European Monetary Integration & Domestic Politics

Britain, France, and Italy

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Negotiating the European Monetary System

After the breakdown of the Bretton Woods regime of fixed exchange rates in the early 1970s, European governments constructed a regional arrangement, commonly called the "snake," to coordinate their monetary policies. The snake soon collapsed into a small group of countries dominated by Germany after Britain, France, and Italy withdrew and allowed their currencies to float. Governments in these three countries were unwilling to tighten monetary policy and risk recession in order to stabilize their currencies against the appreciating German mark. Instead they experimented with new frameworks for monetary policy that included deliberate currency depreciation and expansionary macroeconomic policies to promote growth and employment.

European governments did create a durable institution in 1978, the European Monetary System (EMS), to replace the snake. Yet the rules of the snake and the EMS were quite similar regarding approval of parity changes, balance-of-payments financing, requirements for policy adjustment, and other issues. Why would European governments agree to a new institution in 1978 so similar to the one that had failed to stabilize exchange rates just a few years earlier? Two answers to this question exist in the literature. The learning explanation holds that British, French, and Italian experiments with floating exchange rates and macroeconomic expansion outside the snake produced currency instability and high inflation but had little appreciable influence on growth and employment. By 1978 authorities had a better understanding of the advantages of keeping inflation low and preventing currency depreciation, making them more willing to agree to a new institution with rules likely to encourage such policies and outcomes.[1] The distributional bargaining explanation acknowledges that sharp depreciation and high inflation did give governments reasons to adopt policies more oriented toward price stability. But this change in preferences occurred at the margin and did not involve learning about and adopting new economic policy models and priorities. Governments did not commit themselves to Germany's mix of currency appreciation, monetary targeting, and central bank independence, which was intended to keep inflation low. Therefore, British, French, and Italian negotiators advocated rules for the EMS that differed from those of the snake. They preferred that the new institution provide them with greater external support for policies aimed at maintaining growth and employment and include rules that might require Germany to adjust its economic policy. Germany had little incentive to agree to such changes since it was reasonably satisfied with the status quo of floating exchange rates that allowed it to gear policy toward its primary goal of domestic price stability. This position gave German negotiators the power to insist on rules for the EMS that would allow the Bundesbank to focus on keeping inflation low when doing so conflicted with exchange-rate stabilization.[2]

In this chapter, I evaluate these explanations by examining the negotiation of the EMS in detail. I begin with a brief overview of the snake, demonstrating that by 1978 British, French, and Italian governments had some incentives to stabilize their exchange rates in a regional institution. The second section summarizes the EMS negotiations from the autumn of 1977 to the spring of 1979 and explains the origins of the German government's newfound interest in monetary policy cooperation. The rest of the chapter describes the fate of the EMS proposal in Britain, France, and Italy. For each country I describe government preferences regarding the rules of the EMS and their willingness or unwillingness to challenge domestic political opponents of the new institution. In the final section I conclude that most of the evidence supports the distributional bargaining rather than the learning explanation of the rules of the EMS.

The Snake

All the European countries were members of the Bretton Woods system of fixed exchange rates centered around the U.S. dollar, which was established after World War II. Tensions developed in the system in the 1960s and culminated in the U.S. unilateral devaluation in 1971. The Smithsonian Agreement of December 1971 ratified this devaluation and widened participating currencies' fluctuation bands from ±1 percent to ±2.25 percent against the dollar. This had the effect of greatly increasing the permissible exchange-rate fluctuations among European currencies. If one European currency was at the top of its fluctuation band against the dollar and another was at the bottom of its band, the two currencies would diverge from each other by 9 percent. To prevent such large fluctuations, European governments in March 1972 implemented an agreement to limit bilateral fluctuations to ±2.25 percent, supported by coordinated foreign exchange market intervention and credit lines among central banks. The system of narrower European bands came to be known as the "snake" (technically the Narrower Margins Agreement), which moved within the "tunnel" of wider dollar fluctuation bands established in the Smithsonian Agreement. When European countries stopped defending their currencies' parities against the dollar in March 1973, the "tunnel" disappeared and the European currencies floated jointly against the dollar.

