
Systemic Conflict and Regional Monetary Integration: The Case of Europe

C. Randall Henning

Introduction

Study of the political economy of European monetary integration, stimulated in the 1990s by the commitment of the European Union to create an Economic and Monetary Union, has produced a rich and sophisticated literature. Prevailing theories, however, explain the ambitious European movement toward monetary cooperation predominantly in regional terms. Most of this literature views the global context as irrelevant or having influence that is merely episodic or subordinate to other forces. Instead, regional economic interdependence, political integration, issue linkage and institutions, and domestic politics receive the primary emphasis, as surveyed in this article.

This regional focus, which characterizes the study of European integration in general, has produced a “self-imposed theoretical isolation of the subfield.”¹ Detaching the analysis of monetary integration from broader approaches within international and comparative political economy leaves these fields with only an impressionistic or case-specific understanding of the effect of external events on European monetary cooperation and vice versa. As with the relationship between the multilateral trading system and trade regionalism, the link between the monetary system and monetary regionalism is likely to become an increasingly important research topic. Theory and explanation would benefit from reconnecting the study of European monetary integration to its international context.

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1. Quoting Anderson 1995.

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In this article I advance an international monetary thesis, arguing that disturbances in the international system provided strong incentives for European governments to cooperate on exchange-rate and monetary matters at numerous critical junctures over the last four decades. In general terms I develop a theory, based on open economy macroeconomics, of macroeconomic power and influence that draws explicit linkages to regional monetary cooperation. I test the validity of the international thesis specifically with respect to Western Europe against four periods in which the United States acted to stabilize the international monetary system and against seven episodes in which it disrupted the system.

Although the dominance of the United States features prominently in my argument, the structure of the international monetary system is not its focus. System structure leaves international monetary policies and the incentives for regional integration underdetermined. Where the dominant state provides stability to the system consistent with the preferences of smaller states, the latter are likely to be content with the status quo. Where the dominant state repeatedly destabilizes the system, exploiting an asymmetry in vulnerability to systemic disruption, the smaller states have strong incentives to seek monetary stability on regional terms. Both outcomes are possible within a hegemonic system. In this article I focus on the consequences of neglect or coercion on the part of the dominant state for policy choice within a semi-integrated region of smaller states.

The international thesis adds to our understanding, both theoretical and substantive, in three respects. First, it offers a more complete explanation of European monetary integration. Second, it provides a better theoretical basis from which to predict the future external behavior of the European monetary union, assuming that project succeeds. Third, it better enables us to analyze the relationship between regional and multilateral monetary regimes.

Literature Survey

The literature on the political economy of European monetary integration has evolved in three waves over the past twenty-five years, analyzing consecutively the initial plan for monetary union (Werner Report), the formation and operation of the European Monetary System (EMS), and the (more far-reaching) Maastricht Treaty. This section, organized thematically, describes the basic logic of each theoretical approach, recognizing that individual authors usually subscribe to a combination of two or more causal themes.

One common approach treats the integration of markets as the main force driving European commitments to exchange-rate stabilization and monetary union. As the overall level of economic interdependence rises within Europe, currency fluctuations cause increasing economic disruption and reduce the value of monetary autonomy. Reflecting this changed calculus of economic costs and benefits, societal actors and states shift political support toward exchange-rate stabilization and currency union. This *market-integration* approach, which has more in common with neofunctional-

ism than some proponents acknowledge, has two variants, one focusing on the effects of integration in the goods market, the other on those in the capital market.

