooperation simply makes these political decisions easier to implement. Finally, French monetary followership is the key both to the stability of the current arrangement and to the success of EMU. German monetary leadership has been weak and, at times, failing.

Leading and Following in International Monetary Cooperation

There are at least two factors that distinguish international cooperation in money from international cooperation in trade. First, unlike cooperation in international trade, cooperation in international money has a number of attributes that are *inherently hierarchical*. International monetary cooperation requires the commitment of states to maintain a certain external value of their currencies. At the same time, fixed exchange-rate regimes tend to operate asymmetrically.[9] The combination of these non-controversial insights suggests that international monetary cooperation can be divided usefully into two related but analytically distinct components: leading and following. Successful monetary cooperation has at its centre a powerful state willing to take on the task of leading monetary affairs by providing international public goods and presenting the focal point for cooperative efforts. Yet cooperation will not be successful unless relevant medium-sized states follow the monetary lead of the more powerful states. Thus, monetary cooperation, defined by exchange-rate stability, can fail through either a failure of states to lead or a failure of states to follow.

Second, international currency and capital markets are central players in monetary cooperation. While trade cooperation tends to be based only on intergovernmental interactions, monetary cooperation involves intergovernmental relations *and* relations between governments and markets. The importance of variations in the willingness of private actors to hold national moneys and the psychology of such interactions produce a problem of credible commitment inherent to monetary cooperation.[10] The process of monetary cooperation is much more complex and subtle than that in trade, and it includes interactions between markets, governments, and, in many cases, independent central banks as key actors.

Further, the already hierarchical nature of international monetary relations is reinforced strongly by the internationalization of capital. Monetary followership is made even more difficult and potentially painful as it is required to be more precise by the discipline of large capital flows. The evolution of the EMS

[9] A brief discussion of asymmetry and the N-1 problem in international monetary cooperation based on reserve currencies can be found in P. Krugman and M. Obstfeld, *International Economics: Theory and Policy* (New York, HarperCollins, 1994), ch. 18. See also C. P. Kindleberger, 'The Price of Gold and the N-1 Problem', in his *International Money: a Collection of Essays* (London, George Allen & Unwin, 1981). For a discussion of asymmetry in international monetary history, see R. I. McKinnon, 'The rules of the game: international money in historical perspective', *Journal of Economic Literature*, 31,1 (1993), 1–44.

[10] B. A. Simmons, *Who adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years* (Princeton, Princeton University Press, 1994).

into a quasi-fixed exchange-rate regime with the removal of capital controls mandated by the Single European Act ensures that monetary policies in the various European states can differ very little from the most disinflationary state.[11]

Hierarchy and Leadership

Because of the functions that money is designed to perform, monetary relations have features that are inherently hierarchical.[12] Currencies are used at the international level both privately and publicly. Privately currencies are used for the traditional purposes for which domestic moneys are used: a medium of exchange, a store of value, and a unit of account. Publicly currencies are used intergovernmentally as reserve and intervention media and as pegs for exchange rates. Each of these types of international uses is inherently competitive and thus hierarchical.[13] This hierarchy is both a source of power for dominant states and a unique characteristic of international monetary relations.[14] Monetary relations are more hierarchical when coupled with efforts at cooperation. This commitment of states to maintain certain external values of their currencies coupled with the asymmetry inherent in fixed-exchange rate systems produce this additional element of hierarchy.

The hierarchies in international monetary relations have long been recognized. Inquiry into the politics of international monetary leadership is part of a larger question of the role of power in the stability of international economic relations.[15] However, there have been two different perspectives on

[11] Reference to standard Mundell-Fleming models of open economy macroeconomics helps to elucidate why this should be so. In what has been called the 'triad,' the 'unholy trinity,' and the 'assignment problem', it is a generally accepted axiom of international economics that the policy goals of free capital movements, autonomous monetary policy, and fixed exchange rates cannot be pursued simultaneously. For a good discussion see B. J. Cohen, 'The Triad and the Unholy Trinity: Lessons for the Pacific Region', in R. Higgott, R. Leaver, and J. Ravenhill (eds), *Pacific Economic Relations in the 1990s: Cooperation or Conflict*? (Boulder CO, Lynne Reinner, 1993).

[12] See C. P. Kindleberger, 'The politics of international money and world language', *Princeton Essays in International Finance*, 61 (Princeton, International Finance Section, 1967); C. P. Kindleberger, 'International public goods without international government', *American Economic Review*, 76,1 (1986), 1–13; C. P. Kindleberger, 'Hierarchy versus inertial cooperation', *International Organization*, 40,4 (1986), 841–7; and, more generally, C. P. Kindleberger, *The World in Depression, 1929–1939* (Berkeley, University of California Press, rev. ed., [1973] 1986).

[13] See the discussion of public and private currency internationalization in B. J. Cohen, 'The Political Economy of Currency Regions', in E. D. Mansfield and H. V. Milner (eds), *The Political Economy of Regionalism* (New York, Columbia University Press, 1997).

[14] For a discussion of the question of power in international monetary relations, see J. Kirshner, *Currency and Coercion: the Political Economy of International Monetary Power* (Princeton NJ, Princeton University Press, 1995).

[15] Students of international relations will recognize this as part of the research agenda of hegemonic stability theory. See especially R. Gilpin, 'The politics of transnational economic relations', *International Organization*, 25,3 (1971), 398–419; and Kindleberger, *World in Depression*. On applications to international monetary relations specifically, see J. S. Odell, *U.S. International Monetary Policy: Markets, Power, and Ideas as Sources of Change* (Princeton NJ, Princeton University Press, 1982); J. Gowa, 'Hegemons, IOs, and markets: the case of the substitution account', *International Organization*, 38,4 (1984), 661–83; K. A. Oye, 'The Sterling-Dollar-Franc Triangle; Monetary Diplomacy, 1929–1937', in K. A. Oye (ed.), *Cooperation under Anarchy* (Princeton NJ, Princeton University Press, 1986); and B. Eichengreen, 'Hegemonic Stability Theories of the International Monetary System', in his *Elusive Stability: Essays in the History of International Finance, 1919–1939* (Cambridge, Cambridge University Press, 1990).

leadership in international monetary politics. One emphasizes the purposive fostering and maintaining of international cooperation, while the other emphasizes the sequential order of national policies.

As a theorist of the first perspective of monetary leadership, Charles Kindleberger focuses on the motives of the most powerful state in the international monetary system, emphasizing that international monetary leadership is the result of deliberate maintenance of system stability.[16] On the other hand, Barry Eichengreen's discussion of Bank of England leadership in the international gold standard focuses on strategic price leadership and thus the timing of monetary policy changes, with leaders changing their monetary policies first but not necessarily with the system's stability in mind.[17] However, these insights can be combined into a more comprehensive conception of international monetary leadership.