The snake failed to become the basis for sustained monetary cooperation in Europe. Britain withdrew and floated sterling in June 1972, and Italy and France followed in February 1973 and January 1974, respectively (France rejoined from July 1975 to March 1976). The snake failed because German authorities pursued restrictive monetary policies that encouraged appreciation of the mark, but British, French, and Italian governments were unwilling to follow Germany's lead and implemented expansionary monetary policies to encourage growth and employment.[3]

Governments in all three countries soon became disenchanted with floating currencies. Between withdrawal from the snake and the negotiation of the EMS, each country experienced episodes of rapid currency depreciation and high inflation during a worldwide recession. The Heath government in Britain responded in the early 1970s with a Keynesian strategy of using fiscal and monetary policies to stimulate the economy. The Labour government elected in 1974 under Harold Wilson continued these expansionist policies, and by early 1975 inflation was increasing at an annual rate of 25 percent. A serious sterling crisis in 1976 led the new Labour prime minister, James Callaghan, to turn to the International Monetary Fund for a standby loan and to reduce the growth of government spending, tighten monetary policy, and introduce targets for the rate of growth of the money supply.[4]

French governments maintained an accommodating monetary policy to promote economic recovery in the early 1970s. This placed downward pressure on the franc in the foreign exchange markets, and the authorities chose to withdraw from the snake in 1974 rather than to raise interest rates to stabilize the currency. After winning the presidential election in 1974, Valéry Giscard d'Estaing increased taxes and tightened credit controls to reduce the double-digit inflation rate. Combined with slower growth overseas, these measures led to a recession by the end of the year but did allow the franc to rejoin the snake in July 1975. Despite some evidence that the recession was coming to an end, Prime Minister Jacques Chirac loosened fiscal policy in September 1975. The resulting increase in domestic demand pushed the current account from surplus to deficit in 1976, depreciated the franc, and led the government to withdraw from the snake again to avoid having to disinflate. This second withdrawal from the snake resulted in a 20 percent depreciation of the franc, and the new government under Prime Minister Raymond Barre, who was appointed in August 1976, adopted an austerity program to reduce inflation, stabilize the franc, and restore profitability to French firms. The government was willing to accept high levels of unemployment to achieve these goals, especially after the victory of the right-wing parties in the 1978 parliamentary elections.[5]

The Italian lira depreciated by 15 percent after its withdrawal from the snake in February 1973. Combined with accommodating fiscal and monetary policies, the depreciation created high inflation and rapid economic growth. The rise in world oil prices in the autumn of 1973 pushed the current account into deficit and further increased inflation. In early 1974, the government began discussions with the International Monetary Fund over a standby loan, eventually agreeing on a program to reduce the current account deficit and inflation by tightening monetary and credit policies. This program was more effective than expected, and by late 1974 economic growth had slowed dramatically. The authorities quickly loosened monetary policy, again increasing inflation and output and pushing the current account into deficit. A low level of central bank foreign currency reserves, combined with the recent collapse of a coalition government, fueled speculation against the lira. The central bank stopped supporting the currency in January 1976 and closed the foreign exchange market for two months after nearly exhausting its reserves. In June, Prime Minister Giulio Andreotti assembled a minority government informally supported by all the major parties, including the opposition Communist Party (the Partito Comunista Italiano [PCI]). Hoping to increase its credibility with voters, the PCI backed austerity measures when the lira came under speculative attack again in September, supported another agreement with the International Monetary Fund, and encouraged attempts to restrain wage growth. These measures, combined with the depreciation of the lira, led to slower growth but rapid improvement in the current account balance in 1977 and 1978.[6]