As border and nonborder trade barriers are reduced in the European Union, goods markets become integrated, and a larger number of producers and consumers develop an interest in stable exchange rates. One analyst has argued that the desire to prevent exchange-rate fluctuations from undermining the Common Agricultural Policy (CAP), the flagship of European integration, was an early motive for monetary cooperation.² Others extend this logic to the consolidation of benefits of completing the Common Market and then the Single Market program. By making national currencies a more salient cause of market segmentation, the reduction in internal trade barriers created positive spillover for monetary integration.³ Several analysts, drawing on the experience of the ejection of the British pound and the Italian lira from the Exchange Rate Mechanism (ERM) in 1992 and their subsequent depreciation, conclude that monetary union is necessary to prevent drastic shifts in competitiveness arising from exchange-rate changes and, by extension, erosion of political support for the single market.⁴

Proponents of the second variant of the market-integration approach argue that capital mobility constrains the choices of states in monetary policy.⁵ In the face of high capital mobility, asserts the famous “unholy trinity,” states must choose between monetary autonomy and exchange-rate stability. When goods markets are integrated as well, exchange-rate stability becomes attractive relative to monetary independence. The elimination of capital controls in the early 1990s and integration of the internal market in financial services, according to this reasoning, rendered the maintenance of fixed exchange rates impossible without closely coordinated monetary policies and provided critical impetus for monetary union.⁶

After the EMS had been in operation for five or six years, several economists began to examine its success.⁷ Their analysis led to a debate over what came to be called the “*German dominance*” thesis. One school argued that the EMS functioned asymmetrically: Germany pursued an independent monetary policy suitable to fighting domestic inflation while other countries defended exchange-rate parities within the system by mirroring changes in the Bundesbank’s policies. Through participation in a system in which Germany served as the “nominal anchor,” other European states borrowed credibility from the Bundesbank, which, this school argued, lowered the unemployment cost of reducing inflation.⁸ An opposing group of economists argued that exchange-rate stabilization within Europe was instead the product of more sym-

2. McNamara 1993.

3. Padoa-Schioppa 1990; Delors Report 1989; and Commission of the European Community 1990a.

4. See, for example, Eichengreen 1996, esp. 3–12.

5. See Goodman 1992, esp. 182–208; Sandholtz 1993a; Andrews 1994, esp. 209–11; Frieden 1996; and McNamara 1998.

6. See, for example, Padoa-Schioppa 1994.

7. For a review of the economics literature before the completion of the Maastricht Treaty and the 1992–93 currency crises, see Cobham 1991.

8. See Giavazzi and Pagano 1988; and Giavazzi and Giovannini 1989.

metrical policy adjustments among the members.⁹ Economists' relatively narrow debate over the empirical question of whether Germany dominated the management of the EMS led to a debate among political scientists over the more profound analytical question of the influence of Germany as a regional power in the creation and perpetuation of the system.¹⁰

Domestic politics is the main focus of a related approach. One strand of this approach focuses on the credibility of each currency's peg to the deutsche mark, arguing that the stance of domestic interest groups and political parties on monetary policy is critical to maintaining the confidence of markets.¹¹ A second strand focuses on changes in domestic politics that produced a convergence of national preferences among European states on exchange-rate stabilization in the late 1970s and on low inflation over the course of the 1980s. By reducing the value attached to monetary autonomy and political control of central banks, especially in the late 1980s, such changes reduced opposition to monetary integration. Preference convergence translated into further integration primarily through intergovernmentalist bargaining.¹² Some authors adopting this approach treat domestic actors' positions and national preferences as exogenous, others as endogenous, to market integration.

The Maastricht Treaty commitment to form a monetary union spawned a number of additional causal arguments revolving around *linkage politics* and *European institutions*.¹³ Two types of linkages are ascribed to the politics of monetary integration, political and functional. In the first category, some political scientists perceived a grand bargain between France and Germany that exchanged progress on political union for the commitment to monetary union.¹⁴ Other analysts identified a link between German unification in 1990 and the agreement on monetary union a year later.¹⁵ Functional linkages, such as between the structural funds and monetary union, were facilitated by the dense network of institutions of the European Community (EC).¹⁶ These explanations apply specifically to the Maastricht Treaty commitment, rather than to monetary integration over the decades.

A final school of thought attributes progress in monetary integration to a convergence of *beliefs* among European policymakers regarding the causal links among monetary policy, inflation, and growth. Specifically, a growing consensus that expan-

9. Fratianni and von Hagen 1992. For an appraisal of this debate, see Woolley 1992; Gros and Thygesen 1992, 100–60; and Willett and Andrews 1997.

