Financial Interdependence and the State: International Monetary Relations at Century's End

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Barry Eichengreen and Jeffry Frieden, eds. 1994. *The Political Economy of European Monetary Unification.* Boulder, Colo.: Westview Press.

Eric Helleiner. 1994. *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s.* Ithaca, N.Y.: Cornell University Press.

C. Randall Henning. 1994. *Currencies and Politics in the United States, Germany, and Japan.* Washington, D.C.: Institute for International Economics.

Michael Webb. 1995. *The Political Economy of Policy Coordination: International Adjustment Since 1945.* Ithaca, N.Y.: Cornell University Press.

Introduction

As the twentieth century draws to a close, one can find sharply contrasting views among leading scholars on almost every key issue in positive international political economy. How strong are international as opposed to domestic influences on policy? How important are issues of national security ("high politics") versus economic considerations ("low politics")? What role do institutions—international and domestic—play in influencing and constraining the behavior of governments? Why is international cooperation rare but not unheard of? The list goes on and on.

The volumes under review here address these and related questions. Collectively they demonstrate that increases in economic and financial interdependence have had a major impact on national economic policies but that these effects differ across countries—depending in part on the nature of domestic economic and political institutions. They suggest that international policy coordination during the Bretton Woods system was not as strong as is frequently assumed in current scholarly writings and

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policy discussions, and consequently policy coordination has not declined as substantially as some have supposed. They document how changing views of economic theory—such as declining confidence in a long-run trade-off between inflation and unemployment—can have powerful influences on policy. They remind us that unlike liberalized trade, liberalized financial markets were not an objective of the Bretton Woods negotiators. And they reveal that the push for monetary integration in Europe has had more to do with political than purely economic objectives.

These volumes provide a great deal of valuable information about extremely important international economic matters. Our review focuses on four of these issues: financial market *liberalization*, international policy *coordination*, policy convergence aimed at *disinflation,* and (within the European context) continuing attempts at monetary *integration*. We begin our survey with a simple but very important question: Why has country after country decided to adopt more liberal domestic and international financial policies, especially during the 1970s and 1980s? This is the primary focus of Eric Helleiner's volume. We then turn to the consequences of economic and especially financial market integration for exchange-rate and macroeconomic policy coordination among the major industrial countries. These are the major foci of C. Randall Henning's and Michael Webb's volumes, and, like them, we use domestic interest groups and government structures as explanatory variables. Next, drawing on contributions from all four volumes under review, we address the sources of disinflationary policy convergence during the late 1970s, 1980s, and 1990s. Finally, we turn to issues of European monetary integration, focusing on the contributions in the volume edited by Barry Eichengreen and Jeffry Frieden.

As reviewers, our major criticism of these volumes could apply as well to the vast majority of recent research in international political economy. These studies tell us a lot about factors that are undoubtedly important but much less about the more difficult question of the *relative* importance of these factors. We argue that efforts to discriminate among different hypotheses according to their relative explanatory power should receive much greater emphasis in the research agendas of scholars in international political economy. Only then can we begin to develop a fruitful consensus on the questions mentioned in our opening paragraph.

Liberalization: Financial Market Integration and the Decline of Capital Controls

The origins of capital market integration can be addressed from a variety of perspectives. Attention can be focused on policymakers' causal beliefs and normative preferences,[1] changes in the economic and political environment of the international system (or of key states therein),[2] or on the microfoundations of the movement toward

1. Along the lines suggested by Peter Hall and his colleagues in Hall 1989.
2. Compare Gourevitch 1986.

international capital market liberalization.[3] Helleiner's *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* includes elements of each. The author develops a careful historical analysis, intended to challenge "the argument that the globalization trend in finance has somehow been beyond politics" by providing a "synthetic 'political' history of the [financial] globalization process which focuses primarily on the crucial role played by advanced industrial states."[4]

In so doing, Helleiner provides a valuable corrective to the popular notion that the globalization of financial markets was a direct consequence of the international economic order established under the leadership of the United States at the end of World War II. In fact, the negotiators at Bretton Woods drew a sharp distinction between the utility of liberalization in the realms of trade and finance; it was not until the late 1950s that this distinction began to break down. Helleiner usefully highlights the role that changing ideas about the desirability and effectiveness of capital controls played in the resulting process of financial liberalization, focusing on the underlying interests and changing political influence of private international bankers in London and New York. In addition, he notes how the emerging strategic interests of governments in the United States and Britain led them to promote a more open international financial order.

This analysis leads Helleiner to resist the conclusions of "most histories of the globalization of finance [that] stress the influence of technological changes and market developments" and in which "states have played only a minor role in the globalization process."[5] Instead, he argues that "advanced industrial states have played an important role in the globalization process since the late 1950s"—by granting increasing freedom to financial market actors, by choosing not to implement more effective capital controls when they had both the legal right and (at least arguably) the technical expertise to do so, and by cooperatively preventing the emergence of major international financial crises (in 1974, 1982, and 1987). [6] To Helleiner, the relative increase in financial (as opposed to trade) liberalization is not evidence that financial "globalization" is somehow beyond the control of states.[7] Rather, the behavior of states in these two realms has substantially differed, not least because "the power and interests of three key states—the United States, Britain, and Japan—in finance and in trade differed,"[8] as well as because of differences in the nature of collective action in the two areas.[9]

3. Along the lines of Frieden 1991; Goodman and Pauly 1993; or Sobel 1994.

4. Helleiner 1994, 2. Helleiner identifies other challengers to the thesis of apolitical financial integration, among them Frieden 1987; Pauly 1988; and Strange 1986.

5. Helleiner 1994, 6–7.

6. Ibid., 21.

7. In a similar vein, Kapstein 1994, 9, argues that "the linkages between states and their national banks have not been broken by globalization, and in some respects they have even been strengthened."

8. Helleiner 1994, 207.

9. Ibid., 196–98. Helleiner posits several other partial explanations of differences in behavior in these two domains as well, including the argument that central bankers constitute a nascent epistemic community; see ibid., 198–201.

Causality

A cursory review of Helleiner's book might lead one to conclude that he openly rejects the thesis that international financial integration is a determinant of international monetary behavior. After all, how can financial integration properly be regarded as exerting a constraining influence on states when states themselves have played leading roles in the liberalization process? A more careful reading, however, suggests that Helleiner regards the policy decisions of monetary authorities and the financial environment within which they operate as closely interrelated, with strong feedback effects from one to the other.[10] Far from rejecting the view that financial integration imposes a constraint on states' monetary policy autonomy, Helleiner maintains that

> There is some validity to the argument that market pressures (such as increased financial competition and the growth of multinational corporations) can explain the [financial] globalization process. Whereas some see such pressures as promoting globalization *directly*, however, I am arguing that the influence was *indirect*; the support of neoliberal advocates by private financial firms and multinational corporations encouraged states to turn away from the restrictive Bretton Woods financial order.[11]

Put differently, Helleiner's book tells us much about the *process* whereby international market pressures—themselves influenced partly by technological developments—were translated into liberalizing policies, a process that was unmistakably political. Helleiner is quite successful in redressing the widespread view that these outcomes were driven in some automatic fashion by markets and technology. Neither "forced" to liberalize in any deterministic sense, nor completely at liberty to resist the forces of liberalization, states instead became partners in the process of international financial liberalization.[12] The mechanisms through which this policy transformation occurred require more careful study, however.[13] At present we have little basis to compare the utility of the "outside-in" approach adopted by Helleiner with that of interest group–based, "inside-out" approaches such as that employed by Andrew Sobel.[14]

10. See Goodman and Pauly 1993 for arguments along similar lines. Helleiner's argument is consistent with the so-called agent-structure problem, in which actor agency and system structure are regarded as mutually constituted; see Wendt 1987. For an application to issues of international capital mobility, see Thomas and Sinclair 1997.

11. Helleiner 1994, 16, fn. 29; emphasis in original. For a further refinement of his views, see Helleiner 1995, 337.

12. Indeed, Loriaux 1991 argues that the French financial liberalization of the 1980s was intended (somewhat paradoxically) to increase the French state's influence over the institutions of domestic society. Although the analysis Loriaux provides focuses on a single case, the themes he identifies are probably generalizable; see in this regard Kurzer 1993, as well as Webb's discussion of the "unintended consequence(s) of earlier choices to liberalize"; Webb 1995, 18.

13. In addition to the traditional case study approach, there is considerable scope for useful quantitative research in this area. See the pioneering studies by Alesina, Grilli, and Milesi-Ferretti 1994, 289–321; and Quinn and Incan 1997.