British, French, and Italian governments all had disappointing experiences with floating exchange rates. Each country went through at least one severe currency crisis, and both Britain and Italy turned to the International Monetary Fund for assistance. Many officials and observers concluded that deficit spending and accommodating monetary policies not only aggravated these currency crises but also were ineffective levers over domestic inflation, output, and employment. Thus governments throughout Europe had reasons to view favorably a new attempt to coordinate monetary and exchange-rate policies. Germany's response to the economic problems of the 1970s provided them with an alternative model for policy. German institutions and practices, such as targeting the rate of growth of the money supply and entrusting monetary policy to an independent central bank, produced lower inflation, higher employment, and currency appreciation. Macroeconomic stabilization plans implemented in Britain, France, and Italy from 1976 to 1978 incorporated some elements of German policy.

In the next section, I explain Germany's interest in exchange-rate cooperation and summarize the negotiations that created the European Monetary System in 1978. In the remainder of this chapter, I explore the links between these changes in policy goals and instruments and negotiating positions regarding the design of European monetary institutions.

Overview of the Negotiations

In October 1977, European Commission president Roy Jenkins called for closer coordination of monetary and economic policies within the European Economic Community and initiated discussions of these issues among foreign ministers.[7] His proposals attracted little attention until West German chancellor Helmut Schmidt proposed the creation of a "zone of monetary stability" in Western Europe at the meeting of the European Council of heads of state and government in Copenhagen in April 1978. Schmidt had initiated secret discussions with Giscard on this matter, and they agreed to cooperate in creating a new European monetary institution.[8] In addition to coordinating monetary policies, Schmidt envisioned creating a European Monetary Fund (EMF) to take over existing credit lines among central banks, pooling some official reserves, using European currencies rather than the dollar for foreign exchange market intervention, and encouraging use of the European unit of account (the predecessor to the European currency unit [ECU]) as a composite reserve asset.[9]

Schmidt hoped that a new European monetary institution might stop the depreciation of the dollar and a number of European currencies against the mark that threatened the competitiveness of German industry. Formal monetary policy cooperation might stabilize mark exchange rates and limit Germany's exposure to U.S. policy.[10] The Bundesbank was a reluctant participant in the negotiations, fearing that a new European institution would undermine its independence by requiring changes in interest rates and foreign exchange market intervention to stabilize the mark. These concerns led German negotiators to prefer rules that gave each member state the right to request changes in currencies' bilateral parities, limited requirements for intervention, and minimized any direct multilateral control of monetary policy.[11]

Schmidt's initiative coincided with useful developments in the foreign exchange markets. Sterling, the franc, and the lira all depreciated significantly in the mid-1970s. By 1977, this process had eliminated most of their real overvaluation, especially against the dollar. In 1978, these currencies depreciated in nominal terms against the mark, although sterling depreciated less than the franc and lira and did experience modest real appreciation. There was some speculative selling of the three currencies in October and November 1978, which stopped quickly when central banks raised interest rates. But in comparison to 1975 and 1976, the foreign exchange markets were relatively calm, making contemplation of a new monetary institution much easier. Also by 1978, inflation rates in the three countries had begun to converge; the annual percentage change in consumer prices in 1978 stood at 8.1 percent in Britain, 9.7 percent in France, and 12.1 percent in Italy. And during the preceding two years, governments in each country had made reducing inflation an important goal of economic policy.

After the Copenhagen summit, the next major step came at the European Council meeting in early July 1978 in Bremen, where Schmidt and Giscard persuaded the other leaders to consider establishing a new monetary institution by the end of the year. The essential elements of their proposal involved establishing currency fluctuation bands of ±2.25 percent around central parities to be supported by convergence of macroeconomic policies; subjecting realignments of parities (i.e., devaluation or revaluation) to mutual consent; establishing a new unit of account, the ECU, for settlement of credit lines among central banks; and creating an EMF within two years. At the Bremen meeting, Callaghan and Andreotti demanded that the EMS include significant resource transfers to poorer member states to offset their reduced monetary policy autonomy. Technical advisers discussed the exact structures and functions of the EMS during the summer and fall of 1978. During these discussions, the French, British, and Italians pressed for a system in which responsibilities for policy changes and foreign exchange market intervention would be based on a divergence indicator rather than a parity grid. Under the divergence indicator, countries whose exchange rates were diverging from the EMS average would adjust macroeconomic policy, regardless of whether the currency was appreciating or depreciating. Germany and the Netherlands favored a parity grid to determine policy changes, which in effect would require countries with depreciating currencies to adjust policy. The so-called Belgian Compromise of autumn 1978 held that the EMS would incorporate both the divergence indicator and parity grid. However, the divergence indicator would not *require* policy changes by countries with appreciating currencies and spoke only of a "presumption of action" on their part.[12]