This can be done by elaborating the public goods that monetary leaders provide in the fostering of international cooperation. These public goods include: (i) financial backing for a mechanism that eases the costs of adherence; (ii) toleration for temporary deviation from the rules; (iii) enforcement of rules (surveillance and sanctions); (iv) a numeraire; and, (v) stability of the numeraire.[18] These public goods are not all alike. The first three require conscious motivation on the part of the monetary leader to foster monetary cooperation. In contrast, the last two can be by-products of a powerful structural position and domestic monetary stability. The history of international monetary leadership also highlights these leadership roles, with leaders tending to remain passive in foreign exchanges, maintaining open capital markets, and anchoring the system with a monetary policy chosen independently of the actions of other countries.[19]

At least part of monetary leadership is based on domestic choices of the most important monetary power. But, without consciously attempting to promote cooperation, powerful and stable states can provide the focal point for international cooperation by virtue of the role of their currencies as numeraire. Leadership must take account of both political motivation and structural power. Nevertheless, monetary leaders usually are unable to dictate international monetary developments alone. Although powerful states have an important and differentiated role, the nature and causes of monetary *followership* are crucial for understanding why cooperation occurs.

Hierarchy and Followership

The component of monetary cooperation that is both far more interesting and far less studied is monetary followership. Successful monetary cooperation

[16] C. P. Kindleberger, 'Dominance and leadership in the international economy: exploitation, public goods, and free rides', *International Studies Quarterly*, 25,2 (1981), 242–54.

[17] B. Eichengreen, 'Conducting the international orchestra: Bank of England leadership under the classical gold standard', *Journal of International Money and Finance*, 6,1 (1987), 5–29.

[18] J. Kirshner, 'Cooperation and consequence: the politics of international monetary relations', *Journal of European Economic History*, (forthcoming 1998).

[19] See the discussion and summaries in McKinnon, 'Rules of the game'. In addition, McKinnon contrasts the relatively more symmetric attributes of gold-based systems, which are obsolete in the present era.

requires leaders, but it needs followers just as much, if not more.[20] Although smaller states often have little choice and little consequence in international monetary relations, the problem of middle-level powers has long interested scholars of monetary affairs. Charles Kindleberger explains the hierarchical roles in international monetary politics:

> Great powers, typically one great power, have responsibility for the stability of the international monetary system. Small countries with no power separately to affect the system have no such responsibility and are free to pursue the narrow national interest. In between, near-great powers face a difficult problem since they have power to hurt the system, generally insufficient power to steady it in the face of disruption on a wide scale, but are tempted to pursue national goals which diverge from the interest of the system.[21]

In addition to the insight of systemic-structural theorists of monetary cooperation that leadership is crucial for the emergence and maintenance of cooperation, the specific problem of middle-sized powers presents important avenues for research and helps to illustrate some of the main problems of monetary cooperation. As Kirshner argues, monetary cooperation is so rarely robust, because cooperation 'requires governments to cede some of their authority over basic issues'. Indeed, in order to maintain international monetary cooperation governments are 'forced to engage in unpleasant acts', such as deflation, exchange-rate overvaluation, and costly foreign exchange intervention.[22] This is the primary question of monetary followership: what causes middle-level powers to cede authority over basic economic issues and monetary independence and prestige to states not substantially more powerful than themselves? Just as powerful states choose to lead monetary affairs, middle-level states must choose to follow the leader for arrangements to remain stable.

In fact, the monetary followership of middle-level powers is almost always a political puzzle and almost always short-lived. Although some theorists have deduced preferences for trade followership from the position of nations in the international economic structure,[23] the theoretical task for the study of monetary followership is more problematic. As in any theory of cooperation, the explanation of monetary followership rests on an explanation of the preferences of the national government for followership. For the EMS, monetary

[20] A. A. Stein makes a different but analogous argument about the role of followers in trade cooperation in his 'The hegemon's dilemma: Great Britain, the United States, and the international economic order', *International Organization*, 38,2 (1984), 355–86. See also the discussion of supporter states in the international economic order in D. A. Lake, 'Beneath the commerce of nations: a theory of international economic structures', *International Studies Quarterly*, 28,2 (1984) 143–70. Also, Susan Strange argued for a more complex differentiation of the roles of currencies and countries in the international monetary system in her *Sterling and British Policy: a Political Study of an International Currency in Decline* (London, Oxford University Press, 1971), and 'The politics of international currencies', *World Politics*, 23,2 (1971), 215–31.

[21] C. P. Kindleberger, 'The International Monetary Politics of a Near-Great Power: Two French Episodes, 1926–1936 and 1960–1970', in his *Keynesianism vs. Monetarism, and other Essays in Financial History* (London, George Allen & Unwin, 1985), p. 119. Interestingly, it is France again in the pivotal role of near-great power, this time in the context of the European Union.

[22] Kirshner, 'Political prerequisites of international monetary stability', unpublished manuscript, Cornell University, 1997.

[23] Lake, 'Beneath the commerce of nations'.

followership has rested fundamentally on the domestic determination of monetary preferences.[24]

However, the internationalization of capital does serve to add some incentives regarding monetary coordination. In particular, deficit countries and smaller countries tend to have a greater interest in coordination than do surplus countries, larger countries, or those countries with currencies used internationally for reserves and transactions. As Webb argues, high levels of capital mobility create incentives for monetary coordination at the same time that they make coordination more difficult.[25] This theoretical discussion leads directly to empirical questions of the sources of the international monetary preferences of EMS countries based on their domestically defined preferences, their roles in the region's monetary system, and their relationships to international capital markets.

Leadership and Followership in the EMS before the Crisis: Making and Breaking the System, 1978–1992

Of the two attempts at monetary cooperation in Europe in the post-war era, one was considered a failure and the other a success. The failure was the first attempt, the European Currency Snake, and it lived only briefly in the early and mid-1970s. The success was the second attempt, the European Monetary System, and has lasted since 1979. After a turbulent beginning and quite some initial scepticism in the early 1980s, the EMS eventually was recognized widely as a successful effort at creating exchange rate stability. Much academic scholarship has been invested in the explanation of the difference between these two episodes.

However, a different characterization of events recasts the empirical puzzle to be explained. Since the early 1970s and the days of the Snake a group of small European countries following German monetary policy, known as the Deutsche Mark (DM) block, has been relatively stable.[26] For these countries the Snake was no great failure. In fact, the apparent success of the EMS simply was the continued success of this DM block with the addition of France, Italy, and Ireland.

