

# Political bases of macroeconomic adjustment: evidence from the Italian experience

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**ABSTRACT** This article tests political explanations of policy adjustment to macroeconomic imbalances against the Italian experience since the late 1970s. After describing Italian governments' attempts to implement macroeconomic policy adjustment, I evaluate four possible causes of policy changes: political instability, a 'tying hands' strategy of entangling the state in international commitments, analysis of the aggregate costs of pursuing macroeconomic policies that diverge from the policies of other important states, and the preferences of domestic groups. I evaluate the utility of each explanation according to its ability to answer two empirical questions: Why was adjustment delayed in Italy until about 1988? And why has the form of macroeconomic policy adjustment – monetary or fiscal – changed over time? The evidence indicates that answering these questions requires specifying how the costs of various macroeconomic policy mixes fall on domestic groups, and then determining which of these groups have the most political influence.

**KEY WORDS** Economic and monetary union; European monetary system; fiscal policy; macroeconomic adjustment; monetary policy.

All the countries of western Europe and North America have experienced macroeconomic imbalances at one point or another since the early 1970s. These imbalances take the form of some combination of high inflation, slow economic and employment growth, unstable exchange rates, and current account deficits. Text-book economic theory prescribes that governments respond to imbalances by adjusting macroeconomic policy – which in the present period usually means tightening fiscal, monetary, and exchange-rate policies – to produce more sustainable outcomes.

Yet governments sometimes fail to undertake adjustment in a timely manner, or they implement adjustment policies different from those prescribed by economic theory. For example, Italian governments have not responded to macroeconomic imbalances in accordance with orthodox economic models (Giavazzi and Spaventa 1989). Little serious adjustment occurred in response to problems with high inflation, currency instability, and slow economic growth from the late 1970s until 1988. When governments then embarked on programs to achieve adjustment, their policies took the form of monetary and exchange-rate adjustment from 1988 to 1992 and of fiscal

policy adjustment thereafter. Heterodox experiences such as this lead many to conclude that politics – distributional and institutional factors that mainstream economic policy analysis ignores – drive the timing and form of adjustment policies.

But what exactly is it about politics that is important? The temporal variation in the willingness of Italian governments to undertake adjustment policies provides a useful record against which to examine four political theories of macroeconomic policy choice. Most of these theories have not been evaluated simultaneously against the same empirical record, and doing so permits estimation of the relative importance of the domestic, international, and transnational variables they identify. Understanding the sources of adjustment policies is not just of theoretical interest. Italian macroeconomic policy usually has been out of step with policies pursued elsewhere in western Europe. But during the 1990s Italian governments undertook a sustained and partially successful effort to adjust (or, in European Union parlance, converge) towards the macroeconomic outcomes of Germany in preparation for participation in monetary union. Explaining this effort also sheds light on the political sustainability of full monetary union after 1998.

I evaluate the theories' specific hypotheses based on their ability to answer two empirical questions. First, why was adjustment delayed in Italy until about 1988? Second, why has the form of adjustment – monetary or fiscal – changed over time? The first theory explains the Italian experience as a product of weak coalition governments that lacked the political capacity to implement adjustment. This explanation fits the facts only until 1988; after that date governments were still coalitions but did undertake adjustment. The second explanation looks to how policy-makers who favor adjustment try to bypass domestic political constraints by entangling the state in international commitments such as the European monetary system (EMS) and the Treaty of European Union's blueprint for full monetary union. Careful review of the Italian experience during the 1980s indicates that this 'tying hands' strategy was ineffective. A more promising approach is to look at the net costs of divergence from macroeconomic policy trends in other countries and the possibility of exclusion from European monetary integration. This usefully specifies the consequences of the failure to achieve adjustment after 1988, but does not explain why the initial attempts at adjustment took the form of only monetary adjustment rather than both monetary and fiscal adjustment. The evidence indicates that instead of analyzing the national or aggregate costs of exclusion from European monetary integration, it is necessary to use a fourth class of hypotheses that specify how these costs fall on domestic groups and then to determine which groups have political influence.

## THE ITALIAN RECORD OF ADJUSTMENT

The combinations of monetary, exchange-rate, and fiscal policies pursued in Italy can be divided into three periods: delayed adjustment through 1987, adjustment of only monetary and exchange-rate policies from 1988 to late 1992, and fiscal policy adjustment after 1992 (see Table 1).

*Table 1* Monetary, exchange-rate, and fiscal outcomes in Italy, 1980–97 (averages of annual data)

|   | <i>Delayed<br/>adjustment<br/>1980–7</i> | <i>Monetary<br/>adjustment<br/>1988–91</i> | <i>Fiscal<br/>adjustment<br/>1992–7</i> |
|---|--|--|---|
| Percentage change in consumer prices                                  | 12.7                                     | 6.1  | 4.2 <sup>a</sup>                        |
| Percentage depreciation of lira against mark                          | 5.9                                      | 0.6  | 4.2                                     |
| Percentage appreciation of real effective exchange rate               | 0.8                                      | 1.93                                       | -4.4 <sup>b</sup>                       |
| Central bank status   | Subordinate                              | Subordinate                                | Independent since 1994                  |
| Budget deficit as percentage of gross domestic product                | 11.1                                     | 10.1                                       | 7.2 <sup>a</sup>                        |
| Increase in government debt as a percentage of gross domestic product | 6.4                                      | 4.6  | 2.3 <sup>a</sup>                        |

<sup>a</sup> Data for 1997 are projections.