10. Dyson argues that German power, among other factors, largely explains the Maastricht Treaty commitment to EMU, which is disputed by Sandholtz. See Dyson 1994; and Sandholtz 1993b. Examining other cases of regional monetary integration, Cohen concludes that local hegemony is critical to sustaining monetary unions once created. See Cohen 1993.

11. Frieden 1994.

12. See Story 1988; and Sandholtz 1993a. On preference convergence, intergovernmentalism, and the Single European Act, see Moravcsik 1991.

13. For a discussion of approaches to analyzing the Maastricht Treaty commitments, see Eichengreen and Frieden 1994. For a critique of the explanatory value of supranationalism and intergovernmentalism, see Anderson 1995, 448–51.

14. See, for example, Sandholtz 1993a. On German domestic politics and this imputed bargain, see Woolley 1994.

15. See, for example, Andrews 1993; and Garrett 1993.

16. See Martin 1993; Cohen 1993; and Pauly 1992.

sionary monetary policy had limited scope for boosting growth and employment without also creating unacceptable inflation was a necessary precondition for the establishment of the EMS and for the commitment to Economic and Monetary Union (EMU).¹⁷ Analysts in this school usually portray ideas working in tandem with structural constraints, capital mobility, and interests.

By contrast, the *international monetary* system, and disturbances transmitted through it, is largely absent from the literature as a theoretically developed causal theme. Several analysts give importance to systemic factors, to be sure, but stress the changing political structure of the system and generate conflicting interpretations.¹⁸ Others acknowledge external monetary factors in specific cases.¹⁹ But no international monetary approach, grounded in a rigorous theory of power and influence in macroeconomic relations, has been developed and applied systematically over the four decades of European monetary integration, despite strong connections between global and regional monetary arrangements.²⁰ Such an approach is developed in the next section.

International Conflict and Monetary Regionalism

For groups of smaller states that have achieved a certain level of economic interdependence, macroeconomic conflict with a dominant state and international monetary instability create several incentives for strengthening regional monetary cooperation. Macroeconomic power and influence—that is, the effect of one state’s policies on another state’s economy and policy choices—shape these incentives. Understanding the transmission of policy disturbances requires, first, a modest excursion into open economy macroeconomics. After laying this foundation, I then elaborate on the incentives for organizing regional monetary cooperation, to which such pressures give rise, and offer a testable hypothesis.

Macroeconomic Transmission

Open economy macroeconomics has defined quite clearly the effectiveness of monetary and fiscal policy with respect to domestic output under alternative exchange-rate regimes. The effects of macroeconomic policy abroad, under the assumption that the country in question is large, is the flip side of this analysis.²¹ Because those

17. McNamara 1998. See also Sandholtz 1993a; and Story 1988.

18. Neorealists forecast that the decline of communism and end of the Cold War will eventually undermine European integration. In this tradition, see Waltz 1979, 70–71; Mearsheimer 1990; and Grieco 1995. Others, by contrast, argue that the changing structure of the international system and German unification spurred commitment to monetary union. See Andrews 1993; Garrett 1993; and Sandholtz 1993b.

19. See Tsoukalis 1977; Ludlow 1982, 64–78; and Cohen 1979.

20. For important contributions in this regard, however, see Loriaux 1991; Dyson 1994; and Loedel 1997.

21. For textbook treatments of standard theories of open economy macroeconomics, see Caves, Frankel, and Jones 1996; and Kenen 1994. The academic literature on international transmission of national mac-

		Exchange-rate regime	
		Fixed	Flexible
Policy instrument	Monetary policy	Expansionary	Restrictive
	Fiscal policy	Restrictive	Expansionary

FIGURE 1. *Impact of large-country policy stimuli abroad*

effects produce economic and political pressures for policy change abroad, they are critical to understanding the politics of macroeconomic conflict and policy adjustment.