The question then is not why the EMS was a success and the Snake a failure, but rather why France and Italy changed their policies to reduce inflation and maintain exchange-rate stability within the context of the EMS.[27] These changes in policy made the EMS a success. In fact, the real puzzles of the EMS are questions of the politics of monetary followership.

There are two main empirical tasks for observers of the politics of the EMS. The first is to characterize and offer explanation for the monetary leadership of

[24] See the discussion of domestic sources of governmental preference formation in A. Moravcsik, 'Preferences and power in the European Commmunity: a liberal intergovernmentalist approach', *Journal of Common Market Studies*, 31,4 (1993), 473–524.

[25] M. C. Webb, 'Capital mobility and the possibilities for international policy coordination', *Policy Sciences*, 27,4 (1994), 395–423.

[26] This DM block has included Belgium, Denmark, Luxembourg, the Netherlands, and Germany.

[27] For this insight and an excellent discussion of the domestic politics of the shift, see J. Frieden, 'Making Commitments: France and Italy in the European Monetary System, 1979–1985', in B. Eichengreen and J. Frieden (eds), *The Political Economy of European Monetary Unification* (Boulder CO, Westview, 1994).

Germany during the period under consideration. The second is to explore the monetary followership of various European countries over the course of the EMS. Because the primary focus of this paper is the period since the 1992 crisis, most attention will be paid to French followership during the most recent, informal stage of the EMS. The followership roles of other countries such as Britain and Italy will be discussed only secondarily. Here the period before the crisis is examined briefly in order to provide the background for the leader and follower roles of the post-crisis period. The stability of the EMS has varied over its history and has been a function both of Germany's leadership and of the political decisions of other countries.

German Leadership before the Crisis

The question of Germany's relationship to the EMS has produced an enormous amount of economic and political science scholarship. In particular, there are a number of controversies about the extent to which Germany has led or dominated monetary politics in Europe. This paper argues that the asymmetries of European monetary power are central to an explanation of the dynamics of European monetary politics. In particular, German monetary leadership has been important both for the creation and maintenance of the EMS.

German political, if not monetary, leadership was critical for the creation of the EMS. In a Franco-German initiative, Chancellor Schmidt and French President Giscard d'Estaing pushed forward the creation of the EMS. As Peter Ludlow argues, the 'EMS was arguably the first major act of German leadership in the history of the European Community'.[28] However, neither the Bundesbank nor Bonn generally led the way to the EMS. The idea originated with Roy Jenkins when he became President of the Commission in 1977. Schmidt played a crucial role in initiating cooperative negotiations, despite opposition within Germany from the Bundesbank, the financial community, the industrial sector, and the trade unions.[29] As a result, Germany's act of leadership in the creation of the EMS was possible only 'because the chancellor of the day possessed sufficient political authority to brush aside the collective strength and wisdom of the guardians of the German economy in Frankfurt and Bonn'.[30] In fact, in his contentious negotiations with the Bundesbank Schmidt even threatened to amend the Bundesbank Law if it did not accede to the creation of the EMS before the two strong-willed political agents reached a compromise.[31]

Schmidt pushed ahead with the initiative, despite the opposition of domestic groups, for reasons of foreign policy and domestic politics. Schmidt wanted to insulate, at least partially, European currencies from the volatility of the dollar and to weaken the monetarism of the Bundesbank.[32] Schmidt also later called the EMS his 'grand strategy for integrating Europe', and he asserted that a

[28] P. Ludlow, *The Making of the European Monetary System: a Case Study of the Politics of the European Community* (London, Butterworth Scientific, 1982), p. 290.

[29] H. M. Kaufman, *Germany's International Monetary Policy* (New York NY, Brooklyn College Press, 1985).

[30] P. Ludlow, *Making of the European Monetary System*, p. 290.

[31] E. Kennedy, *The Bundesbank: Germany's Central Bank in the International System* (New York NY, Council on Foreign Relations Press, 1991), pp. 80–81.

[32] P. J. Katzenstein, *Policy and Politics in West Germany: the Growth of a Semisovereign State* (Philadelphia PA, Temple University Press, 1987), pp. 62–3.

primary source of his interest in monetary cooperation was the assumed result of binding West Germany closer to Western Europe.[33]

The cooperative aspects of the creation of the EMS should also be stressed. This is important for two reasons. First, it is important to note that the EMS was designed to operate symmetrically, even though it would quickly evolve into an asymmetric system.[34] Second, this parallels Eichengreen's conclusion that powerful states in the international monetary system have rarely been able to dictate the form that monetary systems take.[35]

Beyond the question of the creation of the EMS, Germany's leadership in the maintenance of the cooperation has also been a central variable in the evolution of European monetary politics. Critics of attempts to explain the patterns of European monetary relations based on Germany's distinctive role have claimed that empirical results of statistical tests demonstrate: that weak currency countries have been able to insulate domestic interest rates with market segmentation, realignments, and capital controls; that Germany, despite a greater monetary independence, does react to other countries' policies; and that decision making on many issues is cooperative rather than hierarchical.[36] However, these studies have misunderstood the nature of power in international monetary cooperation. That Germany is not completely insulated from the rest of Europe's money or that other countries retain some measures of independence does nothing to rule out the possibility that Germany plays a central role in the maintenance of European monetary cooperation. Also, these analyses rest on the fact that capital controls and realignments provided some measure of independence from Germany. But, after 1987 there were no more realignments, and after 1990 there were no more capital controls. Such questions about the strength of the asymmetry of the EMS have been put aside by the events of 1992, during which Germany remained unresponsive to the concerns of the rest of the system.

Thus, German monetary leadership is central to the evolution of the EMS.[37] However, after the cooperation of creating of the EMS, German leadership has

[33] Quoted in D. Marsh, *The Most Powerful Bank: Inside Germany's Bundesbank* (New York NY, Times/Random House, 1992), p. 202.

[34] Indeed, McKinnon argues that distinguishing between the intended and the actual rules of the game of international monetary orders is 'of central analytical importance'. See McKinnon, 'Rules of the game', pp. 2–3. Both the Bretton Woods international monetary order and the EMS regional monetary order were designed to operate symmetrically but functioned as asymmetric systems.

[35] Eichengreen, 'Hegemonic Stability Theories of the International Monetary System', p. 287.

[36] See M. Fratianni and J. von Hagen, 'Asymmetries and Realignments in the EMS', in P. de Grauwe and L. Papademos (eds), *The European Monetary System in the 1990s* (London and New York, Longman, 1990); M. Fratianni and J. von Hagen, 'German dominance in the EMS: the empirical evidence', *Open Economies Review*, 1,1 (1990), 67–87; J. von Hagen, 'Monetary Policy Coordination in the European Monetary System', in M. Fratianni and D. Salvatore (eds), *Monetary Policy in Developed Economies* (Westport CT, Greenwood, 1993); and J. von Hagen and M. Fratianni, 'German dominance in the EMS: evidence from interest rates', *Journal of International Money and Finance*, 9,4 (1990), 358–75.