<sup>b</sup> 1993–6.

*Sources:* Nominal exchange-rate data calculated from Federal Reserve Bank of St Louis, *Federal Reserve Economic Database*; real exchange-rate data calculated from International Monetary Fund, *International Financial Statistics*; remaining data and projections from *OECD Economic Outlook*.

### Delayed adjustment, 1980–7

Little adjustment occurred during this period. The monetary policy of the central bank, the Banca d'Italia, was subordinated to the preferences of the government, and policy-makers devalued the lira every year except 1984 in the exchange-rate mechanism (ERM) of the EMS. These policy choices resulted in high inflation and significant nominal depreciation against the German mark and other ERM currencies. Nominal depreciation did prevent the lira from appreciating in real terms against the currencies of major trading partners and thereby maintained the international competitiveness of Italian firms. Italian policy-makers unsuccessfully advocated changing the rules of the EMS so that countries with appreciating currencies, particularly Germany, would take on more responsibilities for foreign exchange market intervention and macroeconomic adjustment to stabilize exchange rates. Budget deficits were very large during this period, averaging 11.1 percent of gross domestic product, and exhibited little cyclical variation, while the stock of government debt expanded rapidly.

### Monetary adjustment, 1988–91

Italian policy-makers did try to implement macroeconomic adjustment after 1987. However, this adjustment was limited to monetary and exchange-rate policies. The

average inflation rate fell to less than half its level of the early 1980s, there was only one small devaluation of the lira in early 1990 when the currency's ERM fluctuation band was narrowed from  $\pm 6$  percent to  $\pm 2.25$  percent, and the real effective exchange rate appreciated substantially. Policy-makers in 1991 agreed to the Maastricht Treaty of European Union that intended to create a full monetary union by 1999 only among member states with low budget deficits, small public debts, independent central banks, low inflation, and stable exchange rates. But budget deficits and the rate of growth of the public debt declined only marginally despite the fact that Italy experienced rapid economic growth during this period.

### **Fiscal adjustment, 1992–7**

This pattern was reversed in late 1992, when monetary and exchange-rate policies became less restrictive but fiscal policy was tightened. Although inflation remained low and the Banca d'Italia was given legal independence from the government in 1994, the lira depreciated by 36 percent against the German mark between its withdrawal from the ERM in September 1992 and late 1995, rebounding only 12 percent in 1996. The rate of growth of the public debt declined, and budget deficits fell sharply from over 10 percent of gross domestic product in 1992 to a projected level of under 3 percent in 1997. This fiscal adjustment occurred during a period of sluggish economic growth (Della Sala 1997; Walsh 1998).

## **THE POLITICS OF ADJUSTMENT**

This section uses evidence from Italy since the late 1970s to evaluate four explanations of the pattern of adjustment detailed above: political instability, a 'tying hands' strategy whereby élites attempt to change policy by appealing to international commitments, the costs of macroeconomic policies that diverge from those adopted by other major states, and the social bases of the governing majority.

### **Political instability**

One often-cited reason for the Italian propensity to devalue and to run large deficits is the presence of a series of coalition governments of short duration (Della Sala 1997; Pasquino 1987). Such governments have little incentive to bear the political costs of adjustment for two reasons. First, they have short time horizons because they are likely to be out of office before any benefits of adjustment appear. Second, coalition governments may need to satisfy their constituent parties and factions by increasing government spending and/or delaying tax hikes, making it difficult to agree on restrictive policy packages (Grilli *et al.* 1991; Haggard and Kaufman 1992; Roubini and Sachs 1989).

But coalition governments of short duration have been the norm in Italy since the 1970s while macroeconomic policies have changed in important ways (see Table 2). The average duration of governments from January 1979 to June 1987 was 10.4 months, a figure which increased to only 15.8 months during the period of

Table 2 Composition and duration of Italian governments

| <i>Government</i> | <i>Parties in government</i>     | <i>Period in office</i> | <i>Duration in months<sup>1</sup></i> |
|-------------------|----------------------------------|-------------------------|---------------------------------------|
| Andreotti V       | DC-PSDI-PRI                      | Jan–Aug 1979            | 8                                     |
| Cossiga I         | DC-PSDI-PLI                      | Aug 1979–Mar 1980       | 7                                     |
| Cossiga II        | DC-PSI-PRI                       | Mar–Sept 1980           | 6                                     |
| Forlani           | DC-PSI-PSDI-PRI                  | Sept 1980–Jul 1981      | 10                                    |
| Spadolini I       | DC-PSI-PSDI-PRI-PLI              | Jul 1981–Aug 1982       | 13                                    |
| Spadolini II      | DC-PSI-PSDI-PRI-PLI              | Aug 1982–Dec 1982       | 4                                     |
| Fanfani V         | DC-PSI-PSDI-PLI                  | Dec 1982–Aug 1983       | 8                                     |
| Craxi I           | DC-PSI-PSDI-PRI-PLI              | Aug 1983–Aug 1986       | 37                                    |
| Craxi II          | DC-PSI-PSDI-PRI-PLI              | Aug 1986–Apr 1987       | 8                                     |
| Fanfani VI        | DC                               | Apr–Jun 1987            | 3                                     |
| Goria             | DC-PSI-PSDI-PRI-PLI              | Jul 1987–Apr 1988       | 10                                    |
| De Mita           | DC-PSI-PSDI-PRI-PLI              | Apr 1988–Aug 1989       | 17                                    |
| Andreotti VI      | DC-PSI-PSDI-PRI-PLI              | Aug 1989–Apr 1991       | 21                                    |
| Andreotti VII     | DC-PSI-PSDI-PLI                  | Apr 1991–Jun 1992       | 15                                    |
| Amato             | DC-PSI-PSDI-PLI                  | Jun 1992–Apr 1993       | 11                                    |
| Ciampi            | DC-PLI-PSDI-PSI-PDS <sup>2</sup> | Apr 1993–May 1994       | 13                                    |
| Berlusconi        | FI-AN-Lega Nord                  | May 1994–Jan 1995       | 9                                     |
| Dini              | PDS-PPI-Lega Nord <sup>2</sup>   | Jan 1995–Jun 1996       | 18                                    |
| Prodi             | PDS-PPI-Dini-Verdi               | Jun 1996–               |                                       |