Figure 1 presents the effectiveness of monetary and fiscal policy under alternative exchange-rate regimes with respect to foreign prices and output, under the assumption that capital is highly mobile between countries.²² Monetary policy under fixed exchange rates (the upper-left quadrant in Figure 1) affects foreign countries because the foreign exchange operations necessary to defend the parity affect monetary conditions both domestically and abroad. An easing of monetary policy in the large country, under perfect capital mobility, is mostly “exported” abroad through capital outflows, to which domestic and foreign central banks respond by buying the currency of the large country in exchange for their own, reducing interest rates abroad and thus raising foreign prices and incomes.

Under flexible exchange rates, monetary policy can have strong effects abroad that are actually opposite in sign to the domestic effects. Through a depreciation of the currency, for example, a monetary stimulus can reduce foreign prices and income through a deterioration in the foreign current account balance. This “negative” transmission can be somewhat offset in practice by the direct effect of higher domestic demand on the trade balance of the source country.²³

Changes in fiscal policy produce capital flows to which foreign central banks, again, must respond under fixed exchange rates with purchases and sales of foreign exchange that have consequences for monetary conditions. A stimulus, for example, causes capital to flow into the large country, requiring sales of its currency for foreign currency, easing monetary conditions and thus accommodating the fiscal stimulus.

roeconomic policies, particularly as it relates to coordination, is reviewed by Bryant 1995; and Persson and Tabellini 1995.

22. This analysis also assumes, for the moment, that foreign exchange intervention is not both effective and sterilized, nominal prices and wages are “sticky,” and interest-rate differentials produce a continuing flow of capital.

23. Econometric models differ on this point. See Bryant et al. 1988.

The net purchase of foreign currency by central banks tightens monetary conditions abroad, causing a fall in foreign prices and incomes.

Under flexible exchange rates, fiscal policy can have strong effects abroad. Fiscal expansion in the large country stimulates capital inflow, causing the currency to appreciate and the current account to shift toward deficit. The foreign country experiences a depreciation of its currency, a surge in demand for tradable goods, a shift of the current account toward surplus, and a rise in prices and incomes. The Reagan deficits of the early 1980s provide a classic example of this quadrant of Figure 1.

In summary, the effect of policy change in the large country on the economies of smaller countries is substantial in each of the four quadrants in Figure 1. The case of monetary policy under flexible exchange rates could be an exception, depending on other conditions. Generally, however, flexible exchange rates do not insulate countries from policy shocks abroad in the presence of high capital mobility.

Pressure for Policy Adjustment

These cross-border transmission effects create domestic economic and political pressure within other countries for policy adjustment. When states conflict over macroeconomic and exchange-rate policies, in particular, transmission effects emanating from a large state change economic conditions within smaller, receiving states. In this way, the more powerful state can alter the payoffs to existing policy settings in the smaller states and force a reconsideration of macroeconomic policies and political agreements that underpin them, thereby inducing policy change. For the following analysis, assume a world of one large and one small country (this assumption will be relaxed shortly).

Suppose the large country embarks on a fiscal stimulus under flexible exchange rates in an environment of high capital mobility (the case in the lower-right quadrant of Figure 1). As the fiscal expansion is transmitted abroad, the small country experiences an increase in prices, employment, and income. The policies of the small country target a combination of inflation, employment, and growth that was considered optimal by its government. In the face of the stimulus from abroad, however, existing policies will now cause an overshooting of the targets for inflation, employment, and growth. The fiscal stimulus in the large country thus creates economic pressures for the small country to tighten its macroeconomic policies.²⁴

The strength of these pressures rises as we ease three assumptions. First, until now we have assumed that the large country generally neglects the policies of others and the external consequences of its own policies. Such a country, however, rather than being simply neglectful, might deliberately attempt to induce a change of policy in the smaller country—in order to ease its own balance of payments constraint, for example. Aggressive policies such as these give rise to international policy conflict.