14. Sobel 1994. For a discussion of inside-out and outside-in approaches, see Cohen 1996.

Capital Controls

Helleiner presents a valuable discussion of the early debates surrounding the use of exchange controls as a tool intended to insulate national financial markets from one another.[15] Just as the problem initially facing postwar planners was one of mutual inconsistency (between stable exchange rates, independent national macroeconomic policies, and the free movement of financial assets), so the solution adopted at Bretton Woods contained within it elements that were mutually inconsistent. To simplify slightly, the new regime called for liberalizing trade within an environment of exchange-rate stability; exchange controls were viewed as an important tool for the insulation of national capital markets within this system. But whereas the Bretton Woods planners believed that capital flows could be regulated with little adverse effect on trade, experience soon showed otherwise. To have sufficient bite, capital flow restrictions needed to be tough and comprehensive—and consequently more harmful to trade financing than originally thought. In the absence of comprehensive controls, higher capital mobility during the late 1960s and 1970s increased the salience of the one-way speculative option generated by the Bretton Woods adjustable peg exchange-rate mechanism. In short, countries needed to move toward either more genuinely fixed or more genuinely flexible exchange rates.

The eventual collapse of the Bretton Woods system represented a solution of sorts to this dilemma, but the underlying debate lives with us still. For example, although it has recently become popular to argue that international capital mobility has progressed so far that capital controls have lost almost all scope for effectiveness, the truth is rather more complicated. Capital controls induce a great deal of evasion, but that is quite different from saying that they cannot be effective.[16] Moreover, the long-term relationship between capital mobility and trade remains subject to debate. In the tradition of Nurske and Keynes, Helleiner regards capital flows as frequently being a source of instability: destabilizing speculation causes violent fluctuations in exchange rates, which in turn disrupt trade and stimulate protectionism.[17] From a purely economic standpoint, however, the relationship between capital mobility and exchange-rate volatility varies substantially depending on the nature of underlying shocks.[18] Furthermore, although the results of empirical studies are mixed, most find that the effects of exchange-rate instability in discouraging international trade are not strong.[19] In light of this observation, and the limited ability of governments to use controls to discourage "bad" (disruptive) capital flows while allowing "good" (productive) ones, many economists dispute the existence of a fundamental conflict between liberal finance and liberal international trade.[20]

15. Helleiner 1994, 9–10, 28–33, 44–49.
16. On the effectiveness of capital controls, see the analysis and references in Dooley 1995; Marston 1995; Shafer 1995; and Cohen 1996.
17. Helleiner 1994, 206–207.
18. Willett and Wihlborg 1990.
19. For reviews of this literature, see Willett 1986; and Eichengreen 1992 and 1993.
20. For recent views on capital restrictions, see the exchange of views in *Economic Journal* 105 (Jan. 1995): 160–92, 428; Edwards 1995; and Ries and Sweeney, forthcoming.

On the other hand, a political analysis would distinguish between this straightforward market approach to currency fluctuations and the possible effects of exchange-rate movements on trade policy.[21] Should exchange rates change substantially, governments may be pressured to abandon plans for trade liberalization or to adopt trade restrictions; indeed, such issues rose to prominence within Europe following the ejection of the lira and the pound sterling from the exchange-rate mechanism of the European Monetary System (EMS) in 1992. Although there are also strong disincentives against actually adopting protectionist policies, political economists would be well advised not to discount such outcomes a priori.

Coordination: Capital Mobility and International Policy Cooperation

In examining international monetary cooperation (or its absence), it is useful to distinguish between the internal and external determinants of policy. Externally, governments are constrained in their ability to pursue uncoordinated macroeconomic policies; the resulting balance-of-payments disequilibria, especially under conditions of advanced financial integration, will eventually manifest themselves in terms of substantial (and undesired) exchange-rate movements under flexible rates or financial crises under pegged rates.[22] Internally, however, governments are subject to pressures with respect to macroeconomic policy as well. At least occasionally, they are pressed by politically powerful domestic interests to pursue macroeconomic policies at odds with those of foreign partners, frustrating efforts at international policy coordination. Because of these internal pressures, states have traditionally been loath to make commitments for international policy coordination that might limit domestic policy autonomy.

In *The Political Economy of Policy Coordination: International Adjustment Since 1945*, Webb pays particular attention to coordination's external dimension. Building on a typology introduced by Robert O. Keohane, Webb usefully distinguishes between policy coordination as the provision of supplementary balance-of-payments financing ("symptom management") and as negotiated mutual policy adjustments.[23] Webb's analysis emphasizes how changes in the degree of international capital mobility have altered the systemic constraints facing states and how these changes have induced shifts in domestic economic policy. In his view, policy coordination efforts—that is, efforts to produce negotiated mutual policy adjustments—have actually *in-*

21. As Eichengreen and Ghironi 1995 note, such pressures come more from prolonged misalignments than from short-term volatility of exchange rates.

22. Contrary to standard usage in economics, the term *constraint* here as elsewhere in this article refers to a continuous variable; synonyms include pressure. We do not mean to suggest that states' choices are so tightly constrained as to exclude the exercise of political agency; see Andrews 1994, especially 203–209.

23. Keohane 1984, 4, 25.

creased over the past twenty-five years as states have sought to mitigate the economic and political costs imposed by international financial integration.[24]

Capital Mobility and Hegemonic Stability Theory

Webb's observation in this regard contrasts with the perceived diminution of successful collaborative multilateral initiatives in the field of international monetary relations at the global level during the 1970s and 1980s, bemoaned by many observers as an example of decreased international leadership on the part of the United States. In Webb's view, however, this analysis (associated with hegemonic stability theory) is fundamentally incorrect. International monetary coordination has in fact always been rather limited; what has changed most significantly is its form.

Monetary cooperation efforts during the 1950s and 1960s focused on the international provision of balance-of-payment financing, but these efforts were rendered progressively less useful as financial markets became more integrated; under these circumstances, international stability required greater coordination of macroeconomic policies. As emphasized by Webb, policy coordination of this latter variety was much more likely to conflict with domestic political interests than merely bargaining over the provision of supplementary balance-of-payments financing.[25] In his view, the greater degree of international monetary instability that has characterized the 1970s, 1980s, and 1990s does not necessarily reflect a decreased propensity to cooperate on the part of major governments. Rather, changes in the financial interdependence of states have made the successful coordination of policy more costly (in domestic political terms).[26]

The extensive documentation presented by Webb in support of his argument is a healthy corrective to more nostalgic discussions of the Bretton Woods system. He argues that "although international economic instability was much greater in the 1980s than during the Bretton Woods years, this change was a consequence less of the posited erosion of American hegemony than of the increasing integration of capital markets,"[27] mirroring Helleiner's claim that "the financial power of the United States had not really declined with respect to other states but only vis-à-vis the growing global financial markets."[28]

Despite these cogent criticisms of hegemonic stability theory, Webb is hardly indifferent to the role of power in determining the outcome of policy coordination efforts. He notes that "governments retain considerable freedom to adopt policies tailored to their domestic political circumstances, even though the costs of policies inconsistent

24. Webb 1995, 11.

25. Indeed, Webb insists that his "explanatory model is based on the view that domestic political considerations are of primary importance"; Webb 1995, 19.

26. Compare Bergsten and Henning 1996, who argue that policy coordination efforts among the G-7 countries have declined over the past decade because of unjustified perceptions of policy impotency in the face of high international capital mobility.

27. Webb 1995, 9.

28. Helleiner 1994, 134.

with international market pressures can be high."[29] Consequently, the distribution of the costs associated with coordination becomes a critical issue.[30] Webb argues that "international bargaining power shapes the distribution of the burden of policy adjustment among cooperating governments far more than does the concern about maximizing welfare that motivates many discussions of international policy coordination."[31] We concur in this assessment and will return to the issue of bargaining power later in this article.

Macroeconomic Coordination and Exchange Rate Crises

As the foregoing suggests, the constraining effects of financial market integration on states' policy choices are among the most significant developments of the last several decades in the international political economy. As Webb notes, the reduction of capital controls and the increase in capital mobility of recent years have been accompanied by the adoption of increasingly similar (and stability-oriented) trends in national monetary policies by industrial states around the world.[32] Yet the recent trend toward monetary policy convergence and low rates of inflation has also been accompanied by periodic turbulence in foreign exchange markets—for example, the turmoil in western Europe during 1992–93 and the march of the Japanese yen to stratospheric heights in 1995. Should not policy convergence have reduced the international monetary system's propensity to experience exchange-rate crises?