<sup>1</sup> Includes time between vote of no confidence and legislative approval of new government.

<sup>2</sup> Non-political government; parties indicated in table supported government in confidence votes.

*Abbreviations:* AN (Alleanza Nazionale); DC (Democrazia Christiana); Dini (Lista Dini); FI (Forza Italia); PDS (Partito Democratico della Sinistra); PLI (Partito Liberale Italiano); PPI (Partito Popolare Italiano); PRI (Partito Repubblicano Italiano); PSDI (Partito Socialista Democratico Italiano); PSI (Partito Socialista Italiano); Verdi (Greens).

*Sources:* Hine 1993: 345–6; Newell and Bull 1997; Pasquino 1997.

monetary adjustment (July 1987 to June 1992) and fell to 12.8 months during the period of fiscal adjustment (June 1992 to June 1996). All but one government was a coalition of three or more parties, and until 1992 all governments centered around Democrazia Christiana (the DC) and the Partito Socialista Italiano (PSI) and excluded the communist and right-wing parties. This indicates that the existence of short-lived coalition governments alone had little impact on the course of fiscal, exchange-rate, and monetary policies. But closer examination of the data in Table 2 does suggest a possible relationship between the nature of the government majority and macroeconomic adjustment. After 1992 the partisan bases of the governing majority shift from the DC, PSI, and small centrist parties to technocratic and political governments centered around the former Communist party, the Partito Democratico della Sinistra (with the short-lived exception of the Berlusconi

government of 1994). I explore the implications of this shift in more detail below.

## Tying hands

Another frequently employed explanation of Italian economic policy draws attention to how policy-makers tried to ‘tie their hands’ against domestic opposition to adjustment by entering into international commitments (the phrase comes from Giavazzi and Pagano 1988; see also Moravcsik 1994; Vaubel 1989). Certain policy-makers argued that devaluation was inconsistent with participation in the EMS, supported the Maastricht Treaty as an external stimulus for adjustment, and emphasized the importance of the fiscal policy targets embodied in the system of multilateral surveillance instituted as part of the transition to monetary union (Della Sala 1997; Dyson and Featherstone 1996).

A careful examination of the historical record indicates that the policy-makers who tried to implement such a strategy were unsuccessful in changing policy. The Banca d’Italia, occasionally supported by centrist DC ministers and the small Partito Repubblicano Italiano (PRI), advocated that fiscal tightening accompany devaluations during the period of delayed adjustment from 1980 to 1987, but their concerns were brushed aside by the governments of the day. The tying hands strategy was implemented imperfectly during the period of monetary adjustment after 1987, when the lira was stable in the ERM and the Maastricht Treaty was negotiated, but little progress was made in reducing the budget deficit. And the lira was outside of the ERM after 1992 when governments achieved substantial fiscal adjustment.

The Italian lira was devalued seven times between 1981 and 1987. ‘Tying hands’ to international commitments failed to prevent all of these devaluations and succeeded in linking devaluation with fiscal policy only in 1985. Shortly before the devaluation of the lira by 6 percent against other ERM currencies on 22 March 1981, Banca d’Italia officials and ministers of the new Forlani government discussed policy changes that should accompany the parity change. Budget minister Giorgio La Malfa of the PRI and treasury minister Beniamino Andreatta of the DC proposed spending cuts and a public sector wage freeze, arguing that without these measures another devaluation was inevitable. His opponents in the government seemed to acknowledge this position, and the minister for state holdings, Gianni de Michelis of the PSI, quickly and successfully mobilized most of the coalition against significant cuts in public spending (Andreatta 1981; *Bancaria* 1981).

The next devaluation of the lira – widely foreshadowed by ministers’ comments – occurred on 4 October 1981. A Franco-German agreement to devalue the French franc dictated the timing. The French and Germans asked the Italian delegation in Brussels to devalue the lira; although the Italian negotiators were upset about this *fait accompli* and demanded minor changes in the rates of parity changes, they quickly secured approval from political authorities for an effective devaluation of the lira of 8 percent against the German mark. Andreatta emphasized that the reductions in the budget deficit foreseen in the government’s medium-term economic policy document should be implemented with the devaluation, but the

government took no real action on this front (*Il Mondo Economico* 1981a, 1981b; Thygesen 1984).

