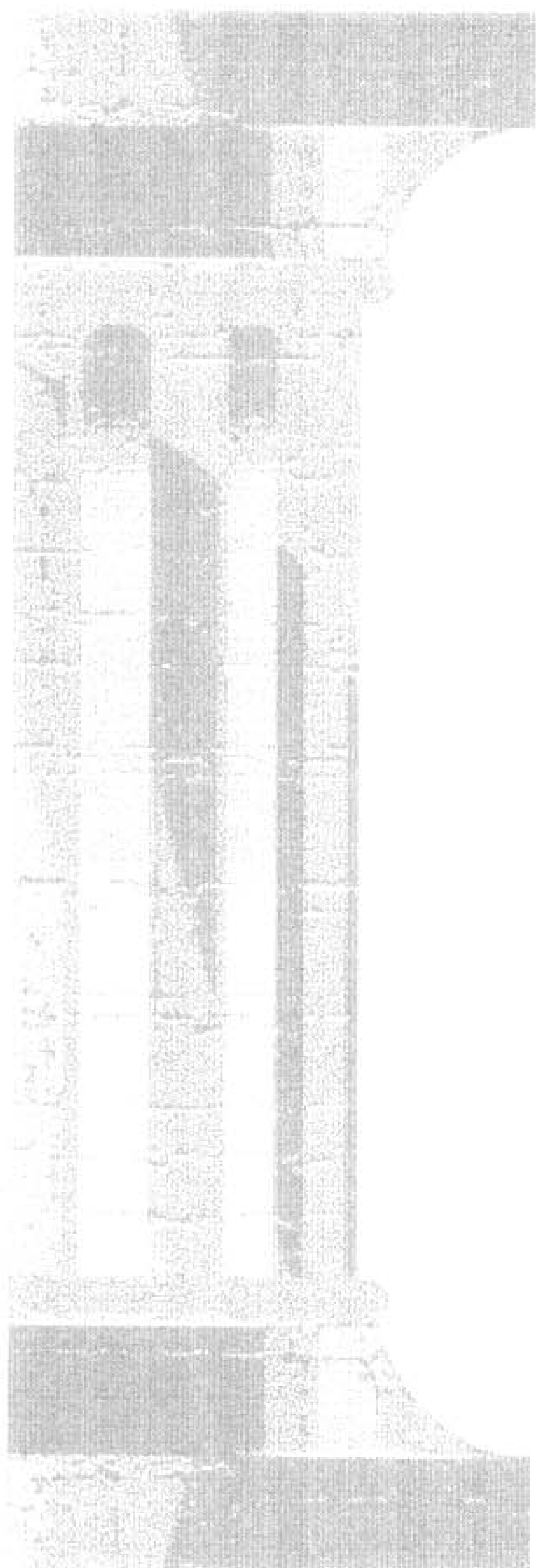
CAPITAL MOBILITY, DOMESTIC POLITICS, and FRENCH MONETARY DIPLOMACY



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ABSTRACT[1]

This article evaluates the role of increased capital mobility, sectoral interests, and domestic institutions in bringing about policy change in French capital markets. Capital mobility played an indirect role by making it more costly for French governments to pursue inflationary economic policies. But it was domestic politics, not capital mobility, that led governments to achieve lower inflation by stabilizing the exchange rate. The key domestic political factor was institutional change to regulatory practices, while financial markets reduced bank lending to industry and internationalized French finance, breaking the strong ties and common monetary diplomacy interests of bankers, industrialists, and policymakers, and thereby weaken the political priority of promoting domestic growth and industrial competitiveness.

French monetary diplomacy—government preferences regarding the exchange rate and international monetary institutions—has changed in important ways since the collapse of the global regime of fixed exchange rates in the early 1970s. French governments privileged economic growth and industrial competitiveness over low inflation and exchange-rate stability until the mid-1980s. They withdrew from or devalued within European monetary institutions when the franc exchange-rate became over-valued. Subsequent policy aimed to achieve low inflation and currency stability within stronger European institutions even when this contributed to slow economic growth and high unemployment. This policy shift culminated in France's participation in the single European currency in 1999.

What drove this change in French monetary diplomacy? In this article I use the French experience to examine some of the complex relationships between globalization and domestic politics. Changes in French monetary diplomacy often are viewed as a consequence of one form of globalization—increased capital mobility. But the evidence from France and elsewhere indicates no straightforward relationship between the degree of capital mobility and monetary diplomacy.

Problems also exist with attempts to understand monetary diplomacy as a result of domestic political struggles among

industry, labor, and finance. Explanations in this vein typically hold that the degree of dependence on international capital and product markets is the principal determinant of groups' policy preferences. I present evidence based on extensive fieldwork that groups in France did not articulate the preferences posited by such pluralist models. Particularly surprising is the fact that French finance actually supported, or did not oppose, inflationary monetary policies into the 1980s.

I describe and explain these counter-intuitive findings. I argue that monetary diplomacy is best understood through close analysis of domestic institutional arrangements ignored by a focus on capital mobility and by pluralist models of interest group competition. Especialy important was the significant weakening of institutions linking French banks and industry in the 1980s. This institutional change broke the strong ties and common monetary diplomacy preferences of bankers, industrialists, and policymakers and weakened the political priority of promoting domestic growth and industrial competitiveness. Governments in the late 1980s and the 1990s had more political freedom to implement macroeconomic austerity and to subordinate economic policy to European monetary institutions.