[37] The authors whose research support the central role of Germany in the EMS include: F. Giavazzi and A. Giovannini, 'Models of the EMS: Is Europe a Greater Deutschmark Area?', in R. C. Bryant and R. Portes (eds), *Global Macroeconomics: Policy Conflict and Cooperation* (New York NY, St. Martin's, 1987); B. Hertz and W. Roger, 'The EMS is a greater deutschmark area', *European Economic Review*, 36,7 (1992), 1413–25; J. Mélitz, 'Discipline monétaire, république fédérale allemande et Systéme monétaire européen', *Annales d'Économie et de Statistique*, 8 (1987), 59–87; J. Mélitz, 'Monetary Discipline and Cooperation in the European Monetary System: a Synthesis', in F. Giavazzi, S. Micossi, and M. Miller (eds), *The European Monetary System*

rested much more on its structural position as the most important monetary power in Europe rather than on the conscious promotion of cooperation in Europe. In particular, provision of the numeraire and maintenance of the stability of the numeraire are the most important public goods Germany provides. But this hierarchy and differentiation of roles in European monetary affairs is interesting because the EMS is designed to operate symmetrically. As Krugman notes, 'the EMS is a symmetric system on paper. In practice, however, symmetry is not what results'. The interesting thing about this development is that 'this strongly asymmetric system is entirely implicit'.[38] Germany does not lead or dominate the EMS attempt at monetary cooperation only because of its size or its power. Germany's leadership role is based on its unshaking commitment to price stability, its relative economic predominance in Europe, *and* the political interests of other countries. It is, however, interesting to note that the tensions of the 1992 crisis resulted in large part from the difficulties Germany faced in reconciling the internal and external demands of its monetary leadership role in Europe after German unification.[39] Indeed, empirical studies show that Germany was the interest rate leader before German unification and again a year after unification;[40] but Germany's exclusive pursuit of national monetary goals in the wake of unification made monetary followership in Europe more painful. Monetary orders built around a single currency seem able to work well as long as leaders' and followers' goals are broadly consistent, and the divergence of monetary preferences after German unification would lead to tensions in the system.

Followership before the Crisis

But the success of the EMS has been defined by the monetary followers in Europe. As followership has varied so has monetary stability in Europe. It is useful to distinguish between two broad periods of EMS operation by the number of realignments. In the early period of 1979–1983, the first four years of the EMS, monetary relations were very turbulent and marked by seven currency realignments as a result of significant policy divergences among the EMS countries. During this early period, prospects for the survival of the EMS were

(Cambridge, Cambridge University Press, 1988); R. Portes, 'Macroeconomic Policy Coordination and the European Monetary System', in P. Ferri (ed.), *Prospects for the European Monetary System* (New York NY, St. Martin's, 1990); and M. Russo and G. Tullio, 'Monetary Policy Coordination Within the European Monetary System', in Giavazzi *et al.*, *The European Monetary System*.

[38] P. Krugman, 'Policy Problems of a Monetary Union', in P. de Grauwe and L. Papademos (eds), *The European Monetary System in the 1990s* (London and New York, Longman, 1990), pp. 56–57.

[39] When Germany was hit by the regional shock of German economic unification in 1990, Germany's role as the focal point for European monetary cooperation and the DM's role as anchor currency came under stress. The Bundesbank was faced with a dilemma of monetary leadership. As Winkler puts it, Germany's 'central bank had to decide whether to implement a national policy, reacting to the regional shock, or to stick to the European policy option'. Further, 'the insistence on fighting inflation in Germany by raising interest rates may have protected the anchor currency status of the Deutsche Mark, but it destroyed the currency area built on the anchor currency'. See A. Winkler, 'The EMS crisis and the prospects for European Monetary Union', *Intereconomics*, 29,2 (1994), 68–74.

[40] E. H. Gardner and W. R. M. Perraudin, 'Asymmetry in the ERM: a case study of French and German interest rates before and after German unification', *IMF Staff Papers*, 40,2 (1993), 427–50.

not greater than those of the Snake, although Germany continued with its policy preferences of monetary stability and was followed (as during the Snake) by several other smaller European countries.

However, during 1982 and 1983 many of the policy divergences began to be reduced, especially in France and Italy, two crucial EMS countries because of their economic size and political importance. From 1983 to 1987 there was significant convergence of economic policies and fundamentals of many of the EMS countries, and only four realignments were necessary. After 1987, with still minor divergences in inflation rates and monetary policies, there were no more realignments.[41]

Germany led the EMS during the entire period, but only after 1983 did France and Italy choose to follow Germany. When France and Italy chose to follow Germany, the EMS and stable DM provided a focal point for policy harmonization and a useful source of monetary credibility for European central banks which lacked it.[42] By tying themselves to the EMS, which was disinflationary as a result of Germany's leading role, countries were actually seen to 'borrow' monetary credibility from Germany.[43]

However, these attempts at monetary followership have met with varying levels of success. Although France and Italy both pursued similar strategies of disinflation and convergence toward Germany, France's attempt, for all its side-effects, has largely succeeded in its objectives, while Italy's has not. This raises a number of research possibilities on the abilities of governments to commit credibly to monetary followership and therefore the abilities of governments to coordinate monetary policies. The strengths and tools of the French state compared to the Italian state seem to go a long way in explaining how these countries with the same goal achieved varying levels of success.[44]

Leadership and Followership since the Crisis: Informal Maintenance, 1993–1996

As speculative market pressures led to the widening of EMS fluctuation bands in August 1993, most observers, including the speculators themselves, expected France, Denmark, Spain, Portugal, and Ireland to use their regained monetary freedom to reflate their economies. Germany had helped to push Europe into recession, and unemployment was climbing under the strain of tight monetary policy and overvalued exchange rates. The Netherlands and Belgium were

[41] With continued divergences and no realignments the exchange-rate parities rested on increasingly shaky commitments to overvalued exchange rates. Credibility was enhanced by plans for a transition to EMU. When EMU was called into question and this credibility was undermined, currency speculators tested the commitments that they knew were less and less firm or justified by fundamentals. This became an important part of the story of the 1992 crisis.

[42] The phrase 'focal point for policy harmonization' is used by Eichengreen to describe Britain's role in the monetary system before 1914 and the United States' role after 1944. See Eichengreen, 'Hegemonic Stability Theories of the International Monetary System', p. 293.