At the general realignment of ERM parities in June 1982, Italian policy-makers agreed to an effective devaluation of the lira by 7 percent against the German mark. Andreatta, supported by Banca d'Italia governor Carlo Azeglio Ciampi, called for austerity measures similar to those taken in France, including wage and price controls and budget cuts. But the government failed to produce a concrete plan of action because the PSI and Partito Socialista Democratico Italiano (PSDI) wanted to loosen monetary policy and opposed changes to fiscal policy. Andreatta was forced to announce a series of 'fantasy' austerity measures in Brussels that were never implemented (*Bancaria* 1982; Ciampi 1982).

In early 1983 serious conflict arose between those calling for a relaxation of monetary policy and those favoring an appreciated lira. The PSI called for giving priority to reducing unemployment rather than inflation, lowering interest rates, and finding unspecified 'new ways' to finance public spending. While DC treasury minister Giovanni Goria was committed to reducing inflation by cutting interest rates only gradually, others in his party joined the PSI in advocating more rapid reductions. The solution to this conflict was to devalue the lira along with the French franc in March 1983, despite the fact that the lira was in the upper half of its ERM fluctuation band until early in the month. Ciampi complained to little effect that these 'successful tactics' improved competitiveness but only in the short run; long-term improvements would depend on Italian inflation and fiscal policy converging with the other members of the ERM (*Il Mondo Economico* 1983a, 1983b, 1983c, 1983d; Ciampi 1983).

The secretaries of the five parties forming the government, along with treasury minister Goria and labor minister Gianni De Michelis, in late June 1985 planned a pre-emptive lira devaluation to offset the inflation differential that had accumulated against other ERM currencies since 1983. News of this plan leaked out on Friday, 5 July, leading to a sharp depreciation against the dollar and prompting the authorities to close the foreign exchange market before securing an 8 percent devaluation of the lira's ERM parity over the weekend. Shaken by this unexpected currency crisis, the government agreed to reduce the budget deficit by about 6 percent to restore its credibility (Magnani 1986: 21–3; Mengarelli 1985; *Il Mondo Economico* 1985). This quick reaction was not repeated after the devaluations of 1986 and 1987. The dollar depreciated against most European currencies in early 1986, causing tensions in the ERM between appreciating currencies such as the German mark and depreciating currencies such as the lira and French franc. When the French government requested a general realignment of parities in April 1986, the Italian authorities joined in to devalue the lira by 3 percent against the mark. The only criticism this move attracted was that, like most previous devaluations, it was not accompanied by supplemental economic policy measures (Istituto Affari Internazionali 1988: 260–1; Magnani 1986: 21–3; *Il Mondo Economico* 1986a, 1986b). Further depreciation of the franc in late 1986 spread to the lira, and policy-makers agreed to a devaluation along with France in early 1987 so as not to lose competitiveness (Istituto Affari Internazionali 1989: 234–7; *Bancaria* 1987: 48–9).

The 'tying hands' analysis has also been applied to Italian acceptance of the Maastricht Treaty's strict convergence criteria for participation in monetary union. While it is true that the Italian negotiators supported the idea of monetary union and its definition in the treaty, this alone is not sufficient evidence to support the tying hands hypothesis for two reasons. First, the provisions of the Maastricht Treaty were largely the product of Franco-German negotiations, and German preferences clearly have the most impact on the inclusion of fiscal policy convergence criteria (De Grauwe 1993). The Italian negotiators had to choose between agreeing to a treaty written to satisfy German preferences or rejecting any realistic possibility of Italian participation in monetary union. Second, the Maastricht Treaty explicitly provided for the possibility that not all member states might participate in monetary union automatically; instead, policy-makers in countries such as Italy would have to choose to adjust macroeconomic policy to meet the convergence criteria.

Italian policy-makers were interested in greater monetary co-operation but their conceptions of how European monetary institutions should be reformed were quite different from the outcome in the Maastricht Treaty. In a 1998 memorandum to the European Community's Committee of Economics and Finance Ministers, treasury minister Giuliano Amato called for reforms to the EMS to give it more symmetry between strong and weak currency countries. He also advocated some mechanism to recycle payments surpluses from countries with appreciating currencies to those whose currencies tended to depreciate. These steps would prevent a repetition of the real depreciation of the German mark against other ERM currencies that had occurred in the 1980s. Ciampi of the Banca d'Italia backed this position, and observed that the EMS had been useful in reducing inflation in the 1980s, but that now the problem was to co-ordinate macroeconomic policies so as to increase growth (Amato 1990; *Europe* 1988; *Il Sole 24 Ore* 1988).

The overall Italian priorities during the subsequent treaty negotiations in 1989–91 have been described in detail elsewhere (Dyson and Featherstone 1996; Cangelosi and Grassi 1996). Italian negotiators' attitudes towards the fiscal convergence criteria are crucial for evaluating the tying hands argument, which holds that they should have supported such external constraints (Dyson and Featherstone 1996; Moravcsik 1994). But the Italian delegation initially opposed the inclusion of any quantitative criteria in the treaty on the grounds that they would expose the monetary union to unforeseen changes in the business cycle and ignored the quite different levels of development of the member states.<sup>1</sup> In the words of three Italian negotiators, they preferred that the treaty include only 'binding procedures rather than binding rules for budget deficits, by accepting the principle that excessive public deficits should be avoided, but referring the judgment of this principle to the multilateral surveillance procedure, using objective criteria only as a yardstick' (Bini-Smaghi *et al.* 1994: 31). Once it became clear that the Germans and Dutch would insist on the inclusion of such criteria (limiting participation in monetary union to member states with budget deficits of 3 percent of gross domestic product and stocks of budget deficits to 60 percent of gross domestic product), the Italian negotiators unsuccessfully argued against giving the criteria

treaty status, holding that they should be defined by the Council of Ministers in Brussels as secondary legislation (Bini-Smaghi *et al.* 1994: 31).