Two important implications follow from this analysis. First, globalization does not have the same effects everywhere; instead, these effects are mediated by domestic politics. Second, formal and informal institutions such as bank-industry ties play a crucial role in structuring domestic groups' definitions of their preferences and their power in the policymaking process.

EXPLAINING THE CHANGES IN FRENCH MONETARY DIPLOMACY

What explains the changes in French monetary diplomacy? Many argue that globalization in the form of increased capital mobility made it too costly for French governments to pursue monetary policies that produced high inflation and currency depreciation

(Loriaux, 1991; Petit, 1989; Sachs and Wyplosz, 1986). Capital mobility increases the costs of high inflation because it allows investors to transfer funds overseas unless the central bank compensates them with high interest rates. Capital mobility may be an important reason that governments around the world placed greater emphasis on reducing inflation beginning in the 1970s and increased their real interest rates (Andrews, 1994). As the cases below make clear, successive French governments did link reducing inflation and stabilizing the franc against European currencies, especially the low-inflation German mark.

But exchange-rate stability is not the only way to achieve low inflation. Policymakers in Britain, which like France experienced high inflation and depreciation in the 1970s and early 1980s, chose to reduce inflation by raising domestic interest rates and allowing sterling's exchange rate to appreciate (Walsh, 2000). Germany and the United States countered inflationary pressures with independent central banks that could avoid political pressures to loosen monetary policy (Henning, 1994). Thus while real interest rates have increased and inflation has fallen among advanced capitalist democracies since the 1970s, this has not been associated with a clear trend towards greater exchange rate stability. Indeed, many governments have abandoned fixed exchange rates (Eichengreen, 1996).

Globalization often is blamed or given credit for making it more difficult for domestic politics to produce distinctive cross-national differences in economic policy. But the increase in capital mobility since the 1970s implies that domestic politics have a *greater* influence by determining national strategies for keeping inflation low. When capital is not mobile across international borders, governments can gear macroeconomic policy to achieve both monetary policy autonomy (the ability to set interest rates at levels different from those of other countries) and stable exchange rates simultaneously. Capital mobility forces governments to chose between these goals, since setting interest rates at levels different from those of other countries will lead to inflows or

outflows of capital, and thus changes in the exchange rate, as investors seek the highest possible returns. Governments may chose to achieve price stability by either retaining policy autonomy while sacrificing exchange rate stability, or keeping the currency stable but matching the interest rate decisions of other countries. Thus, capital mobility creates strong incentives for states to make low inflation an important goal of economic policy, but does not dictate the tools that they use to achieve this goal. It is domestic politics that drives this choice (Eichengreen, 1992).

This insight into the role of capital mobility leads many to argue that domestic political conflict drives the choice of macroeconomic policy. But how, exactly, does domestic politics matter? Recent work on globalization and domestic politics produces two different answers that I refer to as the sectoral and institutional approaches. The sectoral approach views the preferences and political power of economic sectors as the principal determinant of policy. Sectors' preferences are structured by their dependence on the international economy (Frieden & Rogowski, 1996). There are two broad sectors with interests in monetary diplomacy (Frieden, 1994). The first is producers of tradable goods, such as manufacturing industry, whose products are traded and priced on international markets. The second is producers of non-tradable goods whose products are sold only in the domestic market and whose prices are determined by domestic supply and demand, including most services and products protected from foreign competition. Currency appreciation increases the prices of domestically-produced tradable goods relative to tradable goods produced overseas, leading to reduced export opportunities and increased competition from imports. Thus, manufacturing industry prefers policies that prevent currency appreciation and keep the exchange-rate at a competitive level. Conversely, producers of non-tradable goods prefer policies that appreciate the currency, since this reduces the domestic currency prices of tradable goods. Non-tradable goods producers, whose demand is concentrated in the domestic market, also prefer a floating exchange rate that allows the authorities to respond to

changes in the domestic business cycle by altering monetary policy. Any resulting changes in the exchange rate do not greatly effect non-tradable goods producers since they do not face overseas competition. But such currency changes do affect producers of tradable goods. Industry, as well as international investors and traders, value the predictability of returns from domestic and international sales and investments produced by currency stability and prefer fixed exchange rates.

The sectoral approach generates two hypotheses about the politics of monetary diplomacy. First, policy should shift towards stabilizing the exchange rate at a competitive level as a country becomes more open to trade, and the size and political importance of the tradable-goods sector increases. Trade data reveal some support for this proposition. The French economy's dependence on international trade, measured as exports plus imports and a percentage of gross domestic product, increased during the 1980s from 9.6 percent to 10.9 percent. The orientation of French trade towards other members of the European Union also grew somewhat during this period, indicating that industry's preference for stable exchange rates with these countries became more intense. Exports to the European Community as a percentage of total exports increased from 57.2 percent to 61.6 percent, while the corresponding figures for imports grew from 53.7 percent to 60.1 percent (calculated from Commission of the European Communities, 1993, pp. 145, 149, and United Nations, various issues). Second, the policy preferences and lobbying activites of domestic groups should follow the sectoral patterns outlined above, with industry pressing for policies that will keep the currency stable at a competitive level and non-tradable producers favoring monetary policy autonomy and currency appreciation.