[43] F. Giavazzi and M. Pagano, 'The advantage of tying one's hands', *European Economic Review*, 32,5 (1988), 1055–82.

[44] J. I. Walsh, 'International constraints and domestic choices: economic convergence and exchange rate policy in France and Italy', *Political Studies*, 42,2 (1994), 243–58. See also P. J. Katzenstein (ed.), *Between Power and Plenty: Foreign Economic Policies of Advanced Industrial States* (Madison, University of Wisconsin Press, 1978). See Simmons, *Who Adjusts?*, for a discussion of the domestic politics of international monetary commitment during the interwar years.

expected to maintain their DM shadowing commitments that were older than the EMS.

However, the other monetary followers, notably and most importantly Denmark and France, did not use this leeway. Since the widening of the bands they have continued to follow German monetary policy quite rigorously, even though they are not required to do so. Rather than fluctuating widely, European exchange rates are remarkably stable. What causes this stability? How does it happen in practice? What is Germany's leadership role in this arrangement? Why do these countries continue to follow Germany so closely when they are no longer obligated?

The Causes of Exchange-rate Stability

The post-crisis stability in European exchange-rates has been the result of three factors. The first of these is the removal of speculative incentives for financial markets. By widening the exchange-rate fluctuation bands, EMS members re-introduced two-way risks for currency market speculators.[45] The narrow bands were easy and riskless targets for currency speculators. Indeed, Eichengreen and Wyplosz argue that the 1992 crisis was caused in important part by self-fulfilling speculative attacks.[46] This removal of speculative incentives, initially viewed by many observers as an end to official monetary coordination, was a tactical move on the part of the EMS participants. The Bundesbank suggests that 'the enlargement of the fluctuation margins in no way amounts to a reorientation of exchange rate policy in Europe'.[47] Very little has changed in the hardcore of the EMS since the crisis, except their strategy for dealing with international currency and capital markets.

The second cause of the stability is the existence of substantial convergence in macroeconomic policy in many of the EMS member countries. The current stability is not simply the result of conscious policy, but also the result of the cumulative effect of coordinated policy decisions toward monetary stability and the EMU goal over the past decade. Part of the current story requires reference to the emergent neo-liberal policy consensus over the history of the EMS.[48]

[45] The specifics of wider bands and speculative incentives are complex. When countries are committed to defending their currencies at a certain external value, they must align their interest rates with those of the higher interest rate countries and intervene in foreign exchange markets in order to keep within the fluctuation bands. When the value of their currency is too low, countries must purchase their own currencies on international markets or raise domestic interest rates in order to prop up prices. When the value of their currency is too high, countries sell their currencies on international markets or lower domestic interest rates. But, if markets expect devaluation of a currency, as markets did in 1992 with the British and Italian currencies, then speculators will sell a currency before its policy change, buying a harder currency. After the policy change, speculators can then purchase the devalued currency for less than before, earning large and quick profits. If currency speculators can force a country to devalue, they earn the profits nonetheless. When European leaders widened the fluctuation bands to 30% in August 1993, they allowed more potential flexibility to member countries, reducing the likelihood that market speculators could force a devaluation by testing official commitments. For a more lucid discussion, see R. Z. Aliber, *The International Money Game* (New York NY, Basic, 4th ed., 1983), ch. 4.

[46] B. Eichengreen and C. Wyplosz, 'The unstable EMS', *Brookings Papers on Economic Activity*, 1 (1993), 51–143.

[47] Deutsche Bundesbank, *Annual Report*, (1993), p. 90.

[48] K. McNamara, *The Currency of Ideas: Monetary Politics in the European Union* (Ithaca NY, Cornell University Press, 1998).

Countries such as France have gone through dramatic transformations in economic ideology, and as such the current stability is not just the result of cooperation, but of harmony. Unlike accounts that emphasize the dramatic break of 1992, this paper suggests that for many members there is a fundamental continuity in EMS monetary cooperation.

The third cause, one intimately related to the second, is the continued *conscious* and *informal* maintenance of the previous narrow fluctuation bands by member countries. The EU commission summarizes:

> The decision to widen the ERM bands, apart from establishing a two-way risk for speculators, left room, at least in principle, for considerable policy differentiation. The new flexibility was, at least so far, not used to the extent anticipated by markets. Instead, most Member States' authorities continued to orient monetary policies primarily at the exchange-rate stability, they followed a strategy of shadowing the old narrow bands.[49]

Although there are 30% fluctuation bands on paper, the stability in practice approaches that of the narrower bands. It is this continued informal maintenance of the pre-crisis exchange-rate parities that is an important subject of interest here. However, the insistence in published material by participating countries that monetary followership was continuing and that informal coordination had become a central part of the post-crisis EMS suggests that this project could have been pursued only by an observer from the other side of the Atlantic or across the English Channel. The conventional wisdom on the Continent regarding the state of the EMS is remarkably different from that in the USA and Britain. Fewer observers on the Continent thought that European monetary cooperation had died in either September 1992 or July and August 1993. But how can we explain this behaviour theoretically, keeping in mind the pressures on these EMS countries to reflate?

Within the constraints of EMS agreements, it was more understandable to see countries giving up a domestic focus for monetary policy in favour of exchange-rate maintenance. With these formal constraints no longer in place, it seems curious that these countries continue to peg informally to the Deutsche Mark when they no longer are committed officially to do so. One reason may be, as suggested by a senior analyst at the Bundesbank, that with the removal of the narrow bands, central bank responsibility for the external value of the currency has become all the more obvious.[50] But it is important to understand how this happens and why these governments should care in the first place.

How the Exchange-rate Stability is Maintained

Interest rate followership, especially short-term interest rate followership, is the primary mechanism through which the post-crisis stable arrangement has been maintained.[51] This is done virtually unilaterally by those central banks following German monetary policy.[52] Foreign exchange intervention does not play a

[49] EU Commission, DGII, 'ERM tensions and monetary policies in 1993', *European Economy*, 56 (1994), 91–104, p. 103.

[50] Interview, Deutsche Bundesbank (16 June 1995).

[51] Interview, Deutsche Bundesbank (16 June 1995). Also, Interview with Pierre Jaillet, Deputy Head of Monetary Research and Statistics Department, Banque de France (3 July 1995).

[52] Indeed, the apparently unilateral behaviour of these states has led some observers to wonder whether the current arrangement can even be called 'cooperation'.

prominent role in the post-crisis arrangement and, indeed, is quite rare. The emphasis on interest rate followership further strengthens the hierarchy of the situation, effectively removing the German commitment to intervene on behalf of its monetary partners unless currencies reach the extremes of the wide bands. If interest rate policy is the most important mechanism of followership, the question becomes whether France and the other followers can convince Germany and its central bank to lower interest rates so that it might be less painful to follow German monetary policy.