The tying hands hypothesis holds that international commitments empower some actors to change domestic policy. But there is little empirical support for the contention that such commitments influenced the course of Italian macroeconomic adjustment. As I discuss below it seems likely that the reverse causal mechanism, whereby domestic politics determine the willingness and ability of governments to meet international obligations, is more accurate.

### Consequences of divergence

While the tying hands hypothesis views participation in international institutions as a deliberate strategy of some policy-makers to achieve their domestic goals, the approach discussed in this section holds that exogenous increases in international market and policy integration reduce the effectiveness of heterodox or divergent macroeconomic policies. We can divide this approach into two related explanations of Italian macroeconomic policies. The first looks to how expansionary monetary, exchange-rate, and fiscal policies become more costly in an international environment of liberalized capital flows and tight monetary policies; the second focuses in more detail on the possible consequences of exclusion from European monetary union.

The aggregate costs of macroeconomic policies that diverge from those of other states increase with the degree of integration into the international economy. International capital mobility creates strong pressures for the adjustment of fiscal and especially monetary policies (Andrews 1994; Kurzer 1993). Preventing capital flight requires the authorities to match world interest rates. This incentive is particularly strong when policy-makers attempt to fix or otherwise stabilize the exchange rate, since capital flight will result in currency depreciation. International capital mobility also creates incentives for governments to run small budget deficits; failure to do so might result in capital flight driven by investors' concerns about higher inflation or taxes (Garrett 1996: 88–9).

If this argument is correct, orthodox policy adjustment should follow an increase in international capital mobility. The evidence from Italy indicates partial support for this contention. In the early 1970s the Italian authorities instituted an extensive system of capital controls that limited investors' ability to engage in capital flight. These controls were relaxed beginning in the mid-1980s and eliminated completely by 1990 (Goodman and Pauly 1993). This greater exposure to international capital flows did coincide with the shift towards monetary adjustment in the form of currency stabilization and real appreciation. But increased costs of divergence had little influence on the *form* of adjustment. Italian governments continued to run large budget deficits in the late 1980s and early 1990s, despite the fact that doing so increased the interest rate on government debt demanded by domestic and international investors. And while exposure to international capital movements was continuous after the late 1980s, exchange-rate policy underwent a fundamental shift with the withdrawal of the lira from the ERM in September 1992.

Italian efforts to achieve economic adjustment after 1987 have also been

interpreted as an attempt to avoid exclusion from the process of European integration. Divergent macroeconomic policies threatened to marginalize Italy during the negotiation of the Maastricht Treaty in the late 1980s and to keep the country from meeting the convergence criteria in the 1990s. Exclusion from monetary union would have had substantial political costs. It would prevent Italy from exercising much influence over the internal and external policies of the monetary union. Member states participating in monetary union might adopt a less sympathetic attitude towards Italian economic policies, particularly devaluation against the single currency. Indeed, in the mid-1990s French governments complained about the withdrawal of the lira from the ERM in 1992 and the competitive advantage that subsequent lira depreciation gave to Italian exporters. A 'multi-speed' European Union might lead the core of states participating in the single currency to develop additional exclusive arrangements. Therefore, to enjoy all the political and economic benefits of membership in the European Union, Italy would have to pay the cost of macroeconomic adjustment (Dyson and Featherstone 1996).

Exclusion would also have important economic costs. The lira might be unstable against the single currency, making it more difficult for Italian exporters to forecast prices and demand in the important markets of northern Europe. Furthermore, the relatively high Italian inflation rates of the 1980s had led the lira to appreciate in real terms. Although this real currency appreciation was deliberately offset by occasional devaluations, it did impose further costs and uncertainty on Italian industry. This pattern could recur if Italy were excluded from monetary union, since the European Central Bank has an explicit mandate in the Maastricht Treaty to maintain the internal rather than external stability of the single currency. Finally, exclusion from monetary union could decrease the credibility of the Italian government on domestic and international financial markets, raising Italian interest rates and the cost of financing the government's debt.

Italian policy-makers had to measure these costs against the potential benefits of exclusion. Three benefits seem particularly important. First, by maintaining the risk of exchange-rate fluctuations, exclusion from monetary union would hinder foreign firms' penetration of the Italian market. This benefit probably would be modest for Italian industry, much of which was oriented towards export markets and had experience competing with overseas firms. But it could be a significant boost for Italian producers of goods and services sheltered from international competition, including retail establishments for banking services, travel agencies, food distribution, and so on. Although the single market program would reduce barriers to entry in these sectors with or without monetary union, the elimination of exchange-rate risk could be an important spur for further encroachment on the Italian market. Second, exclusion from monetary union would make it possible to devalue the lira against the single European currency. This could benefit Italian industry if the prices it pays for inputs – including labor and services – increase more rapidly than such input costs in other member states (Autorità garante della concorrenza e del mercato 1997; Salvati 1997). Third, exclusion from monetary union might weaken the multilateral constraints on fiscal policy embodied in the Maastricht Treaty convergence criteria, making it easier to influence domestic

demand over the business cycle and to pay for politically important programs such as pensions, government employment, and investment in southern Italy.