The institutionalist explanation explores how intermediate-level institutions structure actors' goals and power in the political process (Hall, 1986; Katzenstein, 1978; Thelen, Steinmo, and Longstreth, 1992; Zysman, 1983). This approach holds that the preferences posited by sectoral analysis hold true

only in an institutional context where financial and industrial firms have weak links (Henning, 1994; see also Hall, 1986; Zysman, 1983). In countries such as Britain, the United States, and France from the late 1980s onwards, finance and industry have weak links because firms borrow short-term funds principally to cover operating expenses and turn to equity and bond markets to finance investment. Banks' monetary diplomacy preferences therefore mirror those of producers of non-tradable goods, as the sectoral approach expects. Banks have a strong preference for low inflation, since unexpected increases in inflation can reduce the spread between the prices of banks' liabilities and returns on their assets. Banks prefer currency appreciation because it reduces the prices of tradable goods and domestic inflation. For similar reasons, banks favor steps to promote exchange-rate stability only when this addresses their core interest in low inflation.

The institutional approach points out that these preferences are different when capital markets are underdeveloped and banks form close, institutionalized ties to industry based on lending and the provision of financial advice. Small and illiquid capital markets produce a situation of mutual dependence between banks and industry. Industrial firms rely on banks for operating and investment funds. In turn, banks are heavily dependent on industrial firms' profitability and ability to repay their debts, since such debts make up a large proportion of banks' assets. Banks, therefore, attach less importance to low inflation and more importance to stabilizing the currency at a competitive level when these goals conflict. Banks and industrial firms with strong ties form a politically powerful and unified coalition that lobbies for policies intended to produce a stable and competitive currency. Close ties with financial firms also give industry entrée with policymakers concerned with exchange rate policy. As Henning (1994: 30-31) puts it, "close ties to the banking community create new channels of access for industry to the exchange rate policymaking process. The banking community is the natural client of finance ministries and central banks. . .[F]inance

ministries and central banks are typically more responsive to policy advocacy by banks and senior bank executives than from other sectors of the economy."

The institutional approach generates two hypotheses about monetary diplomacy that differ from those of the sectoral explanation. First, the preferences of banks and industry should diverge as their ties weaken. Banks should shift from supporting policies that stabilize the currency at a competitive level to those that keep inflation low as their dependence on industrial performance declines. Second, government policy should place less emphasis on keeping the exchange-rate competitive as the preferences and lobbying demands of banks and industry move apart.

The French experience is useful for evaluating the institutional approach because bank-industry ties weakened in the 1980s. State intervention long meant that French finance was oriented towards bank credit rather than capital markets. Treasury regulations restricted access to the bond market to the government and some state-owned firms. Combined with a small and narrow Paris stock exchange, most private and state-owned firms had to rely on bank credit as their most important source of external finance. The state intervened here as well to keep borrowing costs low. The Banque de France subsidized loans from specialized lending institutions and automatically met banks' refinancing to ensure an adequate supply of credit at low interest rates. From 1972 until 1985 governments tried to prevent overly-rapid expansion of credit with a policy of *encadrement du crédit* that punished institutions who exceeded government lending targets (Dony, Giovaninetti, & Tibi, 1969; Goodman, 1992a; Massé, 1965; Zysman, 1983).

During the mid-1980s the authorities became convinced that a credit-based economy offered more costs than benefits, including fuelling inflation, hindering the access of small and medium-sized to external sources of finance, and undermining

the international competitiveness of French financial firms. They embarked on a program to revolutionize French finance by reducing intervention and encouraging the development of capital markets. Specific changes instituted in the mid-1980s included phasing out of *encadrement du crédit* by 1987, opening a second stock market for small firms; creating certificates of deposit, commercial paper, options on securities, and bond futures, and using interest rate policy as the primary instrument of monetary