In fact, it may have done exactly that. A number of factors are simultaneously in play here, and careful attention to the role of international capital mobility is crucial. By facilitating speculative attacks on currencies, the increasingly integrated international financial environment has augmented the incentives for mutual policy adjustment precisely *because* the failure to adjust adequately is more likely than ever to be punished. In the absence of substantial monetary policy convergence, market-generated shifts in exchange rates would almost undoubtedly be even larger and more frequent (given the current financial environment). Capital mobility, in other words, simultaneously promotes both policy coordination and (where sufficient coordination is absent) exchange-market crises.

One important key to understanding the continuing propensity of exchange rates to experience major fluctuations despite substantial convergence in the monetary policies of the major industrialized countries is the remaining disparity (both actual and anticipated) in their fiscal policies. When a strong domestic consensus exists on a particular budget formula, or when powerful coalitions block policy actions such as reductions of budget deficits, the scope for international coordination of domestic economic policies becomes quite limited. The descriptions of policy coordination

29. Webb 1995, 19.
30. See in this regard Simmons 1994; and Andrews 1994, 211–14.
31. Webb 1995, 9–10. Chapter 2 of Webb's book offers a good discussion of the sources of this bargaining power, especially 27–36; we wish, however, that he had applied this analysis more systematically in his later discussion of actual coordination efforts.
32. Webb 1995, 189, 215; see also 140–41, tabs. 8, 9; 152, tab. 11; and 190–91, tabs. 13, 14.

efforts offered by both Webb and, as we shall see, Henning emphasize the domestic difficulties associated with reaching effective international agreements and the apparently limited range of circumstances under which comprehensive macroeconomic policy coordination can appear to be at once in policymakers' interest and within their capabilities.

The most famous instance of successful coordination was the Bonn Summit of 1978. Webb aptly quotes from Putnam and Bayne:

> Each of the three governments called upon to make the most specific contribution to the bargain—the United States, Germany, and Japan—was internally divided. Within each, one faction supported the policies being demanded of their country internationally, but it was initially in the minority. In each case, the domestic advocates of the internationally desired policy were able to use the summit process to shift the internal balance of power in their favour.[33]

The Bonn summit demonstrated that national leaders can use high-level international forums to help manage the domestic politics of macroeconomic policy. Of course, the reverse outcome is possible as well. Even where executives would like to agree on coordination efforts, rational concerns about the negotiators' abilities to implement agreed policies can cast a shadow over negotiation efforts. As Henning's discussions emphasize, this is especially the case with respect to fiscal policy. Henning concludes that the Japanese Ministry of Finance "never compromises to foreigners on fiscal policy, only on monetary policy."[34] In Germany, although the Bundesbank (because of its greater independence) adjusted its monetary policies to international influences less than did the Bank of Japan,[35] fiscal policy followed Japan's pattern of general unresponsiveness to international influences.[36] The situation in the United States with respect to fiscal policy is no different. Major fluctuations in the dollar have been caused by the course of U.S. fiscal policy, whereas only occasionally has the behavior of the dollar had any influence on U.S. budgeting policy.[37]

Societal Preferences and Macroeconomic Policy Autonomy

Whereas the optimistic view of international policy coordination sees efforts at economic policy coordination resulting in beneficial spillover into other areas of cooperation, all too often the reverse occurs: policy coordination discussions degenerate into public displays of mutual recrimination.[38] The European exchange-rate crisis of

33. Putnam and Bayne 1984, 97–98.
34. Henning 1994, 174.
35. Except perhaps with regard to the timing of interest-rate changes.
36. Whereas sufficiently large and prolonged fiscal deficits can ultimately force monetary accommodation, the well-developed nature of financial markets within most industrial countries provides scope for considerable short-term independence between fiscal and monetary policies.
37. Webb suggests that "there are indications that diplomatic considerations sometimes influenced U.S. budget politics, although the impact was undoubtedly minor"; see Webb 1995, 229.
38. See also Bergsten and Henning 1996; and Funabashi 1988.

1992–93, for example, generated considerable political ill will as governments offered conflicting views of the causes of the crisis and what adjustments ought to be undertaken. The recurrent nature of such episodes and the depth of mutual antagonisms they reveal suggest that powerful forces are at work.

These forces are the subject of Henning's volume, *Currencies and Politics in the United States, Germany, and Japan.* Although Henning acknowledges the important role of the balance-of-payments constraint on countries' economic policies, he explicitly rejects the view advanced in some quarters that financial globalization has resulted in convergent preferences among the advanced industrialized states.[39] Rather, he argues that the pressures caused by changed external conditions are filtered through internal structures; differences in these structures (particularly in the organization of the private sector and of the state) can translate the same external conditions into different policies. The purpose of Henning's analysis, then, is to compare states' policy preferences.

Henning succinctly disaggregates interests within the domestic political economy in order to account for variations in policy preferences and strategies across states. Contrary to most analysis of international monetary relations, Henning argues that "bank-industry relations and private preferences, not the role of the state, [should be placed] at the beginning of the causal chain."[40] Banks typically have less intense economic interests in exchange-rate policies than does industry, but they have greater influence with central banks and finance ministries; states in which the banking system has a stake in industrial success are therefore much more likely to favor policies resulting in undervalued exchange rates than are states in which financial and industrial interests are divorced from one another. Thus where banks have strong direct ties with industry, as in Japan and Germany, a much stronger lobbying force exists for competitive exchange rates than in countries like the United States, where the relationship between industry and finance remains at arm's length.

Public choice analyses of interest group influence have been widely applied to the study of international trade policies but rather less to international monetary policies.[41] This is quite understandable, since as Joanne Gowa has shown, there is typically more "publicness" to monetary policies than to trade policies (and hence weaker private incentives for groups to lobby).[42] For the United States, such private-sector lobbying on exchange-rate policy has indeed been rare.[43] But Henning's careful comparative study shows that—of his three case studies—the United States is exceptional in this regard, consistent with his hypothesis concerning the ties between banking and industry.

39. Henning 1994, 48–59. For a similar argument with respect to behavior of private firms, see Pauly and Reich 1997.

40. Henning 1994, 59. Compare Zysman 1983; and Hall 1986.

41. For exceptions, see Frieden 1991; Giovanni 1992; and Hefeker 1997.

42. Gowa 1988.

43. The mid-1980s was the notable exception, as highlighted in an earlier important work by Henning with Max Destler; Destler and Henning 1989.

Henning also stresses the role played by political institutions. Central banks typically emphasize inflation control, whereas finance ministries generally assign greater value to broader economic objectives such as unemployment and industrial competitiveness; thus ceteris paribus the greater the degree of independence of central banks, the greater the overall weight given to price stability objectives. Henning provides excellent accounts of the differences in central bank–government relationships in Germany, Japan, and the United States, stressing the important effects that different institutional arrangements can produce while recognizing that even ''independent'' central banks are not completely free from political pressures.[44] For example, governments typically retain authority for setting exchange-rate regimes and parities, whereas central banks generally carry out exchange-market intervention. This distribution of labor helps explain why the German government, representing as it does the most open of the three economies examined by Henning, has been prepared to participate in regional exchange-rate experiments that did not always coincide with the preferences of its powerful central bank.

More generally, there have been occasions in all three countries when external considerations were a primary determinant of domestic monetary policy.[45] In the United States, however, this has been quite rare; and in Germany, because of the considerable degree of independence of the Bundesbank, this has occurred less frequently than in Japan. Henning provides particularly useful discussions of the formal institutional arrangements that have influenced the limits of the Bundesbank's obligation to intervene in support of other currencies within the exchange-rate mechanism of the EMS,[46] as well as the bias toward inaction that results from the unusual sharing of responsibilities between the U.S. Treasury and the Federal Reserve for foreign-exchange market operations.

Henning's analysis offers substantial insights into differences in the policy preferences of policymakers across states. On the other hand, by focusing on such structural determinants as the organization of the state and of bank-industry relations, the framework he develops is understandably less capable of addressing fluctuations in particular states' policies over time. Future research might profitably devote more attention to partisan considerations as well as to the roles of the conceptual frameworks or belief systems of key government actors, as we discuss later.

44. Henning also briefly considers relationships in France (which is rather more like Germany and Japan) and the United Kingdom (which is rather more like the United States, but with a financial sector that has traditionally had a stronger influence on exchange-rate policy). Complementary analysis is provided by Paulette Kurzer, who attributes the ''sensitivity of Belgium and the Netherlands to trends in global markets to the position of the financial sector relative to other economic institutions and state agencies''; Kurzer 1993, 5.