The initial attempt to achieve macroeconomic adjustment in the form of tighter monetary and exchange-rate policies roughly coincided with serious discussion of further monetary integration in the late 1980s. But analysis of the net costs of exclusion does not explain the form of adjustment undertaken. It is unclear why both monetary and fiscal policy adjustment were not implemented concurrently after 1987. In retrospect, implementing fiscal policy adjustment *before* monetary policy adjustment might have been a more sustainable policy mix. The adherence to currency stability in the ERM after 1988, when the Italian inflation rate was higher than the European average, produced significant real appreciation of the lira. When Danish voters rejected the Maastricht Treaty in their first referendum in June 1992, investors re-evaluated the credibility of the commitment on the part of the authorities in Italy and elsewhere to their ERM parities, and in late August and early September massive sales of lira overwhelmed the Banca d'Italia's ability to stabilize the currency. If earlier they had consolidated fiscal policy, the Italian authorities might have been in a better position to maintain their credibility when the parity became subject to speculation (accounts of the crisis include Deutsche Bundesbank 1992; Goldstein 1993; Henning 1994: 237–41; Padoa-Schioppa 1993; Sandholtz 1996).

### Societal preferences

The principal conceptual difficulty with both the tying hands and consequences of divergence hypotheses is that they do not analyze how the costs and benefits of macroeconomic adjustment affect domestic groups. Tying hands analysis focuses on the preferences of some policy-makers for adjustment, but does not specify the domestic political conditions under which these preferences can be implemented. Measuring the aggregate consequences of divergent macroeconomic policies fails to consider how such policies affect groups whose specific interests may differ from the national interest: 'What . . . counts is not total national costs and benefits, but their incidence, relative to existing coalitions and proto-coalitions' (Putnam 1988: 450; see also Evans *et al.* 1993; Gourevitch 1986; for an application to conditional lending by international financial institutions, see Kahler 1989).

Full understanding of the timing and form of macroeconomic adjustment requires specification of the relevant domestic groups, their preferences, and their influence over public policy. Two approaches exist in the literature; one focuses on class differences between workers and the owners and managers of capital, while the other looks to differences in policy preferences based on degree of exposure to the international economy. Consider first the distributional consequences for social classes of different monetary and fiscal policy mixes. Leftist parties that rely on members of the working class for political support should favor loose fiscal and monetary policies that reduce unemployment but might increase inflation; rightist parties supported by capital owners and managers should support restrictive macroeconomic policies to reduce inflation (Hibbs 1987). This sort of explanation does not fit the Italian experience for three reasons. First, if class interests drove

macroeconomic policy choices, we would expect to see a simultaneous tightening or loosening of *both* fiscal and monetary policies, but this did not occur. Second, the monetary tightening of the late 1980s and early 1990s was not preceded by a change in the class base of the governing majority, since all governments during this period remained centered around the center-right DC and the center-left PSI (see Table 2). Third, the shift towards fiscal tightening after 1992 was brought about not by center-right parties concerned about inflation but by governments supported by leftist parties.

A more promising explanation of short-term changes in policy focuses on the distributional consequences for economic sectors. This approach assumes that human, technological, and physical assets are fixed in the short term and concludes that the costs and benefits of macroeconomic policy fall on producers exposed to international competition and those sheltered from such competition (Frieden 1991; Henning 1994; Garrett and Lange 1996). The largest group of producers exposed to international competition is composed of export-dependent and import-competing manufacturing firms. Other groups are also exposed to international competition, such as producers of tourism, primary products, and agriculture (although agricultural producers in Italy in effect are insulated from exchange-rate changes by the European Union's common agricultural policy). In countries like Italy where most financial flows are intermediated through banks rather than capital markets, banks become dependent on the profitability of their industrial clients and therefore can be considered as indirectly exposed to the effects of international competition (Henning 1994). Producers sheltered from international competition are primarily in the service sector but may also produce certain industrial goods, such as military hardware, that are not heavily traded across borders owing to government procurement practices, market regulation, and other barriers to international trade.

Producers exposed to international competition prefer a monetary policy that results in real exchange-rate stability or depreciation to maintain their competitiveness against overseas producers. At the same time, they oppose large fiscal deficits that can drive up nominal domestic interest rates that attract capital inflows and thereby produce currency appreciation and, over the longer term, increase tax pressure to levels higher than faced their overseas competitors. Conversely, producers sheltered from international competition prefer real currency appreciation that reduces the prices of imported goods. In practice sheltered producers are likely to favor fiscal expansion because most government spending goes to domestically produced goods such as health care, income transfers, infrastructure, and so on. Table 3 summarizes these macroeconomic policy preferences and classifies the three episodes of adjustment policies implemented in Italy by their distributional consequences.