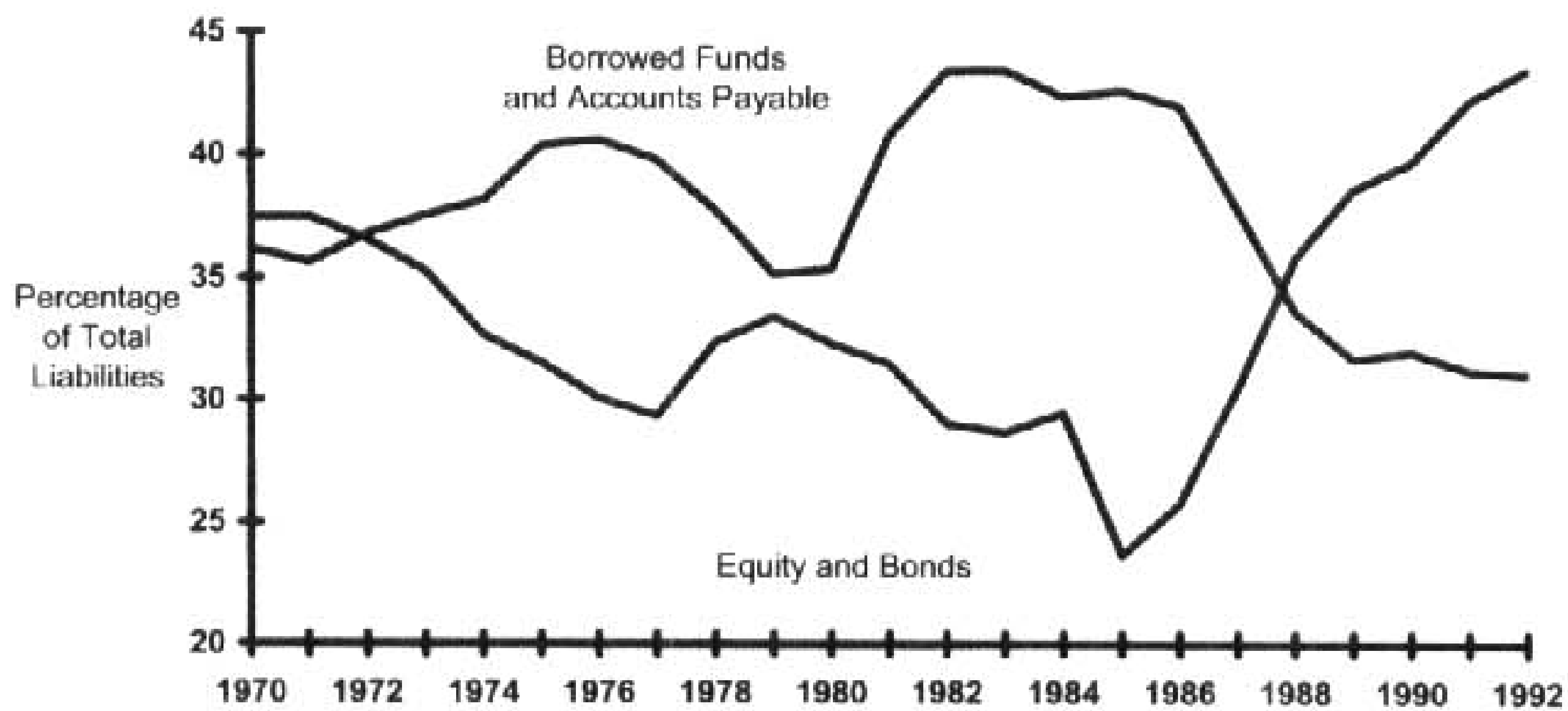

Figure 1. Borrowed Funds and Equity and Bonds as a Percentage of French Industrial Firms' Liabilities. Source: OECD Financial Statements Part 3: Non-Financial Enterprises' Financial Statements, various issues.

policy (Goodman, 1992a, pp. 34-5). Figure 1 illustrates some of the effects of these changes by plotting the stock of a sample of French industrial firms' borrowed and security liabilities from 1970 to 1992. After 1986, when many of the financial reforms were nearing full implementation, industrial firms' reliance on borrowing declined while their use of securities markets rose to unprecedented levels. Other figures bear out these changes. Between 1984 and 1990 the capitalization of the Paris stock market as a percentage of gross domestic product increased from 9.5 per cent to 33.6 per cent. Financial institutions' share in the total external financing of non-financial residents between 1980 and 1991 declined from 72.8 per cent to 46 per cent, while the proportion of securities issues (bonds, commercial paper, and shares) increased from 10.8 per cent to 43.5 per cent. (calculated from de Cecco and Ferri, 1994, p. 33; OECD, 1992, 1995).

French Monetary Diplomacy

As the Bretton Woods international monetary regime collapsed in the early 1970s, European governments negotiated the Narrower Margins Agreement that limited the permissible fluctuation between their currencies to ±2.25 per cent. The intention was for the European currencies to fluctuate as a group against the dollar, leading the regime to be named the "snake in the tunnel". One year later the European governments ceased to support any central parities against the dollar, freeing the snake from the tunnel, but continued to try to limit fluctuations among themselves.

The French preferred to respond to the end of a link to the dollar by strengthening the snake. In September 1974 finance minister Jean-Pierre Fourcade called for the European Economic Community to adopt a common policy against the dollar, coordinated foreign exchange market intervention supported by larger credit facilities, and using the European Unit of Account (EUA) as the pivot of the snake (similar ideas would be repeated by the French in 1978 and 1987). The most novel proposal was the EUA pivot, which would have replaced the snake's bilateral parity grid in determining which countries should adjust to balance-of-payments disequilibria. Under the snake the burden of adjustment was asymmetrical: while countries with both appreciating and depreciating currencies had to intervene on the foreign exchange market to support parities, the latter's intervention was limited by the size of their reserves. But the Fourcade proposals failed because German policymakers were uninterested in a stronger European institution that would give countries with depreciating currencies—such as France—some influence over their foreign exchange market intervention and interest rate decisions (Gros and Thygesen, 1992, pp. 38-9).

Increases in the price of petroleum in the same year reduced French growth, increased inflation and unemployment, and worsened the trade account. Despite its earlier support for a

stronger snake, the government switched the emphasis of macroeconomic policy to promoting growth and exports by withdrawing from the snake in January 1974 and allowing it to depreciate (see figure 2). After winning the presidential election in 1974, Valéry Giscard d'Estaing implemented an austerity plan that, combined with slower growth overseas, led to recession by the end of the year but did allow the franc to rejoin the snake in July 1975 at its original parity. However, the government's poor showing in parliamentary by-elections in October again led policymakers to relax credit controls and to increase spending despite evidence that the recession was ending. Now-buoyant French economic growth switched the current account from surplus in 1975 to deficit in 1976, placing downward pressure on the franc and leading policymakers to again withdrawal from the snake to avoid deflation (Goodman, 1992b, pp. 112-18).