45. Katseli 1989 argues that changes in the international financial environment have resulted in a deflationary bias on macroeconomic policy issues. An alternative view is that they have partially offset inflationary biases; see Willett 1988a.

46. Henning's account of the early years of the EMS contains some minor inaccuracies, including miscounting the number of exchange-rate realignments. These do not distract from the substance of his analysis.

Disinflation: The Sources of Recent Macroeconomic Policy Convergence

One of the most remarkable developments of the 1980s was the substantial reduction in the rates of inflation in industrialized countries (and in many developing countries as well).[47] One partial explanation of this outcome is that increased financial interdependence raised the costs of pursuing more inflationary policies than one's neighbors, as stressed by both Webb and Henning. For example, Henning argues that

> the increase in international capital mobility for Japan produced a fundamental transformation in Japan's external macroeconomic relations. Through its effects on the exchange rate, international capital mobility also transformed the domestic politics of macroeconomic policy in Japan . . . . Private-sector preferences with respect to fiscal policy changed as the mechanisms through which it worked were altered by capital liberalization. Because a fiscal stimulus would tend to push the yen upward, Japanese business had far less incentive to lobby for budget expansion than it did during the 1970s.[48]

Likewise, Paulette Kurzer stresses the roles played by direct investment in strengthening management's hand relative to labor's in wage negotiations and by financial capital flows in limiting governments' abilities to pursue Keynesian-oriented expansionary macroeconomic policies.[49]

It is important to recognize, however, some caveats about the consequences of international capital flows for national macroeconomic policies. In particular, the short-term effects of capital mobility on monetary and fiscal policy may differ quite substantially. In the classic Mundell-Fleming analysis, whereas loose monetary policy generates capital outflows, loose fiscal policy (if not monetized) will attract capital inflows. Large, prolonged deficits will ultimately reduce confidence and raise the cost of new international financing. However, initially the inflows of capital generated under conditions of advanced financial integration may actually make it *easier* to finance increased budget deficits. In such cases, any early disciplining would come from the effects of payments surpluses and currency appreciation rather than through the traditional channels of payments deficits and depreciation. And as Henning demonstrates, sensitivity to currency appreciation varies substantially between countries. In Japan, for example, concerns over the effects of currency appreciation had a substantial impact on the business community's weakening support for fiscal expansion. Even in the United States, the rise in the value of the dollar resulting from the combination of tight money and easy fiscal policy during the 1980s ultimately brought pressures on fiscal as well as trade policies—but only after a lag of several years.

47. For an analysis of the role of exchange-rate crises in provoking financial liberalization in developing states, see Haggard and Maxfield 1996.
48. Henning 1994, 141–42.
49. Kurzer 1993.

In short, although high capital mobility generally constrains monetary policies, in the short run it can sometimes ease the financing of fiscal deficits.[50] Exactly this phenomenon has occurred within Europe. Marcello De Cecco and Francesco Giavazzi argue that capital inflows during the 1980s "reduced the urgency with which the Italian political leaders had to address the structural problems of the Italian economy . . . a fool's paradise was created in Europe with foreign short-term capital flows validating the virtuousness of monetary authorities and the profligacy of political authorities, putting fiscal and monetary policies on collision courses which foreign capital inflows temporarily managed to hide from view."[51]

Policymakers' Beliefs and the Role of Ideas

The domination of fiscal policy by domestic considerations helps explain why exchange-rate fluctuations have remained large despite the remarkable convergence of inflation rates among advanced industrial societies to low levels in the 1980s. It also raises questions about the extent to which the external constraints argument can explain the disinflationary record of this period. It seems likely that a substantial part of the disinflationary convergence of the industrial countries was due to the international transmission of changed ideas about inflation, as opposed to the international transmission of direct economic effects. Combined with the theoretical and empirical research of professional economists, the stagflationary experiences of the 1970s fundamentally changed perceptions of the utility of expansionary macroeconomic policies over the medium and long terms.[52]

In the short run, expansionary macroeconomic policies do still tend to increase output and employment, whereas contractionary policies reduce them. However, rather than a positive long-run trade-off between inflation and growth as assumed in traditional Keynesian models, mounting evidence shows that higher rates of inflation tend to be more variable and therefore to generate greater uncertainty than low-inflation environments; this in turn tends to depress rather than to stimulate economic growth.[53] Knowledge of the adverse longer-run effects of inflation is often not sufficient to eliminate political pressures on macro policy; nevertheless, increased recognition of the costs of inflation appears to have had a major impact on the views of a number of officials in both international organizations and national governments.

50. In our view, this accounts for Garrett's finding that "rather than being constrained by increasing capital mobility, the relationship between left-labor power and fiscal expansions has strengthened [during the 1970s and 1980s] with greater internationalization"; Garrett 1995, 682.

51. DeCecco and Giavazzi 1994, 231. For further analysis of this issue, see Giavazzi and Spaventa 1990; and Bini-Smaghi and Micossi 1990. An early caution about this potential problem was given by Walters 1986.

52. Recent work that stresses the role of changing ideas about inflation includes Collins and Giavazzi 1993; Sandholtz 1993; and McNamara 1997.

53. For recent analysis and references to the literature, see Burdekin, Salamun, and Willett 1995.

Certainly this hypothesis seems worthy of careful study along the lines of Peter Hall's edited volume on the spread of Keynesian ideas.[54] Helleiner's book provides an excellent analysis of the shift from embedded liberal to neoliberal ideas during the postwar period; Kathleen R. McNamara examines similar developments within the European context during the 1970s and 1980s.[55] Careful case studies such as these provide a necessary foundation for discrimination between contending generalized explanations.

Exchange-Rate Pegging and Disinflation

A third explanation of the shift to disinflation, and one that has attracted considerable popularity in both academic and official circles, focuses on the role of pegging exchange rates as a commitment mechanism in order to promote disinflationary policies; the EMS is generally cited as the prime example.[56] Beginning in 1979, participants in the exchange-rate mechanism of the EMS pegged their exchange rates, and under this regime a number of EMS countries have successfully disinflated. A causal relationship is often posited between the institutions of the EMS and this outcome; Bank of France official André Icard's statement in this regard is typical: "One of the greatest achievements of the ERM [the exchange-rate mechanism of the EMS] has been to promote convergence on lower inflation rates."[57]

It is worth recalling the academic debates on disinflation underway at the time when this interest in exchange-rate pegging arose. During the late 1970s and 1980s, developments in the literature on public-choice and rational-expectations macroeconomics stressed the incentive compatibility problems that stimulated pressures for the government to create inflationary surprises and thereby generate political business cycles. These insights stimulated economists' interests in finding institutional mechanisms to limit or to offset the resulting incentives for inflationary bias.[58] The simplest approach is to adopt money growth rules, á la Milton Friedman; however, the effectiveness of this approach relies on the velocity of money being relatively stable, and in many countries the variability of the velocity of money has increased substantially (due to financial innovations and other factors, including to some extent international currency substitution). Thus the economic literature began to focus variously on more complicated multistage rules (which are of course less attractive politically), greater central bank independence, and exchange-rate pegging. The EMS employed this latter strategy, whereas elements of the latter two approaches were later combined in the Maastricht Treaty's plans for the transition to EMU (Economic and Monetary Union).

54. Hall 1989. See also Webb's interesting argument that it is questionable whether a Keynesian consensus guided international macroeconomic coordination efforts in the 1960s; Webb 1995, 136–37.

55. McNamara 1997.

56. On the founding of the EMS, the classic work is Ludlow 1982; see also Story 1988; and Walsh 1994.

57. Icard 1994, 243.

58. See, for example, Dorn and Schwartz 1988; Willett 1988b; Persson and Tabellini 1994; and Wijnholds, Eijffinger, and Hoogduin 1994.

It was in this context that older, disciplinary arguments for pegged exchange rates were revived in modern and technical formulations, focusing on issues of credibility.[59] In particular, theorists became interested in the role of credible institutional commitments in reducing the transitional output and employment costs of pursuing disinflationary policies. And although (as Webb notes) most policy officials have paid little attention to technical research on the econometrics of policy coordination,[60] economists' ideas on the potential benefits of credibility gains through exchange-rate pegging did become quite popular in a variety of policy circles—including the European Commission and several European governments.