Macroeconomic policy through 1987 accommodated the preferences of both the exposed and sheltered sectors. Large budget deficits maintained demand for producers sheltered from international competition, while devaluation kept industrial firms and other exposed producers competitive on domestic and international markets. In the short term, policy-makers suffered few costs from this

Table 3 Distributional effects of fiscal, monetary, and exchange-rate policies

|                                     |  | Fiscal policy  |  |
|-------------------------------------|--|--|--|
|                                     |  | Contractionary   | Expansionary   |
| Real appreciation                   | Exchange-rate policy decreases returns to exposed sector | Exchange-rate policy decreases returns to exposed sector | Exchange-rate policy decreases returns to exposed sector |
|                                     | Fiscal policy decreases returns to sheltered sector      | Fiscal policy increases returns to sheltered sector      | Fiscal policy increases returns to sheltered sector      |
|                                     |  | <i>Monetary adjustment 1988-92</i>                       |  |
| Monetary and exchange-rate policies | Exchange-rate policy increases returns to exposed sector | Exchange-rate policy increases returns to exposed sector | Exchange-rate policy increases returns to exposed sector |
|                                     | Fiscal policy decreases returns to sheltered sector      | Fiscal policy increases returns to sheltered sector      | Fiscal policy increases returns to sheltered sector      |
|                                     |  | <i>Delayed adjustment 1980-7</i>                         |  |
| Devaluation or depreciation         | <i>Fiscal adjustment 1992-7</i>                          |  |  |
|                                     |  |  |  |

policy mix. As the earlier discussion of the tying hands strategy indicates, the formal and informal practices of the ERM during this period allowed Italian governments to devalue without implementing reforms to fiscal policy. Heavy government borrowing was possible because of the high domestic savings rate and capital controls and domestic regulations that increased the attractiveness of investment in government bonds.

Initial attempts to achieve macroeconomic adjustment after 1987 took the form of stabilizing the exchange rate. Since the Italian inflation rate remained higher than the average in the European Community, the stability of the lira in the ERM until September 1992 produced real currency appreciation that undermined the competitiveness of Italian industry. Real currency appreciation combined with large fiscal deficits favored the preferences of producers sheltered from international competition by maintaining demand for their products while decreasing the real costs of imported goods. The timing of this move towards adjustment coincided with the relaxation of capital controls and with serious discussions of a strengthening of European monetary institutions, raising the possibility that Italy could be excluded from further integration. While policy-makers favoring adjustment now could point to the greater costs of macroeconomic policy divergence, as discussed earlier this had little impact on the *form* that adjustment initially took in Italy. Monetary rather than fiscal adjustment proved to be the path of least political resistance for the coalition governments centered around the DC and PSI. As Catholic and lay political sub-cultures declined in importance in the 1970s and 1980s, these parties needed to reward their state-financed, inter-class patronage networks composed principally of sectors sheltered from international competition such as the civil service,

agriculture, construction, and retail trades (Graziano 1980; Pasquino 1987).

Adjustment after the withdrawal of the lira from the ERM in 1992 took the form of nominal and real exchange-rate depreciation and large cuts in the budget deficit. This favored the preferences of producers exposed to international competition by making their goods more competitive, while reducing the relative prices of their domestically produced inputs. Two pieces of evidence indicate that this change in form of adjustment was linked to societal preferences: lobbying by industry and changes in the governing majority.

A consequence of real appreciation of the lira was that by 1990 'the protests of Italian exporters about the loss of competitiveness had become vehement'.<sup>2</sup> But instead of advocating another devaluation, as it had in the 1980s, the peak industry association Confindustria began drawing attention to the effects of an expansionary fiscal policy. Deficit spending forced the central bank to maintain high interest rates, which in turn attracted capital inflows and appreciated the lira. Smaller deficits would reduce industry's borrowing costs as well as prevent further appreciation. While rapid growth and a lenient international environment (including strong export demand from Germany after unification) prevented serious problems in 1990 and 1991, this situation was not seen as sustainable. Industrialists also pointed out that failure to reduce the budget deficit might keep Italy out of monetary union.<sup>3</sup>

But this lobbying was ineffective until late 1992; it would not be translated into policy changes until the DC-PSI led coalition weakened with the moderation of the former Communist party, the challenge of the Lega Nord regional movement, and the systematic government corruption exposed in the Mani Pulite investigations (Gilbert 1995). In the general election of 1992 the governing parties' share of the vote fell, and for the first time they lost their electoral majority (but retained a slim majority of parliamentary seats). These parties were able to cobble together another coalition government under Socialist prime minister Giuliano Amato, who was untainted by the ongoing corruption scandals. The weakness of traditional party leaders gave Amato a window of opportunity to begin implementing important reforms to fiscal policy (Della Sala 1997: 25-6).

By 1993 the DC and the PSI had collapsed as viable political forces, and the early fiscal policy steps of the Amato government would be sustained by a new governing majority with a quite different base of societal support. With the exception of the short-lived Berlusconi government, the Ciampi, Dini, and Prodi governments relied on the former Communist party, the Partito Democratico della Sinistra (PDS), for support in parliament (see Table 2). Much of Italian industry supported the 'non-political' Ciampi and Dini governments' emphasis on fiscal consolidation and their willingness to countenance currency depreciation and to delay re-entering the ERM until late 1996. These governments also secured the political backing of the three major labor confederations for their economic policies. The largest labor confederation, and the one with the closest ties to the PDS - the Confederazione generale italiana del lavoro - was more heavily concentrated in sectors exposed to international competition than the traditional ally of the DC (the Confederazione italiana sindacati lavoratori) or that of the PSI (the Unione italiana del lavoro) (Frieden 1994). The confederations negotiated changes to wage-bargaining

institutions and pension spending with the Amato, Ciampi, and Dini governments, and played a supportive role in formulating and supporting the governments' crash programs of fiscal adjustment (Braun 1996; Chimenti 1994).