Figure 2. Monthly Franc-Mark Exchange Rates, 1970-98.
Source: Calculated from Federal Reserve Economic Database.

The European Monetary System

In early 1978 Giscard and West German Chancellor Helmut Schmidt called for a "zone of monetary stability" in Western Europe. They proposed establishing a European

Monetary System by the end of the year that would include currency fluctuation bands of ±2.25 per cent, allow parity changes only by mutual consent, create a European Currency Unit (ECU) for settlements among central banks, and form a European Monetary Fund within two years.

Schmidt was dissatisfied with recent depreciation of the dollar that made German exports less competitive. A European exchange rate arrangement could stabilize the mark against some of Germany's largest trading partners and partially shield Germany from United States monetary policy. However, the Bundesbank feared that a European monetary regime could undermine its autonomy by requiring changes in interest rates or foreign exchange market intervention. These concerns led German negotiators to prefer a regime that preserved a significant degree of national control over monetary policy, including limits on intervention obligations and the right to request changes in parities (Ludlow, 1982; Henning, 1994, pp. 185-9). For the French, participation in the European Monetary System (EMS) would provide external support for stabilizing the franc. It would also reinforce the government's credibility and prevent an inflation-devaluation spiral that could harm competitiveness (Goodman, 1992b, p. 126; Ludlow, 1982, p. 200). However, the French did not wish to participate in another version of the asymmetrical snake and preferred that the new institution not overly restrict French economic policy options.

The conflict between the French desire for a symmetrical regime and the German concern to retain policy autonomy came out in the discussions over the parity grid and the divergence indicator as determinants of foreign exchange market intervention. Under the divergence indicator, favored by French negotiators, the country whose exchange rate was diverging from the EMS average would have to intervene or change monetary policy, regardless of whether the divergence was caused by appreciation or depreciation. The Germans favored relying on the parity grid, which in effect required countries with depreciating currencies

to tighten policy. These issues were resolved in the "Belgian compromise" of September 1978 that incorporated both the divergence indicator and the parity grid. The French conceded that the more symmetrical divergence indicator would not *require* policy changes, but only a "presumption of action" (Giscard, 1988, pp. 141-3; Ludlow, 1982, p. 239).

AUSTERITY WITH DEVALUATION, 1979-87

The franc was stable in the EMS for the next two years. But high French inflation meant that by early 1981 it was overvalued against the mark by about 10 percent, which undercut the international competitiveness of French industry. The franc began to depreciate when the Bundesbank raised its interest rates and because of worries that Giscard would lose the May 1981 presidential election to the candidate of the Parti Socialiste (PS) and the Parti Communiste Français, François Mitterrand. Mitterrand's electoral program included commitments to fiscal reflation and extensive nationalization, and his victory pushed the franc to its floor in the exchange-rate mechanism of the EMS (Gras and Gras, 1991, p. 69).

The over-valuation of the franc and speculation against its parity in the EMS launched a political struggle over the Mitterrand governments' monetary diplomacy priorities. By summer 1981 many business leaders began to express concern about the overvaluation of the franc, and some members of the PS began advocating withdrawing from the EMS and depreciating the franc. By the end of the summer even the finance minister, Jacques Delors, had decided that a devaluation was necessary to restore competitiveness despite the fact that it would increase inflation. The government negotiated an effective devaluation of 8.5 per cent against the mark on 4 October (Delors originally hoped for a larger devaluation, on the scale of 12-15 per cent, but was stymied by German and Dutch opposition). Delors proposed a modest austerity package to accompany the devaluation but Mitterrand and other ministers would agree only to a scaled-down

version (Bauchard, 1986, pp. 55-60; Favier and Martin-Roland, 1990, pp. 405-7).

Two groups emerged to try to influence exchange-rate policy in early 1982 as the franc's exchange rate remained near the bottom of its EMS fluctuation band. The first, composed of industrialist Jean Riboud, bankers Georges Plescoff of Suez and Jean Deflassieux of Crédit Lyonnais, and a number of PS ministers close to Mitterrand, drew attention to the fact that the combination of nominal exchange-rate stability in the EMS and high domestic inflation produced real currency appreciation that damaged French industry's competitiveness. They advocated a large devaluation within, or withdrawal from, EMS. The second group, centered around advisers to prime minister Pierre Mauroy and Delors, called for tighter macroeconomic policy in the face of large trade deficits and high inflation. During early 1982 they secretly prepared an austerity program including devaluation, wage and price controls, and a reduction in the budget deficit. Mauroy brought the austerity plan to Mitterrand in March 1982 and also advocated a 10 per cent devaluation within the EMS (Bauchard, 1986, 91; Favier and Martin-Roland, 1990, 4125; Gras and Gras, 1991, pp. 101-3). Mitterrand delayed a decision until after the Group of Seven summit meeting in June but then sent Delors to Brussels to negotiate an effective 10 per cent devaluation of the franc against the mark. Unlike in 1981, the French government tightened fiscal policy to accompany the devaluation (Cameron, 1996; Gras and Gras, 1991, pp. 105-7).