After an initial period of exchange-rate instability, most participants in the exchange-rate mechanism of the EMS experienced substantial disinflations beginning in the middle and late 1980s. Frieden, for example, shows that during the decade from 1977–78 to 1987–88 the inflation rates of four original EMS members had fallen further relative to Germany than had those of a group of seven non-EMS members.[61] In the later 1980s the International Monetary Fund attempted to export the apparent success of the EMS to other industrial and developing countries, as well as to the "economies in transition" of the former Soviet bloc, urging them to adopt pegged exchange-rate regimes.

In retrospect, however, the evidence is mixed as to the relative success of disinflationary efforts among the European countries that pegged to the deutsche mark (some through the EMS, some unilaterally) as opposed to those that chose more flexible exchange rates. Although specific results vary somewhat depending on the time periods and particular sets of countries compared, several recent studies demonstrate that disinflation occurred more rapidly on average in the non-EMS countries considered; furthermore, the unemployment costs of these disinflations were, if anything, somewhat lower.[62] In light of this evidence, Eichengreen argues that "changing attitudes toward inflation were conducive to exchange-rate stability and the emergence of the EMS, not that the EMS played a causal role in bringing down European inflation."[63]

Although we substantially concur with this assessment, we nevertheless note that the institutions of the EMS did play an important role in this process, both in the transmission of policy ideas and in helping to create a more congenial environment in which to undertake sometimes painful economic reforms. The evidence strongly suggests that the credibility of bilateral exchange-rate pegs within the EMS increased during the 1980s, and, as Eichengreen notes, this was largely due to major changes in domestic economic policies.[64] In other words, credibility was primarily earned the old fashioned way (through monetary and fiscal restraint) rather than on the cheap (through simple declarations of commitment to multilateral exchange-rate regimes).

59. Willett and Mullen 1982.

60. See the discussion in Webb 1995, 201–204.

61. In Eichengreen and Frieden 1994, 28.

62. See, for example, Collins 1988; Giaviazzi and Giovannini 1988 and 1989; and Fratianni and von Hagen 1992.

63. Eichengreen 1992, 6–7.

64. Burdekin, Westbrook, and Willett 1994; see also De Grauwe 1994; Froot and Rogoff 1991; Giovanni 1990; and Woolley 1992.

However, high-level international commitments such as those involved in the EMS may have augmented the political resources—and hence the political will—of governments already predisposed to adopting disinflationary reforms.

Credibility, French Policy, and the Evolution of the EMS

Too often exchange-rate credibility is discussed as an all-or-nothing variable. Typically, however, it is a matter of degree: less credible policies are seen as having a lower probability of being sustained than are more credible policies. In rational choice models, these probabilities will be a function of the expected costs of maintaining the policy or regime, on the one hand, or of abandoning it, on the other. To most economists, formal exchange-rate commitments are viewed as raising the costs of abandoning the domestic policies necessary to maintain the peg, thus increasing the credibility of anti-inflation efforts. Although typically assumed to be high,[65] we actually know relatively little about the political costs imposed by the abandonment of exchange-rate commitments—an important area for future study.

Frieden's contribution to the Eichengreen and Frieden volume is consistent with this view of credibility as a variable.[66] He focuses on "the ways in which the French and Italian governments' commitments to a fixed exchange rate became increasingly credible between 1979 and 1985."[67] He identifies six possible explanations of this change: the efficacy of the formal institutions of the EMS, the relative transparency of exchange-rate targeting, the convergence of national preferences among EMS member states, changes in the international economic environment, changes in the structural characteristics of EMS member states, and linkage politics. Most of these hypotheses, however, he finds wanting. He concludes that the success of the EMS in the 1980s rests on linkage politics and especially linkage between progress on monetary coordination with the broader issues of European economic and political integration.

Frieden argues that in both France and Italy, there was broad agreement among sectoral interest groups on the general desirability of European integration, whereas sharp cleavages existed on the issue of monetary integration or participation in the exchange-rate mechanism of the EMS. "Linking the exchange-rate issue to European integration more generally, then, created a new political reality, for a country's inability to join [the ERM] implied moving away from the EC [European Community]."[68] Frieden goes on to argue that "the decisive turning point in the evolution of the EMS came between 1981 and 1985, when the French and Italian governments changed course to bring their inflation rates in line with the EC average. This turning point was in large part made possible by the linkage of the EMS to European integra-

65. See, for example, Bean 1992.

66. In Eichengreen and Frieden 1994, 25–46; see especially 26. In this regard, see also De Grauwe and Papademos 1990, especially the chapter by Giavazzi and Spaventa, 65–85.

67. Eichengreen and Frieden 1994, 25–26. See also Collignon 1994.

68. Eichengreen and Frieden 1994, 32.

tion more generally . . . [since] a country not in the EMS would become a second-tier member of the Community."[69]

Although we agree with the central thrust of Frieden's argument, we have questions about several elements of his analysis. To begin with, we are persuaded that the underlying preferences of French policy elites did in fact substantially converge with those of their German counterparts over the course of the 1970s (especially in the UDF, Union pour la Démocracie Française) and 1980s (for the right wing of the Socialist party, Parti Socialiste). More generally, changing beliefs about both the Phillips curve and the nature of so-called vicious circles of exchange-rate depreciation and price instability resulted in a substantial change in official attitudes toward anti-inflation policies.[70] Furthermore, we wonder why the EMS failed to impart enhanced exchange-rate credibility to its participants until after 1983 (or, in Frieden's assessment, until between 1981 and 1985) if in fact the institution was invested with the disciplinary characteristics that Frieden ascribes to it from the very beginning (due to its high-profile linkage with European integration).[71]

Instead, we find the French policy reversal of March 1983 to be a critical juncture in the institutional development of the EMS. The new German government of Helmut Kohl was not prepared to countenance another formal devaluation of the franc without some change in the underlying direction of French policy. This in itself represented an important shift away from earlier practice within the regime; initially, the emphasis within the EMS had been on small, frequent parity adjustments. It was not until 1981 that the practice of insisting on pledges of domestic policy reform in exchange for authorizing currency devaluations was initiated (and not until 1982–83 was this practice applied to France).[72] As a consequence, continuation of the Socialists' program of macroeconomic expansion could only be undertaken outside the exchange-rate mechanism of the EMS.

In other words, floating was seen as the only means of maintaining the Socialist government's commitments on domestic economic policy. However, the government expected that the inflationary effects of a rapid fall in the franc's value would be enormous.[73] At this point, the existence of the EMS (and, more generally, of the EC) played a convenient role in political blame management for the French government.[74] Frieden argues that "the link between the exchange rate and France's rela-

69. Ibid., 33.

70. Although the vicious circle argument has been the subject of considerable debate by economists, it clearly had a substantial impact on the views of many European policymakers. For analysis and references to the literature, see Willett and Wolf 1983.

71. In this regard, Frieden's assessment understates the extent to which the EMS's predecessor (the "snake") was publicly linked with the Community's institutions; Eichengreen and Frieden 1994, 33.

72. The formal rules of the EMS called for realignment decisions to be made by "mutual agreement," which by 1980–81 had come to be interpreted as requiring unanimity.

73. This expectation might be challenged retrospectively but appears to have been widely accepted by officials at the crucial policy meetings; see the references in fn. 76. Recent empirical research suggests otherwise; see, for example, De Grauwe 1992; Mast 1996; Papell 1994; and (specifically on the effectiveness of exchange-rate adjustments for France) Blanchard and Muet 1993.

74. On political blame management, see Weaver 1986; and McGraw 1991. For applications to Europe, see Andrews 1993a, 12–27; Moravcsik 1994, 12–15; and Pierson 1996, 144–47.

tions with its EC and EMS partners was explicit. It was clear by mid-1982 . . . that the EMS commitment was of paramount importance to broadening French participation in the EC. The linkage between [monetary integration] and European integration was crucial in leading the Socialist government to abandon its economic policies and commit itself to austerity."[75] Although this proposition has been widely advanced,[76] we believe that it is largely based on ex post facto justifications of the French actions. In our judgment, the reverse interpretation is more likely: namely, the decision to abandon its economic policies and commit itself to austerity was crucial in leading the Socialist government to link (in its public statements, at any rate) de facto regional monetary integration with the de jure institutions of the EC. This rhetorical association allowed François Mitterrand (a committed European) to distance himself from the hostility he and his party had previously expressed toward the EMS and thereby helped rationalize French austerity policies to a reluctant public.

Integration: The Political Economy of EMU

Soon after this blame-management strategy was adopted by the Socialists, the French government renewed its erstwhile support for formal monetary integration. Beginning with the rather low-key insertion of language creating a "monetary capacity" for the EC into the text of the Single European Act,[77] and continuing with Finance Minister Edouard Balladur's January 1988 call for the introduction of a single European currency, the eventual result of this policy was the signing of the Maastricht Treaty in 1992. And although the interim steps were modest, the Maastricht agreement represents a radical transition in international monetary affairs: several of the world's leading currencies are now scheduled to participate in a project that would end national monetary sovereignty.