## CONCLUSIONS AND IMPLICATIONS

Table 4 summarizes the ability of each hypothesis to explain the timing and form of Italian macroeconomic policy adjustment. No individual hypothesis alone successfully addresses both these issues, although the political instability, tying hands, and class-based policy preferences hypotheses all fail to explain both the timing and form of adjustment.

Measuring the net costs of divergence successfully answers the question of the timing of adjustment but fails to predict the form this adjustment will take. Capital market and monetary policy integration did increase the overall cost of macroeconomic divergence but did not dictate a policy choice, since Italian policy-makers' attempts to adjust after 1988 were limited to first monetary and then fiscal policy. This analytical weakness is a consequence of the fact that the approach – especially when utilized by economists and policy analysts – measures the national or aggregate costs of failure to adjust without devoting attention to the incidence of these costs on domestic groups. How these costs fall on such groups has a crucial influence on the adjustment process, and understanding the politics of adjustment requires models that specify the relevant groups, their preferences, and their political importance.

Two additional findings follow from this. First, the analysis contradicts the conclusions of many explanations – particularly those that focus on political instability and policy-makers' tying hands strategies – that domestic politics interferes with a natural tendency towards the 'efficient' adjustment of policy to economic shocks. Both the political instability and tying hands approaches hypothesize that the existence of more powerful governments would have brought about more effective and timely adjustment in Italy. But knowing that a government is in a powerful position does not tell us what the government will do; instead, we also need to know what groups support the government and what these

*Table 4* Hypotheses and outcomes

| <i>Hypotheses</i>                        | <i>Does hypothesis predict timing of adjustment?</i> | <i>Does hypothesis predict form of adjustment?</i> |
|--|--|--|
| Political instability                    | No   | No   |
| Tying hands                              | No   | No   |
| Costs of divergence:<br>capital mobility | Yes  | No   |
| Costs of divergence:<br>monetary union   | Yes  | No   |
| Class preferences                        | No   | No   |
| Sectoral preferences                     | No   | Yes  |

groups want from politics. Heterodox adjustment policies may be inefficient in terms of mainstream economics but can be quite efficient in terms of garnering political support. Second, it appears that the sectoral model for defining the relevant groups and their macroeconomic policy preferences is more accurate than the class-based model. This is a contentious finding that differs from much of the literature on macroeconomic politics in advanced capitalist democracies. The analysis of one national experience cannot settle this issue, and it would be useful if future research explicitly addressed the question in a more systematic manner.

These conclusions unavoidably ignore the effects of formal and informal institutions on economic policy (e.g. Garrett and Lange 1996). Italy experienced little change in the institutions governing politics, the labor market, and the financial system from the late 1970s to the early 1990s. The only leverage over institutional effects is the case of electoral and party institutions. An electoral system based on proportional representation, and a political system with many parties, are often seen as the underlying causes of Italy's series of short-lived coalition governments, but these institutionally derived characteristics had little effect on the timing and content of macroeconomic adjustment. More recent institutional changes, such as granting independence to the central bank and some reductions in the proportionality of the electoral system (although not enough to reduce substantially the number of parties in the legislature), and the possibility of more radical changes to the constitution, will provide a useful ground for testing the political and policy effects of institutional change.

Finally, this analysis sheds some light on the politics of European monetary union. It is often assumed that monetary union is likely to produce quite deflationary macroeconomic policies. The European Central Bank, responsible for implementing a single monetary policy for the entire Union, will be legally independent of governments. All things being equal, a central bank with such a degree of political independence is likely to implement tight monetary policies that focus on maintaining low inflation. European Union governments in 1997 pledged to observe a 'Stability and Growth Pact' that penalizes member states running 'excessive' budget deficits. This combination of monetary and fiscal contraction will not be a political problem as long as most of the governments in the European Union are supported by sectors favoring this policy mix. In such a situation, the European Central Bank's single monetary policy and fiscal policy co-ordination among the member states will focus on technical rather than political issues. However, this result seems unlikely to obtain for two reasons. First, it harms both the exposed and sheltered sectors, and the empirical conclusion of this article would lead one to expect that an elected government could not maintain this policy mix for very long. Second, it is possible that governments in different countries could be supported by different combinations of sheltered and exposed sectors and therefore hold divergent monetary and fiscal policy preferences. This sort of political division among the member states could have quite serious implications for the functioning of the Union's macroeconomic policy institutions. Monetary policy would become more politicized, and the member states might try to undermine the European Central Bank's political independence in attempts to pressure the institution to

pursue favorable policies. Fiscal policy co-ordination and observance of the guidelines in the Stability and Growth Pact would also become contentious and it would be difficult for the member states to agree on an overall fiscal stance that is appropriate for the entire European Union.

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## ACKNOWLEDGEMENTS

I thank C. Randall Henning, James Lee, Martin Rhodes, Stephen J. Silvia and two anonymous referees for comments on earlier versions of this research and American University, the Delegation of the European Commission to the United States, and the European University Institute for financial and research support.

## NOTES

- 1 Guido Carli, who served as treasury minister during the Maastricht Treaty negotiations, would later write that his goal was to use the convergence criteria negotiations as an 'alternative solution to problems that we were not able to tackle through the normal channels of government' (Carli 1993: 435, my translation), but this claim is belied by the Italian negotiators' actual behavior.
- 2 *Bancaria* 1990 (quotation is from p. 50 and is my translation), and interview with former Banca d'Italia official.
- 3 *Il Mondo Economico* 1990, 1991a, 1991b, 1992a, 1992b, and interview with Banca d'Italia official.

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