But the franc remained weak in the EMS, and losses for the PS in the first round of municipal elections in early March 1983 accelerated the franc' depreciation. Mitterrand proposed withdrawal from the EMS and a government reshuffle tilted towards the left of the PS. Mauroy threatened to resign rather than to lead such a government, and Delors emphasized that withdrawal was only a short-term solution to France's economic problems. His arguments convinced two prominent PS politicians Laurent Fabius and Pierre Bérégovoy to persuade Mitterrand to

remain in the EMS (Bauchard, 1986, pp. 144-5; Favier and Martin-Roland, 1990, pp. 466-71). Mitterrand instructed Delors to negotiate an effective devaluation of 7-9 per cent against the mark; after complex and difficult negotiations in Brussels, the Germans and French agreed on an effective devaluation of 8 per cent and "supplementary guarantees" that the French would tighten fiscal policy again.

The decision to remain in the EMS marked the beginning of the shift in monetary diplomacy from maintaining competitiveness with frequent devaluations to a greater emphasis on keeping inflation low. The discussion and selection of economic policy options began to emphasize the interests of finance over those of labor and industry. The elite policymaking network of finance ministry and central bank officials and presidential and prime ministerial advisers saw exchange-rate stabilization and austerity as the best way to restore balance to the French economy (Cameron, 1996, pp. 75-6). The general idea came to be known as "competitive disinflation" which would stabilize the exchange-rate in the EMS and improve competitiveness by reducing inflation and inducing real depreciation of the franc. [1]

But this shift did not occur overnight. Policymakers continued to exhibit concerns about the competitiveness of French firms in the mid-1980s, when French inflation was still higher than German inflation and the franc appreciated in real terms. The conservative government elected in 1986 and led by prime minister Jacques Chirac and finance minister Edouard Balladur was quick to negotiate a six per cent devaluation against the mark to restore industry's competitiveness. A tight German monetary policy in 1986 further appreciated the mark and dragged up other EMS currencies in its wake, resulting in a 3 percent devaluation of the franc in January 1987. These parity changes eliminated most of the remaining franc overvaluation that had accumulated in the early 1980s.

NEGOTIATING MONETARY UNION

By 1987 French inflation was quite low, but the rules of the EMS continued to give Germany a great deal of influence over the monetary policies of other member-states. Governments did agree to minor changes in the EMS rules in the Basle-Nyborg accords of 1987. But Balladur was convinced that the EMS would continue to operate in an asymetrical manner. This led him to propose stronger supranational control over European monetary policies with the creation of a full monetary union and a European central bank (Balladur, 1988). He soon realized that German officials, especially in the Bundesbank, would only support a monetary union that included substantial convergence of macroeconomic performance and a single currency managed by a politically independent European central bank.

A full account of the subsequent monetary union negotiations is beyond the scope of this article; instead, I focus on the priorities of French officials. Compared to earlier negotiations over monetary integration, the French proved willing to make significant sacrifices to the German priority of price stability. French negotiators pressed for three major goals during the negotiations that concluded in the approval of the Treaty on European Union in Maastricht in December 1991. First, they felt that the treaty on monetary union should be binding on all member states. French negotiators opposed a German draft treaty of early 1991 that proposed a unanimous vote in the European Council on the timing of the move to the final stage of monetary union, fearing that this would allow the British or Germans to delay the creation of a monetary union. They also opposed British proposals in 1991 that would allow any member state to "opt out" of monetary union. In December 1991, the French (and Italians) successfully insisted that the treaty allow opt-outs *only* for Britain and Denmark and be binding on all other member states meeting convergence criteria on inflation, long-term interest rates, exchange-rate stability, and fiscal deficits and debt. At the time

French officials did not think that it would be difficult for them to meet these criteria.

Second, the French favored early and pre-established deadlines for the timing of transitions between the final stages of monetary union, while the Bundesbank preferred to move to each stage only after economic convergence among the member-states. The key issue was the timing of the final stage, which would irrevocably fix participating currencies and create the European Central Bank. To guarantee that this stage would begin, in December 1991 the French proposed that it commence automatically in January 1999 and include all states meeting the convergence criteria (Bini-Smaghi, Padoa-Schioppa, and Papadia, 1994, pp. 22-3; Italianer, 1993, pp. 70-1).

Third, the French favored strengthened policy coordination during the lengthy transition to full monetary union in order to increase their influence over the Bundesbank in cases of conflicting views on the proper setting of monetary policy. The French also were reluctant to accept the idea of central bank independence, arguing that the European Community's Council of Economics and Finance Ministers should be a political counterweight to the European Central Bank and retain significant control over exchange-rate policy. German negotiators opposed both of these positions. On both points the treaty favored the German preferences by creating only weak coordinating mechanisms before full monetary union, requiring that both national central banks and the European Central Bank be independent of political authorities, and dividing responsibility for exchange-rate policy between the European Central Bank and the Economics and Finance Council (Aeschimann and Riché, 1996, pp. 137, 158; Balleix, 1994, p. 42; Bini-Smaghi, Padoa-Schioppa, and Papadia, 1994, p. 34-5).

The monetary union negotiations included more significant concessions by French officials than did the EMS negotiations of 1978. French officials accepted a lengthy transition

to full monetary union based on explicit convergence criteria, which ensured participation only by that countries that had achieved German levels of economic stability. The French also agreed to create a very independent European Central Bank modeled after the Bundesbank and having the explicit goal of price stability. In comparison, the French negotiating successes—pre-established deadlines and specific rather than general opt-out clauses—were of much less overall importance.