Callaghan decided by October 1978 against taking sterling into the new institution. Over the next two months, he would negotiate a compromise under which Britain would become a member of the EMS, but sterling would continue to float and would not participate in the core of the system, the exchange-rate mechanism (ERM), which established parities among participating currencies. During final negotiations at the European Council

meeting in December 1978, Giscard threatened to scuttle the EMS unless provisions dealing with agricultural trade were changed, and Andreotti briefly threatened not to participate because of insufficient resource transfers. These difficulties were resolved in late 1978 and early 1979, and the EMS began operation on 13 March 1979, with France, Italy, Germany, and five other countries joining the ERM and Britain opting not to participate in the ERM.[13]

The final agreement created a system of fixed-but-adjustable exchange rates with changes in parities agreed on by mutual consent. Each currency had a parity expressed in ECU, from which bilateral central exchange rates were calculated to form the parity grid. Market exchange rates were permitted to fluctuate within ±2.25 percent of these central rates (the fluctuation band for the Italian lira was ±6 percent). When a currency reached the margins of its fluctuation band against the ECU, states participating in the ERM were required to undertake "marginal intervention" in the foreign exchange markets to maintain the parity, preferably by intervening with EMS currencies rather than with the dollar. Central banks could intervene before their currency reached its fluctuation margin (so-called intramarginal intervention) if they secured the approval of the central bank whose currency was being bought or sold. If a currency crossed the divergence indicator, which was set at 75 percent of the currency's fluctuation band, the authorities were "presumed," in the language of the agreement, to take measures to maintain the parity. The agreement also increased currency swaps among participating central banks to finance intervention and to prevent balance-of-payments disequilibria. These consisted of the very-short-term financing facility (VSTF) to finance (required) marginal intervention, short-term financial support (STFS) to finance immediate balance-of-payments problems, and medium-term financial assistance (MTFA) for longer-term financing. Because marginal intervention was required for countries whose currencies reached their bilateral fluctuation margins, credit under the VSTF was automatic, unlimited, and initially repayable within forty-five days; the repayment period could be extended up to three months. Borrowing countries repaid half the credit in the borrowed currency and half in ECU. Finally, all countries, including Britain, contributed 20 percent of their foreign exchange reserves to the European Monetary Cooperation Fund but maintained control over the use of these reserves, and an EMF was to be created within two years to further institutionalize monetary policy coordination.[14]

European governments had incentives to create a new monetary institution in the late 1970s to replace the snake. The German government hoped that the EMS could restrain the appreciation of the mark that reduced industry's competitiveness. British, French, and Italian governments favored a new European institution that might prevent speculative attacks on their exchange rate and could support their attempts to reduce inflation. But this possibility of joint gains does not tell us much about the specific rules that each state preferred. In the following three sections, I examine British, French, and Italian preferences regarding the rules of the EMS to see if policy failure during the snake period led them to favor Germany's proposals or if their preferences remained substantially different from those of Germany.