Eichengreen and Frieden's edited volume, *The Political Economy of European Monetary Unification*, addresses a number of the central issues raised by these developments. In their introduction, the co-editors point out that the potential gains from the elimination of currency conversion costs are likely to be modest; and whereas some assert that a single currency is necessary for preservation of the single market,[78] Eichengreen and Frieden maintain that such arguments are not logically valid.[79] After briefly summarizing the arguments for and against regarding the EU as an optimal currency area, they argue that "uncertainty about the empirical magnitude of every

75. Eichengreen and Frieden 1994, 38–39.

76. See especially Sachs and Wyplosz 1986, 194–95. Compare, however, the accounts in Bauchard 1986, 34; Hall 1987, 62; Petit 1989; Jacquet 1992; Goodman 1992, 136–137; Moravcsik 1994, 48–49; and Helleiner 1994, 140–44.

77. This Belgian proposal was later supported by the French; see Louis 1988, 11–21.

78. Such arguments have not been limited to European politicians and EC officials. See, for example, Icard 1994; and Masera 1994.

79. Eichengreen and Frieden 1994, 6–7. Eichengreen has argued more recently that there may be a political-economy rationale to such assertions, based on the need to avoid protectionist pressures generated by currency misalignments under flexible rates. See Eichengreen and Ghironi 1995.

one of these benefits and costs suggests the absence of a clear economic case in favor of EMU.''[80] Since ''neither economic theory nor economic evidence provides a clear case for or against monetary unification,'' they conclude that ''events in Europe are being driven mainly by political factors.''[81]

This conclusion is being reached by an increasing number of economists.[82] The importance of political considerations in the creation and maintenance of currency areas is the subject of Benjamin Cohen's contribution to the Eichengreen and Frieden volume.[83] His study includes six instances of regional currency unions of varying longevity.[84] To account for these variations, Cohen examines three sets of independent variables: the economic factors suggested by optimum currency area theory, organizational factors (including the legal provisions governing exchange-rate relations between the states), and political factors (broadly construed). Of these, Cohen concludes that ''the evidence does seem clearly to suggest that political conditions are most instrumental in determining the sustainability of monetary cooperation among sovereign governments.''[85]

Among these political conditions, Cohen points to local hegemony and ''an institutionalized sense of community'' as potential keys to understanding the sustainability of monetary cooperation.[86] However, the evidence he marshals admits of another interpretation. Cohen correctly notes that neither the factors associated with optimum currency area theory nor the organizational factors he identifies, considered separately, provide a powerful explanation of the differences in these currency unions' respective life spans. However, considered jointly, these economic and organizational factors perform a creditable job of explaining the variation across cases. Of the six cases examined, the least successful experiment (the East African Community, which only lasted ten years) was also the only case predicted to fail by both economic and organizational factors. Conversely, the most successful case (the Belgian-Luxembourg Economic Union, still functioning after three-quarters of a century) was predicted to succeed by both these criteria, as was the East Caribbean Currency Area (again, still functioning after more than thirty years). Indeed, the only real anomaly—an instance where *both* economic and organizational factors predicted the wrong outcome—was the Scandinavian Monetary Union, which endured substan-

80. Eichengreen and Frieden 1994, 9. For analysis and references to other literature on whether Europe is an optimum currency area, see Wihlborg and Willett 1991; Bean 1992; De Grauwe 1992 and 1993; Eichengreen 1992 and 1993; Masson and Taylor 1993; and Taylor 1995.

81. Eichengreen and Frieden 1994, 5.

82. See Fratianni and von Hagen's contribution to the Eichengreen and Frieden volume as well as their 1992 book; De Grauwe 1993 and 1994; Giovanni 1992; Goodhart 1995; and Minford 1995.

83. Eichengreen and Frieden 1994, 149–65. Cohen includes both monetary unions, where a common currency is employed, and formal exchange-rate unions in his definition of currency unions.

84. These are the Belgian-Luxembourg Economic Union, or BLEU (1922–present), the CFA Franc Zone (1959–present), the East African Community (1967–77), the East Caribbean Currency Area (1965–present), the Latin Monetary Union (1865–1914), and the Scandinavian Monetary Union (1873–1914). Note that although neither the Latin Monetary Union nor the Scandinavian Monetary Union formally dissolved in 1914, from a practical standpoint neither functioned after the outbreak of hostilities in World War I.

85. Eichengreen and Frieden 1994, 152.

86. Ibid., 161.

tially longer than might have been expected.[87] Cohen has clearly identified an important area for further research.

International Bargaining Power

In their analysis of the political factors conducive to European monetary integration, Eichengreen and Frieden distinguish three sets of political considerations: interstate bargaining (or intergovernmentalism), issue linkage, and domestic distributional factors. Whatever the approach employed, Eichengreen and Frieden emphasize that "it is especially important to insist on explicit analytical arguments and on conscious attempts to disentangle the causes of the processes we observe."[88] They suggest, however, that such analytical rigor is more typical of arguments emphasizing linkage politics and trades between governments,[89] and each of the chapters written by political scientists within the volume invokes some version of this framework.

The essential distinction between issue-linkage and intergovernmentalism, in Eichengreen and Frieden's view, hinges on whether international bargains are characterized as resulting from "coercion" on the one hand or free and "mutually beneficial exchange" on the other.[90] Issue linkages, in their analysis, are typically instances of the latter phenomenon, consisting of "the tying together of two otherwise unconnected issue areas, permitting the parties to an agreement to make concessions on one in return for concessions on the other."[91] Frieden expands on this concept in his own chapter: "Linkage politics ups the benefits of initial and continuing cooperation because tying two issue areas together enables gains from political trades. A group that has a strong preference for a policy in one arena and a weak preference against a policy in another arena can compromise with another group that has a weak preference against the first policy and a strong preference for the second policy. In this way, each group gets what it cares about more in return for giving up what it cares about less."[92]

According to this analysis, if international monetary relations are characterized as inherently coercive, both the language and analytical premises of *realpolitik* are appropriate for their study (as the literature on intergovernmentalism presumably suggests). On the other hand, if interstate monetary coordination is essentially about mutually beneficial agreements between states across different issue areas, both the language and analysis of neoclassical economics and especially public choice theory is in order. We find that this distinction, though helpful in principle, is problematic in practice. International bargaining is unlikely to be characterized either by completely

87. The economic and organizational predictions are at odds on the LMU, which endured for forty-nine years, and the CFA Franc Zone, now approaching forty years. However, as Cohen notes, France served (and, in the CFA Franc Zone, continues to serve) in both these institutions as a hegemonic power.

88. Eichengreen and Frieden 1994, 15.

89. "A systematic analysis of such trade-offs . . . requires a notion of linkage politics typically lacking in simple analyses of intergovernmentalism"; ibid., 10.

90. Ibid.

91. Ibid.

92. Ibid., 29–30.

free exchange between parties with equal bargaining power or by entirely coerced choices. Since from an empirical standpoint these two options are not mutually exclusive, we wonder whether linkage politics and intergovernmentalism cannot be usefully merged in a more robust notion of international bargaining power.

Consider in this regard what some have argued was a central bargain underlying the Maastricht negotiations: French support for German unification in exchange for German support for EMU according to a fixed timetable.[93] Did this instance of international bargaining represent a free exchange between parties in the marketplace of political support, or was it instead the result of the skillful employment of a combination of coercive threats and promises? France needed Bonn's support in order for EMU to succeed; Germany was in a position to deny that support and thus frustrate the whole EMU project (which had been a subject of renewed negotiations since Balladur's 1988 initiative). Likewise, however, France was at least hypothetically capable of blocking international ratification of German unification because of its role in the so-called two-plus-four negotiations. Unlike the premises outlined in Frieden's chapter for conditions ideally favorable to political exchange (that is, that each government has a strong preference in an area where the other government has a weak preference), both governments had pronounced preferences with regard to the outcome of both issues. French authorities were deeply concerned by the prospect of a unified Germany, and Germans were not at all complacent about the prospect of the abolition of the deutsche mark.