AUSTERITY WITHOUT DEVALUATION: 1988-95

"Competitive disinflation" became the official mantra of French monetary diplomacy in the 1990s. Policymakers believed that, with the French inflation rate very low and the franc a competitive level, any devaluation would do little to improve the performance of French industry but would undermine the government's credibility with financial markets and drive up interest rates (Trichet, 1992; for a critical evaluation see Fitoussi, 1995). But by 1992 Germany and the rest of Europe were at different phases of the business cycle. Unification in 1990 produced rapid domestic economic growth, large budget deficits, and inflationary pressures in Germany, leading the Bundesbank to raise interest rates. At the same time most other European countries, including France, entered a deep recession and favored lower interest rates.

Despite this difference, exchange rates were quite stable until Danish voters rejected the Maastricht treaty in a referendum in June 1992. To re-launch the political momentum for monetary union, as well as to divide the center-right opposition parties, Mitterrand called a referendum on the treaty for 20 September 1992. The franc came under speculative attack even afer the positive results of the referendum, and French officials raised interest rates and coordinated foreign exchange market intervention with the Bundesbank to defend the currency's parity. Similar speculative attacks occurred from November to January, but on each occasion increases in interest rates and foreign exchange market intervention coordinated with Germany reduced

selling pressure on the franc. (Cameron, 1993). Higher interest rates attracted strong opposition from many industrialists in late 1992. For example, a Louis Harris poll of 402 presidents of firms found that 71 percent preferred lower interest rates to promote growth rather than the government's *franc fort* policy (Aeschimann and Riché, 1996, 160, pp. 178-80).

After the March 1993 parliamentary election delivered a victory to the center-right coalition, Edouard Balladur became prime minister and Edmond Alphandéry became finance minister. Balladur was intent on lowering interest rates as it became clear that France was experiencing a serious recession. The Bundesbank, however, was not interested in accelerating reductions in German interest rates, and the hint of conflict between French and German authorities led investors to the franc on a massive scale beginning in early July. Both the Banque de France and the Bundesbank intervened on the foreign exchange markets, while the Banque de France raised its overnight lending rate and persuaded French banks to hold domestic interest rates below its interest rates to support the currency. By Friday, 29 July, the Banque de France had exhausted its reserves and allowed the franc to fall to its floor, requiring unlimited intervention by the Bundesbank under the rules of the EMS. French policymakers hoped this might persuade the Bundesbank to reduce interest rates, since heavy intervention increased the German money supply. German officials requested meetings of the European Community's financial committees over the weekend, during which the French refused to devalue the franc and unsuccessfully pushed the Germans to reduce interest rates. On Sunday, 31 July, the ministers agreed to widen the EMS fluctuation bands to ±15 per cent. This allowed the French government to deny that they had devalued the franc, while reducing pressure on the currency and the Bundesbank's need to intervene to support it (*The Times*, 12 August 1993, p. 1).

The French did not take advantage of the wider fluctuation bands to depreciate the franc and boost exports during recession.

The immediate reason for this was to rebuild the reserves of the Banque de France, but policymakers continued to resist devaluation that might increase inflation and undermine their credibility in the financial markets. In early 1994 the government granted independence to the Banque de France in accordance with the Maastricht treaty. Central bank officials made it clear through their subsequent announcements and willingness to raise interest rates when the franc depreciated that their primary goal was to continue to stabilize the franc against the mark. (*Financial Times*, 22 April 1994; p. 2).

The unwillingness of the Balladur government and the central bank to devalue left it with fiscal policy as its only macroeconomic tool, and the government allowed the budget deficit to increase towards 6 per cent of gross domestic product in 1993. Efforts to meet the Maastricht criterion of a budget deficit of less than three percent of gross domestic product became embroiled in the presidential election campaign of May 1995. The two candidates of the center-right, Balladur and Chirac, emphasized that unemployment and recession were the biggest challenges facing France. Chirac, who won the election, was particularly ambiguous about the tensions between achieving the Maastricht treaty's budget deficit criterion and reducing unemployment. But once Chirac won the election, his government under prime minister Alain Juppé was quick to emphasize fiscal consolidation over growth and employment (Aeschimann and Riché, 1996, pp. 301-17).

The government's budget plan for 1996, introduced in September 1995, aimed to cut the budget deficit to 3.5 per cent of gross domestic product as well as to overhaul the social security system, financed by by rejecting Chirac's campaign pledge of tax cuts, freezing civil service pay and limiting the growth of military spending, and effectively reducing individual retirement benefits. In a widely-publicized television interview Chirac backed this program by declaring that his priority was to reduce the budget deficit. Labor unions mobilized large-scale strike

actions in November and December and shut down most of France's public transport and utilities, and on 7 December over one million took part in demonstrations throughout the country. Chirac again publicly backed the Juppé plan, although the government did agree to consult with the unions to end the crisis (*Financial Times*, 14 December 1995, 1; *Le Monde*, 27 October 1995, 1).