Britain: The Primacy of Domestic Politics

James Callaghan was chancellor during the devaluation of 1967 and prime minister during the sterling crisis of 1976. These experiences had "made him sensitive to the difficulties facing sterling and much more aware of the problems which exchange-rate fluctuations and large flows of capital from one reserve asset to another could cause."[15] The 1976 crisis also jarred the Treasury, which "was disenchanted with floating exchange rates and naturally saw the immense advantages of currency stability as correspondingly more attractive."[16] In its EMS Green Paper, the government acknowledged that depreciation alone would not solve Britain's economic problems and that participation in the EMS might quell short-term speculation.[17]

The British nonetheless had serious reservations about the EMS proposal during early negotiations. Callaghan and Chancellor Denis Healey feared that participation could repeat the experience of the snake, in which currencies fixed to the mark that did not devalue or withdraw experienced real appreciation and high interest rates. This result could increase unemployment and trade union opposition to the Labour government.[18] Shortly before the Bremen summit in July 1978, Callaghan expressed doubts about a fixed exchange-rate regime that did not include significant resource transfers and stated that he would not unequivocally support the Franco-German plan for the EMS.[19] These concerns led the British to push during the summer of 1978 for greater resource transfers, a more symmetrical distribution of policy adjustment requirements among countries with appreciating and depreciating currencies, and an emphasis on economic growth over currency stability.[20] In addition, Callaghan earlier had proposed policy coordination within the Group of Seven (G-7) countries with the aim of persuading Germany to reinflate its economy. The G-7 had an advantage over European fora because it would allow Britain to ally with the United States and increase pressure on Germany.[21]

British officials analyzed the pros and cons of membership in the EMS during summer and autumn 1978. The Bank of England and the Treasury pointed out that some form of participation could stabilize expectations about future monetary policy and reduce both speculation against sterling

and inflationary wage demands. In the end, this argument did not carry much weight with Callaghan and Healey, who, for example, rejected an Italian proposal that both the lira and sterling enter the EMS with wide fluctuation bands.[22] The Department of Industry concluded that participation in the EMS might make it easier to maintain a competitive exchange rate by stabilizing expectations, reducing the effects of future North Sea oil exports on the exchange rate, and providing Britain with access to balance-of-payments financing:

> The Department concluded that, provided satisfactory arrangements could be negotiated, there could be net benefits to British industry in joining the EMS. The main requirements were flexibility to adjust exchange rates, a commitment by the strong countries to expansion or upward adjustment of their exchange rates, and access to the EMF on reasonable terms.[23]

This analysis also did not influence the thinking of Callaghan and Healey because they felt it made unrealistic assumptions about possible German concessions.

Opposition from parts of the Labour Party to higher interest rates and sterling appreciation contributed to the government's reluctance to participate in the EMS. Callaghan decided in September to delay the next general election until the last possible moment in spring 1979. Since the government did not have a Labour majority in Parliament, it not only had to hold marginal seats but also had to win seats from the Conservatives and Liberals. Polls published at the time showed the Conservatives with a small lead, and Callaghan did not wish to risk an election in this environment.[24] His decision to delay the general election made him a captive of intra–Labour Party conflicts over the EMS and other issues. The government received a number of signals that any attempt to join the EMS would provoke rebellion among Labour members of Parliament and threaten the government's position in the House of Commons.

Labour's annual conference in October 1978 revealed strong opposition to the EMS proposal from the left wing of the party, which felt that participation would lead to higher interest rates and sterling appreciation. At the meeting of the Labour Party's National Executive Committee on 1 October 1978 to consider motions for the upcoming party conference, a proposal "denouncing and rejecting the EMS" passed by a vote of sixteen to nine.[25] Opponents of the EMS failed to force a vote on this motion at the conference, but their efforts revealed enough hostility to the EMS to persuade Callaghan that he could not count on the party's support.[26] In mid-November 1978, over half of backbench Labour members of Parliament signed a motion opposing "any attempt by the [European Economic Community], its institutions or its member states to assume control of domestic policies through a new monetary system for the Community." The sponsors of the motion claimed that many more Labour parliamentarians and half of the noncabinet members of the government supported their position. In late October, the Trade Unions Congress informed Callaghan and Healey that it opposed participation in the EMS as well.[27] The prime minister avoided formal cabinet discussions of the EMS until November 1978 because of this opposition. When the cabinet discussed the issue, a clear majority, including Healey, opposed British participation on the grounds that it would require higher interest rates and a reduction in monetary policy autonomy.[28]