Second, we have also assumed until now that the exchange rate is completely endogenous to the open economy macroeconomic model and the transmission pro-

24. See Feldstein 1986; and Henning 1987, 21–23.

cess. However, governments and central banks can influence the exchange rate to varying degrees without changing monetary and fiscal policy through, for example, declarations, signaling, and foreign exchange intervention.²⁵ Less vulnerable to precipitous exchange-rate swings and prolonged exchange-rate misalignments because its economy is more closed, the large country wields an “exchange-rate weapon.”²⁶ The large state might well employ exchange-rate policy in its effort to extract policy adjustment from the small state.

Third, we have not allowed the currency of the large country to play a significant international role for transactions and store-of-value purposes. When the currency of the large country serves as the invoicing currency for a substantial share of international trade—the most prominent example being the pricing of oil in U.S. dollars—a depreciation affects the small state beyond the extent of its trade with the large. When foreign investors accept financial assets denominated in the currency of the large country, they facilitate the financing of current account deficits and enable the large country to deflect the exchange-rate risks associated with foreign borrowing. When, under fixed exchange rates, foreign central banks hold the currency of the large country in reserves, the monetary policy of the large country dominates the monetary conditions of the system as a whole. Thus, the role of the currency magnifies the asymmetry in macroeconomic interdependence between the large and small state.

Now consider the small state’s response to the pressures for policy change by referring again to the case of a fiscal stimulus by the large country under flexible exchange rates. Current policy settings represent a bargain that satisfies a governing majority. The economic pressures arising from the stimulus abroad satisfy demands for jobs and growth while aggravating fear of inflation and its consequences, altering the political demands on the policymaking process. Because macroeconomic policies are set through an elaborate architecture of political and governmental institutions, the politics of renegotiating the original bargain in order to adjust policy are unlikely to be smooth. Moreover, domestic bargains, often carefully and delicately crafted, have broader purposes than simply attaining the macroeconomic targets, such as satisfying key constituency demands, ideological priorities, and election promises. Any decision to tighten fiscal policy, for example, would have to specify the particular spending programs to be cut or the particular taxes to be raised. The adjustment of macroeconomic policy will therefore probably be fraught with political conflict.

The government of the small state might welcome the policy shock of the large country if, for example, cross-border effects ease a balance-of-payments constraint on growth. Thus, whether the small state actually adjusts policies depends on the magnitude of the transmitted effects, economic conditions in the small country, and

25. The exogeneity of the exchange rate is a contentious issue among economists. Foreign exchange intervention can be successful under certain conditions, as argued by Catte, Galli, and Rebecchini 1994; and Dominguez and Frankel 1993; among others.

26. See Henning 1987, 139; and Henning 1991. Cases of deployment of the “exchange-rate weapon” are treated in Destler and Henning 1989, 50–56; Putnam and Henning 1989, 49, 84; and Helleiner 1994, 113, 131, 184.

its domestic politics, policymaking institutions, and preferences. But, regardless of whether policy adjustment occurs, when the policy shock creates stresses on the governing coalition in the small country, it also creates further incentives for the small country to shield itself from the large country.

Regional Integration

Now consider an expanded, three-country world composed of one large, relatively closed country and two small, open countries. Assume that the trade and investment flows comprising each of the three bilateral relationships are equal in absolute terms and thus more important relative to the domestic economies of the smaller countries compared to the large one. The two smaller economies are not identical: the international status of their national financial markets differs, international confidence in their national economic policies varies, and their national currencies have different international roles.

Policy shocks emanating from the large state, whether neglectful or aggressive, will affect the small states asymmetrically, in the economist's sense of the term. The unevenness of these effects arises from the differing status of the smaller countries in the international economic system. When losing confidence in the monetary policy of the large country, for example, international investors do not rebalance their investment portfolios in all foreign markets equally; they favor the market in which they have greater confidence. Capital outflows from a leading country will therefore disrupt the monetary, trade, and investment relations among the smaller states. *For this reason, small states have strong incentives to counter the effects of policy shocks and the use of macroeconomic power by strengthening exchange-rate and monetary cooperation between them.*

Creating a regional "island of monetary stability" conveys five distinct advantages. First, for countries that desire stability in their effective exchange rates, fluctuation in the level of the large-country currency places a premium on the stabilization of the currencies of their regional trading partners. A small country experiencing an appreciation might be tempted to seek an offsetting depreciation against regional currencies. But such an operation is generally very difficult to execute and, even if successful, does not avoid redirection of trade flows, redeployment of labor and capital, and associated frictional costs. The greater the integration of goods and capital markets, the stronger the preferences of small states for currency stability.