Despite the intensity of their preferences, however, it seems probable that French authorities recognized that the costs of attempting to block German unification were substantially greater than those associated with shaping the international ramifications of that outcome. In turn, authorities in Bonn no doubt understood the depth of French concerns about resurgent German power as well as the potential of the Paris government to undermine the ruling coalition in the run-up to all-German elections. The strategy ultimately adopted by the Bonn government allowed Germany to accede to French demands for a commitment in principle to EMU while maximizing German influence over both the transition process and the shape of the proposed European central bank. Thus although both parties held deeply felt preferences about the outcomes on each of these dimensions, differences in their bargaining power on each rendered possible a trade of German support for European monetary unification in exchange for French support for German political unification.

In short, negotiations between Paris and Bonn over EMU were characterized by elements of both coercion and exchange. Nor was this central Franco-German bargain the only one engaged in at Maastricht: to date, we have evidence of at least three others, including German insistence on parallel discussions on reform of European political institutions, a doubling of financial transfers in exchange for Spanish, Portuguese, Irish, and Greek acceptance of the Maastricht Treaty's EMU provisions,[94] and

93. Andrews 1993b. Compare Sandholtz 1993; and Garrett's contribution to Eichengreen and Frieden 1994, especially 57–59.

94. As discussed by Martin and Woolley, respectively, in Eichengreen and Frieden 1994; see the following discussion.

Kohl's support for the United Kingdom's opt-out clause on EMU in exchange for the Major government backing German recognition of Croatia.[95] The multiplicity and variety of these arrangements raise profound questions about the prospects for developing parsimonious explanations of important international bargains.

The Credibility of Issue Linkages

Eichengreen and Frieden identify the same potential analytical pitfall for both intergovernmental and issue-linkage arguments: the issue of credibility. Despite their revealed preference for the latter of these two forms of analysis, the editors acknowledge that "linkage arguments, though compelling, are not unproblematic." As with intergovernmental analyses, the primary issue in rendering such accounts rigorous or "systematic" is attention to the credibility of threats or promises. But "even more when issue areas are linked than when bargaining over each issue occurs in isolation, such threats are unlikely to be fully credible. Not only must commitments on each dimension be credible, but the commitment to link dimensions must be credible as well."[96]

In matters of interstate bargaining, what is it that renders some (but only some) negotiating threats and promises credible? These questions are fruitfully addressed in the chapters by Lisa Martin and John Woolley. Martin's contribution relates both the international institutions of the European Union (EU) and the domestic institutions of its member states to the public choice literature on bargaining and issue linkage. By emphasizing the influence of small states (and of Denmark in particular), Martin's analysis appears to take issue with a fundamental tenet of intergovernmentalism: namely, that bargaining between major powers largely determines political outcomes.[97] However, we believe that Martin's argument is better understood as a highly qualified addendum to the intergovernmentalist position.

While accepting that the substance of EU agreements has primarily been shaped by the large (and rich) members, Martin argues that the institutions of the EU have allowed the poorer member states to demand side payments in exchange for their acceptance of these agreements. These side payments have often taken the form of financial concessions,[98] and the Maastricht Treaty was no exception: formal commitment to the "cohesion fund" agreed in principle during the negotiations over monetary union came one year later, at the December 1992 Edinburgh summit. Other side payments were expressly political; most notably, after Danish voters rejected the Treaty on European Union in the country's June 1992 referendum, Denmark's EU partners dutifully agreed to a special addendum to the treaty in order to help Danish

95. *The Economist,* 14 December 1991, 51; and 18 January 1992, 48–49.

96. Eichengreen and Frieden 1994, 11. This is easier said than done; note that Frieden "take[s] the tie between the EMS and European integration as given" in his account of French and Italian policy; ibid., 292, fn. 8; see also 32, fn. 16.

97. Ibid., 91, fn. 4, and 93.

98. Ibid., 90–91, citing Marks 1992; Moravcsik 1991; and Lange 1993. Note that the same process occurred in the Jamaica Agreements on international monetary reform in the 1970s; see Solomon 1982.

political leaders secure a national majority in a second plebiscite. But although the governments of these small states were able to obtain special concessions in exchange for their agreement to the Maastricht Treaty, there is no evidence that they were able to alter the agreement's central provisions. Instead, those provisions were negotiated primarily by representatives of Britain, France, and Germany.

Focusing on the German negotiating position, Woolley examines the linkages between simultaneous negotiations regarding monetary union and reform of the EC's political institutions. Woolley's analysis pays close attention to the strategies of various political actors and, in particular, Helmut Kohl. More than any other actor, Kohl was responsible for the introduction of discussions on European Political Union (EPU) in a forum parallel to the previously agreed intergovernmental conference on monetary union. In doing so, Kohl chose a particular response to a multitude of external pressures and internal constituencies and did so in a fashion that maximized the German bargaining position at the Maastricht negotiations. In Woolley's phrase, Kohl embraced "an ultimately ambiguous strategy—one that echoed deeply held German commitments while exploiting their potential for producing stalemate."[99]

As previously discussed, Germany's European partners, and in particular Mitterrand, had been pressing Kohl for a commitment to monetary union well in advance of the collapse of the Berlin Wall; later, French acceptance of German unification became linked to German acceptance of monetary union. Kohl was inclined to accept this bargain, but faced substantial resistance both from German public opinion and from the Bundesbank. His solution to this problem was to insist on linking EMU and EPU negotiations. This was credible, Woolley argues, because of long-standing commitments in German domestic politics to the principle of European integration. Thus the domestic context of German politics at once constrained Kohl's options and yet allowed him to advance a strategy that ultimately enhanced his government's influence in intergovernmental negotiations.

This discussion suggests the existence of at least three different aspects of linkage politics, each with different functional attributes. Linkages can facilitate *political exchanges* between parties, as Eichengreen and Frieden suggest. Linkages can also enhance the *bargaining power* of one party, by making its position less assailable to negotiation; Woolley's analysis is an exemplary instance of using *two-level bargaining* to this end. Finally, *rhetorical linkages* can help manage *political blame* through the association of unpopular policies with either necessity or some independent, desirable outcome. The latter can have very real consequences, as the chapter by Frieden on French and Italian macroeconomic policy suggests. In the first instance, governments may be able to reduce the political costs of controversial policies by altering the terms of political discourse.[100] In the longer term, however, governments may find themselves constrained by the same rhetorical associations that they them-

99. In Eichengreen and Frieden 1994, 77.

100. This happened in the German case as well, where "Kohl's linkage of political union and EMU [was] a rhetorical device to explicitly evoke the deepest commitments of German politics in order to preclude issues from being framed in strictly cost/benefit terms"; Woolley in Eichengreen and Frieden, 1994, 77, fn. 30.

selves initiated—once again suggesting the political significance of linking otherwise distinct policy choices.[101]

The Political Importance of Technical Details: The EMU Transition Strategy

To those interested in European monetary integration primarily as a lever to promote political integration, the specifics of the transition strategy for the movement to European monetary union (including the institutional framework and operating procedure of the resultant European central bank) may appear to be technical details of interest only to economists and bureaucrats. Several contributions to the Eichengreen and Frieden volume, however, demonstrate that this is not the case.

Although international monetary economists hold widely differing views about the desirability of EMU, a substantial number have joined in criticisms of the Maastricht strategy for achieving monetary union.[102] This approach hinges on potential participants in the future monetary union meeting a number of so-called convergence criteria during the period before their exchange rates are permanently and irrevocably fixed. Among these criteria are successful participation in the exchange-rate mechanism of the EMS, convergence of inflation and long-term interest rates, and specification of the maximum allowable budgetary deficits and public debts as a percentage of national gross domestic product.[103] In his balanced review of the controversies stimulated by the Maastricht treatment of these two latter fiscal policy issues,[104] Eichengreen concludes that although a (controversial) rationale exists for fiscal restrictions after monetary union has been achieved—the topic of recent "stability pact" discussions—the provisions of the treaty restraining fiscal behavior during Stage Two of the transition to monetary union are difficult to justify on any economic grounds.[105] Indeed, even enthusiasts of the EMU project have sharply criticized the view that there needs to be nominal convergence prior to the initiation of monetary union.[106]

One of the major reasons the convergence criteria have generated such controversy has to do with differing assumptions about the initial credibility and effectiveness of the new monetary institutions proposed by the Maastricht Treaty. For example, there is a political-economy argument for prior convergence (especially with

101. For example, by choosing to link high interest rates in France during the mid-1980s with participation in the EMS rather than with the exigencies created by international financial integration, French officials substantially undercut the rationale they later presented during the domestic debate over ratification of the Maastricht Treaty: that permanently uniting French and German monetary policymaking in EMU would enhance Paris' control over domestic interest rates.