CONCLUSION

How well do increased capital mobility, sectoral preferences, and institutional changes in bank-industry ties account for the evolution of French monetary diplomacy? Capital mobility played an indirect but nonetheless important role. As discussed earlier, capital mobility creates pressures to maintain low inflation but does not determine the exact method policymakers will use to achieve this goal. The French experience illustrates this point well. During each major economic crisis, senior policymakers considered the effects of different policy choices on the confidence of international investors in the franc. This is true even in those cases where policymakers attempted to "buck the market" and downplayed the importance of such confidence. For example, during the early 1980s Mitterrand and some advisors considered withdrawing the franc from the EMS, imposing trade barriers, and using fiscal policy to engage in large-scale redistribution. But Mitterand softened this position just over one year after taking office in 1981, and by 1983 had reversed policy to place greater emphasis on low inflation and currency stability. Concerns about the reaction of international investors to reflation clearly played a role in this policy shift. Another example is the Bérégovoy and Balladur governments' attempts to stabilize the franc at a parity that investors considered unrealistic in 1992-93. By the early 1990s the policy the *franc fort* had become the centerpiece of economic policy for the center-left and center-right, and both governments feared that a devaluation would destroy their credibility in the financial markets.

But monetary diplomacy also has domestic distributional consequences that a focus on capital mobility alone does not capture. An important goal of this article was to evaluate how well the sectoral and institutional approaches explain groups' preferences and influence over monetary diplomacy. As both explanations predict, industry always opposed policy choices that would appreciate the franc in real terms or that would result in exchange-rate instability. The bulk of the evidence supports the conclusion of the institutionalist approach that the preferences of banks depended on ties to industry. Until the early 1990s French finance supported or did not oppose potentially inflationary depreciation to maintain industrial competitiveness. During the mid-1970s and early 1980s policymakers briefly tried to combine nominal exchange-rate stability with high inflation. When this policy mix produced real appreciation of the franc that undermined industry's competitiveness, policymakers withdrew from the snake or devalued in the EMS. French banks did not lobby against these devaluations; indeed, the leaders of the financial group Suez and the bank Crédit Lyonnais advocated devaluation in meetings with Mitterrand in 1982 and 1983. While it is true that many advocates of austerity came from the finance ministry and the Banque de France, and thus had expert knowledge of and influence within the financial system, they all recognized that sizable devaluations would have to accompany tighter policies. And there were no serious proposals for deliberate currency appreciation to reduce domestic inflation at the expense of competitiveness, which is what financial firms in the United States and Britain advocated in the early 1980s (Henning, 1994; Walsh, 2000).

The institutions of French finance experienced significant changes in the second half of the 1980s that weakened the ties between banks and industry. When the franc appreciated in real terms in 1993, French bankers did not support devaluation, and went so far as to briefly hold domestic interest rates below Banque de France interest rates to support the government's policy of remaining in the EMS. The shift to more distant relationships between banks and industry in the late 1980s led French finance

to attach greater importance to low inflation and less importance to a competitive value for the franc, breaking its earlier pattern of allying with industry on exchange-rate issues. This, in turn, reduced pressures on policymakers to maintain the franc at a competitive level, and allowed them to turn their attention to increasing their credibility in financial markets by meeting the conditions for monetary union laid out in the Maastricht treaty.

This shift in banks' preferences was associated with important changes in governments' exchange-rate policy choices and preferences regarding European monetary institutions. French exchange-rate policy shifted from favoring a competitive exchange rate to an emphasis on keeping inflation low and stabilizing the franc. Policy choices emphasized allowing the franc to depreciate in 1974 and 1976 and avoiding macroeconomic austerity rather than participating in the snake of European currencies. The Barre government of 1976-81 implemented a modest program of monetary and fiscal austerity, as well as negotiate the EMS, but the Socialist administration elected in 1981 returned to policies of reflation and devaluation. French governments began placing greater importance on raising their credibility in financial markets beginning with the decision in March 1983 to devalue but remain in the EMS and to implement macroeconomic austerity. The adoption of this *franc fort* strategy coincided with reforms to French financial markets that weakened the previous strong ties between banks, industry, and the state. The 1990s were marked by an over-riding emphasis on exchange rate stability and low inflation at the costs of a reduction in competitiveness, slower economic growth, and high unemployment. Until 1993 policymakers did not have to choose between keeping the franc at a competitive level or increasing their credibility because inflation fell to very low levels. They successfully defended the franc's EMS parity, and their credibility, against large-scale speculation in 1992. In 1993, however, policymakers *did* have to choose between credibility and competitiveness as the franc appreciated in real terms, and they chose the former goal by opposing depreciation.

The sectoral explanation has more difficulty accounting for these policy changes. The dependence of the French economy on international trade did increase between the 1970s and 1990s but it is difficult to find a direct relationship between this and the sharp changes in French policy for three reasons. First, the openness of the French economy changed gradually during this period while policy experienced rather sharp discontinuities. Second, the direction of change in French policy is the opposite of that expected by the sectoral approach. Each major policy change placed greater emphasis on exchange-rate stability even when this produced real currency appreciation, which damaged the growing number of industrial firms exposed to international competition. Third, banks' preferences did not accord with the sectoral approach, which correctly predicts a priority for low inflation in the 1990s but cannot explain their earlier preference for keeping the exchange-rate at a competitive level.

Globalization does not reduce the influence of domestic institutions and politics on policy outcomes. As the discussion of capital mobility makes clear, the effects of globalization are not always obvious, and institutions such as bank-industry ties mediate the relationship between these effects and public policy. Research on globalization needs to keep this point in mind because monetary diplomacy is not unique in this regard. For example, other studies find that labor market institutions (Western, 1997) and (Garrett, 1998) continue to matter for macroeconomic outcomes such as inflation and unemployment.

ENDNOTES

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