To this end, the French and other followers certainly have ample opportunity to plead their case to the Germans. European monetary cooperation is densely institutionalized, and multilateral meetings are routine. The three main institutions are: the informal and formal ERM infrastructure;[53] European Monetary Institute (EMI) Council meetings; and EU Commission Monetary Committee Meetings.

The ERM infrastructure is very much part of the formal and informal institutionalization of cooperation that a senior Bundesbank official insists 'continues intensely'.[54] Not only does the ERM infrastructure ensure that communication is regular and monitoring intense, but it also helps to lend credibility to the monetary policies of follower countries. As part of this infrastructure, the central banks have daily consultation mechanisms which take place four times per day and have weekly consultations on exchange-rate behaviour.[55]

In addition, there are monthly EMI Council meetings and monthly Monetary Committee meetings. For the maintenance of the current informal aspects of monetary cooperation, the EMI Council meetings are more important. For the more formal aspects, the Monetary Committee meetings are more important.[56] It is in these arenas that national preferences and policy intentions are both expressed and discussed. Of course, there is quite some disagreement over the evolution of national policies and how they interrelate at the level of exchange-rate management. It is likely that at least some of the discussion revolves around the requests of EMS member countries for the Bundesbank to loosen its monetary policy for the sake of the group. There is certainly a great deal of talking, but it is not at all clear how much these discussions affect the course of European monetary policy. In particular, it is not clear how often Germany gets convinced.

German monetary leadership in the current arrangement consists primarily of the provision of a numeraire and the maintenance of the stability of the numeraire. This is consistent with Eichengreen's emphasis on hegemonic leadership's provision of a focal point for monetary cooperation.[57] As such, the purposive aspects of monetary leadership are de-emphasized and the size aspects become

[53] I owe the phrase 'ERM infrastructure' to an informative discussion with Peter Ludlow, Director, Centre for European Policy Studies. Interview (29 June 1995).

[54] Interview, Deutsche Bundesbank (16 June 1995).

[55] Interview, Deutsche Bundesbank (16 June 1995).

[56] This was the consensus of all those interviewed. Interview, Deutsche Bundesbank (16 June 1995). Interview, Heinrich Matthes, Deputy Director-General for Economic and Financial Affairs (DGII), EU Commission (23 June 1995). Interview, Pierre Jaillet, Deputy Head of Monetary Research and Statistics Department, Banque de France (3 July 1995). Interview, Pierre Jacquet, Deputy Director, Institut Français des Relations Internationales (4 July 1995).

[57] Eichengreen, 'Hegemonic Stability Theories of the International Monetary System'.

more important. The Bundesbank does not seem to be very responsive to the requests of its monetary partners. In fact, the Bundesbank's high level of independence offers bargaining strength for officials at the EMI and Monetary Committee meetings who can, as a result, promise very little. As Pierre Jacquet suggested, it was German leadership and cooperation which helped to set up the EMS and the rules of the game. But within this system, Germany's cooperation is merely to play by the rules of the game, rather than to *actively* promote monetary cooperation.[58] As the Bundesbank put it, Germany tries 'as far as is possible' to meet the requests of other partners for changes in interest rate policy.[59] The Bundesbank and Germany have no wish to alienate the other EMS members. It is just that in the current arrangement 'as far as is possible' is often not very far. Of course, this is so for two familiar reasons, such a big part of the story of the EMS: the Bundesbank Law and the necessity of the stability of an anchor currency for monetary cooperation.

With the re-emergence of global financial markets and the elimination of the need for foreign exchange intervention with the widening of the fluctuation bands, the EMS and its attending informal monetary arrangement have become even more, rather than less, asymmetrical.[60] Although the institutionalization of monetary cooperation in Europe has been very important at various periods during the history of the EMS, the role of institutionalization has changed somewhat in the post-crisis system. The kinds of decisions that underlie the stability of the new EMS are structured such that the primary effects of the EMS institutions are to make intentions and preferences clear. But these institutions seem neither to underlie German policy nor to motivate French policy. At least when the Bundesbank raises interest rates, the Banque de France and other monetary followers sometimes know when to jump and how high, since they have been discussing the policy beforehand.

If German monetary leadership is neither overly responsive nor purposive and European monetary cooperation has become more hierarchical, the empirical questions lead directly toward discussion of the motivations of the monetary followers. The group of monetary followers has become smaller. Italian followership was relatively short-lived, and both Spanish and Portuguese followership have recently turned out to be too loose. Indeed, the Spanish and Portuguese cases demonstrate the slipperiness of the slope that financial markets create between the credibility of tight monetary followership and the use of even small amounts of monetary freedom. British followership lasted an even shorter time. Other currencies, like the Irish pound, have had increasing success. The core group has become the Netherlands, Belgium, Luxembourg, Denmark, Austria, France, and perhaps Ireland. The small countries like the Netherlands

[58] Interview, Pierre Jacquet, Deputy Director, Institut Français des Relations Internationales (4 July 1995).

[59] Interview, Deutsche Bundesbank (16 June 1995).

[60] The literature on the re-emergence of global financial markets is large and growing. See E. Helleiner, *States and the Reemergence of Global Finance: from Bretton Woods to the 1990s* (Ithaca, Cornell University Press, 1994); J. B. Goodman and L. W. Pauly, 'The obsolescence of capital controls? Economic management in an age of global markets', *World Politics*, 46,1 (1993), 50–82; L. W. Pauly, 'Capital mobility, state autonomy, and political legitimacy', *Journal of International Affairs*, 48,2 (1995), 369–88; and J. Frieden, 'Invested interests: the politics of national economic policies in a world of global finance', *International Organization*, 45,4 (1991), 425–51. For a review see B. J. Cohen, 'Phoenix risen: the resurrection of global finance', *World Politics*, 48,2 (1996), 268–96.

and Austria have pursued a DM shadowing policy since before the EMS, and little has ever been expected to change. On the other hand, the followership of Denmark and France has been an increasing part of the story of the success of the EMS. However, the real middle-sized power whose monetary followership really makes or breaks the system is France. Without the franc, the current arrangement is just a DM zone.