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

> I favored the general idea as likely to bring more order into the currency markets of Europe and the world, but quite apart from my technical concerns I could not travel fast. Many people in the Labour Party remained suspicious of what they thought was too close an entanglement with Europe, and this, coupled with my own and the Treasury's belief that sterling was standing too high to make our entry advantageous, led me . . . to tell Schmidt and Giscard that we could not enter the European monetary scheme at the outset. On the other hand, I publicly welcomed the scheme in principle, and when it was finally set up the Cabinet agreed to a number of steps to associate Britain with the development of a European Currency Unit (ECU).[29]

The British government was not enthusiastic about Schmidt's EMS proposal, and its weak political position in the House of Commons and strong opposition within the Labour Party further reduced government interest in participation. Callaghan feared that the domestic political consequences of British participation would outweigh any advantages in terms of stabilizing sterling but also wanted to prevent Britain from being locked out of future European and international monetary initiatives. Thus in late November the British negotiators successfully proposed separating participation in the ERM, the system of fixed but adjustable parities among participating currencies, from membership in the EMS. This would allow Britain to have a flexible exchange rate and some input into the development of the EMS.[30]

France: A Preoccupation with Economic Power

French president Giscard strongly believed that French economic and political power should match that of West Germany; this was "a theme to which he [returned] constantly, almost obsessively, in his speeches."[31] France, Giscard stated, must be the equal of Germany to secure its influence over European politics. As he put it in an interview in October 1978, "Why do I talk so much about Germany. . . ? Because it would not be a good idea for Europe to be dominated by one country. . . . What I want France to achieve is to make sure that there are in Europe at least two countries of comparable influence, . . . Germany and France."[32] He emphasized that doing so required that France increase exports, especially of high-value-added goods; improve the competitiveness of French industry; and reduce inflation. These goals, along with stable agricultural prices, could be achieved with the creation of a new European monetary institution that would stabilize currencies, increase exports, and strengthen the government's credibility in the financial markets.[33]

Giscard expressed interest in Jenkins's proposals in the fall of 1977 but was hesitant about participating in a new institution that resembled the snake, from which he had withdrawn the franc on two occasions.[34] Instead, he preferred an institution with rules that not only would stabilize European currencies but also would give France greater resources to avoid disinflationary policies.[35] From this perspective, the initial EMS proposal had a number of advantages over the snake, including rules requiring that realignments be approved by mutual consent, which could reduce the necessity of choosing between withdrawal or sharp disinflation; the possibility of using the divergence indicator, which could limit the appreciation of the mark and the policy autonomy of the Bundesbank; and extensive balance-of-payments financing.[36]

By early 1978 the French were committed to a new monetary institution in western Europe. The government faced an early constraint on its economic policies and approach to the EMS in the form of parliamentary elections scheduled for March 1978. Following setbacks in local elections in the mid-1970s, it was widely expected that the ruling coalition of the Rassemblement pour la République (RPR), led by Jacques Chirac, and the Union pour la Démocratie Française (UDF), affiliated with Giscard, would lose the election to the alliance of the Socialist and Communist parties.[37] As events turned out, the RPR-UDF alliance won a majority of eighty-nine seats in the National Assembly. What was more significant was the distribution of seats within the right-wing alliance. The RPR remained the largest party in the legislature but lost twenty seats, whereas the UDF made significant advances. As a consequence, the government gained a certain amount of legitimacy to continue its moderately disinflationary policies and greater freedom to begin serious negotiations on the EMS. The victory of the right, and in particular of the UDF, also was important in persuading Schmidt to proceed with the negotiations.[38]

Serious negotiations over the EMS began soon after the French legislative elections, culminating in the agreement reached at the Bremen summit in July 1978. An important turning point was the Franco-German summit in