102. For a sympathetic treatment, see Gross and Thygesen 1992; compare Kenen 1995.

103. The convergence criteria can be found in Article 109j of the Treaty on European Union; they are further elaborated in a protocol annexed to the treaty.

104. Eichengreen and Frieden 1994, 167–90.

105. Ibid., 167. The stability pact discussions are intended as an adjunct to the excessive deficit procedure already outlined in the Treaty on European Union (Article 104c and its associated protocol).

106. See, for example, De Grauwe 1992 and 1993.

regard to inflation) that focuses on the desirability of minimizing pressures on the new institutions of the monetary union. As the case of German unification illustrates, where economies are substantially out of line with one another, monetary union can force painful economic adjustments (which are generally assumed away in the flexible price versions of new classical macroeconomic models). Andrew Crockett puts it this way:

> Enforcing a common price level across countries with widely different initial inflation propensities as a result of adopting a single currency would impose political and economic costs on one or more partners. Tensions which had previously been reflected in divergent inflation rates would find their reflection in other ways—unemployment, excess demand, labour migration, and so on. The purpose of requiring inflation convergence before union is therefore to eliminate potential sources of friction that might otherwise occur after a single currency has ensured inflation convergence.[107]

On this view, then, the convergence criteria are intended to help ensure the viability of the new European Central Bank. A related argument offered by Max Corden suggests that the convergence criteria offer proof to those concerned with price stability, particularly in Germany, that the other potential members of the monetary union have genuinely experienced a shift in their policy preferences and will therefore be prepared to allow the European Central Bank to act independently.[108]

As Henning emphasizes in his book, it is only a mild overstatement to argue that although the German government made the decision to seek monetary union, it left the negotiation of the convergence criteria and the constitution of the future European Central Bank up to the Bundesbank—a necessary consequence of the distribution of monetary policy decision-making power within the Federal Republic.[109] In their contribution to the Eichengreen and Frieden volume, Jurgen von Hagen and Michele Fratianni explore some of the implications of this decision. Presenting an argument introduced in their earlier book,[110] they explore a public-choice interpretation of the implementation strategy presented in the Delors Report and later adopted in the Maastricht Treaty; their explanation emphasizes the desire of central banks to increase their own independence and power relative to (elected) fiscal authorities.[111] Arguing from this perspective, they conclude that the treaty's inefficiencies and biases are the price for maintaining monetary policymaking at the national level for as long as possible. "Proponents of EMU have long regarded monetary integration as a vehicle for political integration," they argue. "Our discussion points to an internal contradiction of this view . . . . Lacking political integration to back a common mon-

107. Crockett 1994, 176–77. Crockett goes on to argue that "there are several reasons for questioning whether the Maastricht criterion is the best possible measure of these sources of friction."

108. Corden 1993. On the case for independent central banks and the structure of the European Central Bank, see the analysis and references in Burdekin, Wihlborg, and Willett 1992; Canzoneri, Grilli, and Masson 1992; Kenen 1995, 126–27; and Nölling 1993.

109. Henning 1994, 228–37.

110. Fratianni and von Hagen 1992.

111. See also Vaubel 1991.

etary policy, the EMU risks settling for merely a set of tightly coordinated, yet essentially national monetary strategies. Public dismay with the resulting inefficiencies may well become an obstacle to the political integration of Europe."[112]

A somewhat milder version of Fratianni and von Hagen's argument is certainly consistent with the overriding concern of Delors in presiding over the Committee for the Study of Economy and Monetary Union during 1988 and 1989: that the Committee, which was composed almost exclusively of central bankers, produce a unanimous report. Unanimity was considered essential in order for the report to have the maximum possibility for acceptance by national leaders (including the government of Margaret Thatcher) followed by successful ratification in the member states (especially Germany).[113] This approach, though pragmatic in the short term, has generated substantial difficulties in the medium term. Indeed, the multi-speed approach to monetary union proposed in the Delors Report and later incorporated into the Maastricht Treaty has substantially exacerbated tensions within the EU during the run-up to the final stage of EMU (scheduled to begin on 1 January 1999).

It bears noting that the existence of criteria for participation in the proposed monetary union, whatever their economic rationale, constitutes a sharp break with the Community's traditional emphasis on solidarity between member states. In our view, the political implications of this approach were given insufficient attention by the Maastricht negotiators, in part because of their eagerness to deepen post–Cold War Germany's ties to the West. Yet the ramifications may be quite significant, not least because the final membership of EMU may be path dependent. In an innovative chapter, Alberto Alesina and Vittorio Grilli show how expectations of future political equilibrium can lead to the permanent exclusion of prospective members even when their inclusion in a "one-speed" monetary union would be mutually beneficial.[114] Of course, their model only demonstrates the *possibility* that for EMU, one of the "variable speeds" for future membership could be zero. But such analysis underlines the significance of the ongoing debate concerning the relationship between the "ins" and the "outs"—that is, those members of the EU that are included in the initial group of EMU participants, and those that are not. It also highlights the importance of issues of institutional design for both academic research and practical policymaking.

Conclusion

Each of the books under review offers examples of how international market conditions can have powerful influences on government policies by altering the costs and benefits of alternative strategies. Collectively, they highlight the limited utility of the

112. Eichengreen and Frieden 1994, 146. For an argument that the political effects of monetary integration are likely to be quite different from those of trade integration, see Willett 1994.

113. The treaty's fiscal limitations were an important element in the German government's strategy for explaining EMU to a concerned German public. See Lionel Barber, "When the Countdown Faltered," *Financial Times,* 27–28 January 1996, 8.

114. Eichengreen and Frieden 1994, 107–27.

traditional grand theories of international political economy[115] and illustrate the fruitfulness of blurring the traditional boundaries between economics, international relations, and comparative politics.[116] They remind us that financial liberalization was not an objective of Bretton Woods negotiators, nor was international policy coordination during the 1950s and 1960s as strong as is frequently supposed. Increases in financial interdependence—some of them unintended—have nevertheless had a major impact on national economic policies. The disciplining effects of international capital mobility on monetary and fiscal policy differ, and policy responses to the new financial environment have varied substantially across states and over time (influenced in large part by differences in institutional arrangements and changes in the beliefs of policymakers). On the whole, however, macroeconomic policy coordination efforts have not declined so much as altered form as capital has become more mobile. This is most evident within Europe, where experimentation with various forms of regional exchange-rate cooperation is currently scheduled to be replaced by formal monetary union. Interestingly, the forces behind this latter development appear to be as much political as economic, suggesting the utility of a cross-disciplinary perspective.

Governments, in their decisions regarding economic policies with important international ramifications, are subject to political and market pressures emanating from sources both internal and external to the state. Distinguishing between internal and external pressures on policy is increasingly complicated, however. In a highly interdependent world, international economic policy decisions are likely to produce feedback affecting at least some domestic actors; likewise, many domestic policy choices are bound to influence foreign interests. The result is a complex game in which the "internal" and "external" consequences of governments' policies are tightly intermeshed. In the realm of macroeconomic policy, policymakers find themselves engaged in simultaneous negotiations with political representatives and private actors from both home and abroad; the decisions they reach will then be assessed by international markets.

International financial integration has doubtless increased the pressures for policy coordination. However, seldom if ever are these pressures so strong as to remove any practical element of choice altogether, which suggests a role for political agency that is sometimes underplayed in theoretical accounts of both domestic and international policy decision making. Although the subset of choices satisfying demands on the state is doubtless limited, rarely will choices be fully constrained. Instead, government leaders choose to respond to particular circumstances in particular ways; their choices are influenced by existing constellations of economic and political forces and at the same time alter (sometimes significantly) those constellations.[117]

115. For a critique of these approaches, see Willett 1996. As Grieco 1995 notes, the Maastricht Treaty presents particularly serious problems for neorealist theory.

116. Keohane and Milner 1996.

117. Ibid., 255–58. This is also a major message of Helleiner's book and is underlined by the analysis in Woolley's chapter in Eichengreen and Frieden 1994.

Fortunately, recognition of the complexity of factors that influence international economic policy does not call for the abandonment of theory; rather, it suggests a need for its more systematic development and employment. As we consider contending explanations of important phenomena in the international political economy, we are unlikely to discover that one approach is wholly right and others completely wrong; nor should we expect the comparative explanatory power of different theories to be constant across countries, issue areas, or time. Rather, as the complexity of state policy in a financially interdependent world demonstrates, the generalizations for which we may hope to find support will typically be both limited and contingent.[118]

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118. See Dillon, Odell, and Willett 1990

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