The Banque de France has invested over a decade in the acquisition of credibility through its followership of the Bundesbank, and the cumulative effect of this policy stance has been quite successful. Although French monetary followership is not something new, it has been changed in important ways by the EMS crisis of 1992–93. After the crisis, for the first time in the history of French followership in the EMS, France is not obligated officially by the EMS to follow German monetary policy so closely. Further, as noted above, French followership has been forced to become even more hierarchical than previously. For all intents and purposes, the Bundesbank is no longer obligated to intervene on behalf of the franc. French monetary followership has also become more fundamentally discretionary in a way that it was not while under the thumb of the narrower bands of the EMS. Whereas the previous question of monetary followership was one of whether or not to stay in the EMS, France *could* now stay within the EMS, enjoy its increasingly credible central bank, and still use some of the monetary leeway afforded by the wide bands.

But is has not. In fact, given the economic and political opinion within the French government and Banque de France that underlies the *franc fort* policy, it does not seem that France was ever likely to follow the expectations and advice to break the tight link to the German mark, despite the highly significant changes in the formal institutionalization of this policy in mid-1993. Having come this far along the deflationary road of the Bundesbank, little additional sacrifice seemed necessary to maintain the policy.[61] Though apparently clear in France, the sources of continued French monetary followership within a different institutional environment deserve inquiry, particularly given the fact that it defied the expectations and theoretical predictions of many analysts.

Discretionary, informal cooperation is always much more conditional than that based on external political commitments. Generally it is necessary to explain why the narrow, domestically defined self-interest of monetary followers supports followership. What are the political foundations for French monetary followership? There are at least three political interactions that underlie the current French policy, and they are the focus of the next section of this paper.[62]

France, the EMS, EMU, and the Political Sources of Monetary Followership

The attempt to use a tight link to the German mark in order to acquire anti-inflation credibility and maintain the strength of the franc has been the central component of the French monetary strategy over the past decade and a half.

[61] I have benefited from the advice of an anonymous reviewer in clarifying this point.

[62] Here I use interdependent interactions or interdependent relations to mean three different political struggles whose outcomes and strategies are related. This notion is consistent with new literatures on interdependent games. No formal analysis is attempted, though reference to interesting work on nested games and interdependent games suggests that future work might formally analyse these political interactions which will be relevant increasingly for international monetary cooperation.

However, the political context of French monetary policy has undergone a number of substantial changes. Although the policy has not changed, there are new political foundations for it. The rise of an independent Banque de France with an increasingly credible commitment to fight inflation, the elimination in 1993 of the rigor of narrow fluctuation bands, the European movement towards monetary unification, and serious domestic and international pressures for reflation have all substantially changed the political-economic setting within which French monetary policy is formulated.

Perhaps most important is to realize that the post-crisis monetary arrangements in Europe are intended, particularly by France, to be preliminary. Although the long-term political goals of France are central to the stability of the arrangement, the highly asymmetric, informal coordination of the post-crisis EMS has been only an intermediate step toward EMU, a wrinkle in the plan. French convergence has been effective, and inflation rates of recent years have been below even those of Germany. Further, from the French perspective, it is not obvious why France, furnished with low inflation, an increasingly credible central bank, and the second largest economy in Europe, should have virtually no influence over the course of European monetary policies while Germany has so much. Thus a Banque de France official asserts, the current 'asymmetric system is not an equilibrium outcome'.[63] France has consistently felt the dilemmas of being the near-great monetary power in Europe.

And the French monetary policy that defined the success of the EMS has continued in the post-crisis and pre-EMU period, defying the expectations of markets and analysts, as well as their advice. Having invested so much in the *franc fort* policy and acquiring monetary credibility with a link to the German mark, the French were not about to give up the policy for the possible reflation offered by wider fluctuation bands just as the longest-term monetary goal of France, EMU, was in sight. The post-crisis system has been stable as an intermediate arrangement on the way to EMU. But as an essentially voluntary abdication of monetary policy autonomy it is not a long-term outcome.

Though academics and markets have progressively conceded that the future of French monetary policy and European monetary stability was mis-read in 1992 and 1993, it is still not understood adequately why France has not responded to the numerous incentives for less strict followership. The structure of the political logic that underlies French behaviour is explicable by reference to three interdependent political-economic interactions of French monetary politics.[64] Although discussions of international monetary relations often

[63] Interview, Pierre Jaillet, Deputy Head of Monetary Research and Statistics Department, Banque de France (3 July 1995).

[64] I owe the insights for several component parts of this formulation to a discussion with Pierre Jacquet, Deputy Director, Institute Français des Relations Internationales, Interview (4 July 1995). The formulation of this situation as one of interdependent political-economic interactions is related to the work of Robert Putnam on two-level games and other game-theoretic work on nested and interdependent games. See R. D. Putnam, 'Diplomacy and domestic politics: the logic of two-level games', *International Organization*, 42,3 (1988), 427–61; A. Moravcsik, 'Introduction: Integrating International and Domestic Theories of International Bargaining', in P. Evans, H. K. Jacobson, and R. D. Putnam (eds), *Double-edged Diplomacy: International Bargaining and Domestic Politics* (Berkeley CA, University of California Press, 1993). For related discussions of interdependent games, see G. Tsebelis, *Nested Games: Rational Choice in Comparative Politics* (Berkeley CA, University of California Press, 1990); and J. E. Alt and B. Eichengreen, 'Parallel and overlapping games: theory and an application to the European gas trade', *Economics and Politics*, 1,2 (1989), 119–44.

involve the language of unitary state actors, it is crucial to disaggregate the actors in this story. There is a *primary interaction between the central governments* of the members of the EU. However, when central banks are independent there exists a *domestic bargaining interaction between central governments and central banks* when their preferences diverge. Finally, unlike bargaining over political commitments or trade agreements, bargaining over monetary affairs also involves a *credible commitment problem for central banks in their interactions with international financial markets.* Market reactions have become pivotal for the behaviour of exchange rates. Here I intend to make the case that these three relations define the structure of the monetary politics underlying French followership in the post-crisis period as well as those underlying international monetary relations in general. Particularly in the current era of independent central banks and highly mobile international capital, central governments, central banks, and markets interact in complex ways to produce international monetary outcomes.

In the French context these interdependent political interactions' past and current outcomes have ensured that France is a tight monetary follower. In order of increasing importance, the first interaction is a fiscal and interest-rate policy contest between the Banque de France and the French central government. The second is the credibility struggle between the Banque de France and international currency markets. The third is the EMU bargaining at the regional level between the governments of EU countries. These relations are highly interconnected and do not carry equal explanatory weight for understanding French monetary policy. But, they all are geared fundamentally toward the French attempt to regain monetary independence, or at least power over the direction of European monetary affairs.

The fiscal and interest-rate policy struggle between the Banque de France and the French central government is a very recent aspect of French domestic politics and a relatively new addition to the political sources of French exchange rate and monetary policy. Without an independent Banque de France with preferences which diverge in some respects from those of the fiscal policy makers of the central government, such a struggle would not exist. In an attempt to curb the expansionary impulses of the central government, responding to the domestic pressure from labour and agriculture, the Banque de France has found the exchange-rate maintenance an effective restraint. Indeed, there is much at stake in this domestic struggle, as the high interest rates required by following a Bundesbank reigning in post-unification inflationary pressures have kept the French economy weak and French unemployment high.

The credibility interaction between French monetary authorities and international markets is a more long-standing struggle. Dating at least to the early 1980s and the Mitterrand experience with reflation and austerity, the politics of French monetary credibility in the face of sceptical international capital markets have been central to the formulation of French foreign economic policy.[65] The Mitterrand government learned early on that, in an age of

[65] See J. Sachs and C. Wyplosz, 'The economic consequences of President Mitterrand', *Economic Policy*, 2 (1986), 261–322; P. Hall, *Governing the Economy: the Politics of State Intervention in Britain and France* (New York and Oxford, Oxford University Press, 1986); and M. Loriaux, *France after Hegemony: International Change and Financial Reform* (Ithaca, Cornell University Press, 1991).

internationalizing financial markets, the insulation provided by the capital controls of the Bretton Woods system was gone. No longer could countries pursue reflation without consequences for the exchange rate. Recognizing the increasing tension between external and internal monetary goals, the French began a policy of creating monetary credibility. The first part of the strategy was to tie the franc firmly to the German mark, borrowing its credibility. The creation of an independent Banque de France, as well as a virtual revolution in economic ideology and monetary orthodoxy, are essential components of the French monetary strategy. But France has been plagued continually by the monetary problems of a near-great power. Their larger, disinflationary German neighbour has ensured that the middle-level powers, such as Britain, Italy, and France, have had a particularly difficult time reconciling the demands of monetary followership. France did find *one* possible way out: to share a common monetary helm with Germany.

Finally, the political bargaining over EMU is one of the more intriguing of these political–economic interactions underlying French monetary policy in the post-crisis period. The EMU negotiations at the regional level have as their goal the recapture of French monetary authority. However, rather than a national monetary sovereignty, the promise of EMU is to regain at the regional level the monetary sovereignty that has become so elusive at the national level. The Maastricht criteria specify that exchange-rates must be stable for a period of two years prior to the transition to EMU, and the stability of the post-crisis period has been part of the attempt to make sure that EMU arrives safely. Interestingly, because all of these political-economic interactions have the same ultimate goal for France, namely real monetary authority, if the credibility struggle were won by the French the EMU bargaining would become economically obsolete. Indeed, some informed political opinion in France holds just that; French monetary authority is quite credible. Nevertheless, the EMU end-game has kept the post-crisis EMS stable.

Along these lines, there are a number of reasons why a strong franc enhances France's bargaining position on EMU with regard to Germany. As Mélitz argues, long-term political goals underlie the policy. The strong franc policy signals determination to meet the convergence criteria, demonstrates France's monetary reliability, and moves Europe further toward a process of joint decision making in monetary affairs.[66] To the extent that a more widely fluctuating franc after the 1992 and 1993 crises might have supported arguments within the German political establishment that monetary union should be postponed or even avoided, the tight monetary stance of France has clarified French preferences to its own citizens, to Germany, and to Europe.

Although the French policy of credibility creation through external anchoring is now well over a decade old, the political sources of French behaviour have gone beyond the attempt to reduce inflation. In addition to this original goal, the *franc fort* policy has also become central to the fiscal politics of the French state *and* the European movement toward monetary unification. This analysis emphasizes these newer political–economic foundations of the now long-standing French monetary policy.

[66] J. Mélitz, 'French Monetary Policy and the Recent Speculative Attacks on the franc', in Cobham, *European Monetary Upheavals*, p. 63.

Conclusions

There are two types of conclusions that emerge from this paper. The first concerns the theory and application of the politics of monetary leadership and followership. Differentiation of the roles played in monetary cooperation allows for substantial insight into the dynamics of European monetary politics. The most important area for inquiry is the politics of monetary followership, with the variation in French, Italian, and British policy as the central questions. Indeed, comparison of the British case of failed followership suggests some important conclusions about the political sources of these decisions.

While Britain is no longer a monetary follower or major player in European monetary affairs, it is clear that, from the perspective of the Bank of England, nothing changed in practice for France, Germany, Denmark, and the Benelux countries with the widening of the fluctuation bands. Indeed, the current stability, far from being a surprise, is 'business as usual' for the hardcore of the EMS.[67] For the purposes of this paper, however, the crucial point is that Britain is still involved heavily in the multilateral negotiations and discussions surrounding European monetary politics. The main arenas for the maintenance of European monetary cooperation, the EMI Council meetings and Monetary Committee meetings, involve all EU members. But, with no variation on the formal institutionalization of monetary coordination for countries involved, there is substantial variation in the extent to which monetary followership takes place. Very little would change in the organization of European monetary cooperation if Britain were to return to its follower role.[68] The only difference would be the domestic choice made by Britain.

The second type of conclusion concerns the empirical questions associated with European monetary relations in the period since the currency crises. Since the 1993 widening of the exchange rate fluctuation bands European exchange rates have been more stable than the official 30% bands suggest. This stability is the result of the removal of speculative incentives, convergence in macroeconomics of the hardcore of the EMS, and the continued informal but conscious maintenance of the previous narrow bands of the EMS.

Regarding this continued informal cooperation, German monetary leadership has been quite weak, and the post-crisis stability has rested almost wholly on the followership of the other countries of the hardcore. The most important middle-sized power of this hardcore is France and thus is the key to the success of the arrangement. However, the transition to an almost exclusive reliance on interest rate followership of the post-crisis stage of the EMS has ensured that it is both more hierarchical and more dependent on the domestic sources of this self-constraint.

Although the informal and formal institutions of the EMS continue to be relevant for the official decisions surrounding the EMS and the expression and discussion of policy preferences, the decision structure which underlies the current stability is based upon three interdependent and overlapping political–economic interactions played out within the context of French monetary politics. These interactions include a credibility struggle between the Banque de

[67] Interview, Suzanne Hudson, Economist, Monetary Assessment and Strategy Division, Bank of England (6 July 1995)

[68] Interview, Susanne Hudson, Economist, Monetary Assessment and Strategy Division, Bank of England (6 July 1995).

France and capital markets, a fiscal policy interaction between the Banque de France and the central government, and the intergovernmental EMU bargaining. The EMU bargain constitutes the conditional end-game of these monetary policy considerations and will help ensure that the current arrangement, although not robust, politically feasible, or an equilibrium in the long-term, is stable in the short-term.

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