Second, by tightening regional integration, the smaller countries can counteract the asymmetrical effects of the large country's policy shock on the members of the region. When currency fluctuations of the large country drive wedges between the currencies of the smaller countries, disrupting their trade and investment relationships, exchange-rate cooperation can lend greater regional stability to currencies than would otherwise be the case.

Third, by banding together, smaller states can reduce the chances that any one of them will be singled out for pressure for policy change. Because the smaller states coordinate and harmonize macroeconomic policies and objectives, the large state has

fewer opportunities to divide and prevail. In a regional group, macroeconomic outliers are less salient, and small states are less likely to align with the large against another small state.

Fourth, when the large state does single out one country in the region for policy adjustment, whether a tightening or easing of policy, regional monetary cooperation enables the target to spread the economic and thus political pressure across a larger monetary area. A capital inflow of a given size, stimulated by a large-country policy shock, may have strong effects on the exchange rate, prices, employment, and income of a single country but considerably weaker effects across the regional monetary area as a whole. By enlarging the economic size of the area of monetary stability and reducing the vulnerability to fluctuations of outside currencies, regional integration bolsters the defense against unwanted pressures for policy adjustments.

Finally, a relatively advanced monetary region can transform the status of its members in the international monetary system from “small” to “large.” Collectively, they not only will be better able to deflect shocks and pressures for policy adjustments, but also might exercise countervailing influence of their own and place themselves on a more symmetrical footing vis-à-vis large states when bargaining over the operation of the international monetary system or the assignment of policy adjustments.

Small states will not respond immediately to systemic disturbances. Policy shifts in the large state, such as an increase in the government budget deficit, unfold gradually over months or years. The international transmission of those shifts takes time; exchange rates affect trade balances, for example, with a lag of one to two years. Small states’ knowledge of the condition of their economies trails reality by the time required to compile and report economic data. Mounting a cooperative response requires international consultation, negotiation, and sometimes domestic ratification. Governments might anticipate the effects of a shock by acting before they become fully visible in reported data. However, economic and political uncertainty—about the effects of the shock, the domestic political reaction, and the receptiveness of would-be regional partners to cooperation—tend to predispose governments against anticipatory action.

When governments and central banks learn from experience, moreover, the response of small states to repeated shocks by the large state will be cumulative. Institutional approaches to politics, including historical institutionalism²⁷ and regime theory,²⁸ commonly conceptualize institutions as embodying the lessons, ideas, and politics of the past. With institutionalized learning, each shock causes the small states to increase their estimated probability of such shocks occurring in the future. Weak international constraints on the dominant state and a revealed predilection on its part to target policy toward (cyclically changing) domestic concerns, to the neglect of international economic conditions, raises that probability, which in turn raises the

27. See, for example, Hall 1986; Thelen and Steinmo 1992; and Pierson 1996. For a treatment of the single market, see Cameron 1992.

28. For an examination of regimes and learning, see in particular Jervis 1976; Haas 1980; Nye 1987; and Haas 1992. Etheredge examines learning from repetition over a series of foreign policy events; see Etheredge 1985. See also Ikenberry 1988; Odell 1988; Goldstein 1988; and Goldstein and Keohane 1993.

value of insurance in the form of regional cooperation among small states. Defensive arrangements set in place after previous episodes, moreover, alter the set of choices available to small states when responding to subsequent episodes, creating path dependency. Small states under these circumstances would be expected to increase regional integration after each episode more than they allow it to decay between system disturbances, producing an upward ratcheting of regional cooperation.

Intraregional Conflict

Allow next for differences in macroeconomic preferences between the two small countries in this three-country world. Assume that their macroeconomic preferences differ substantially enough to create conflicts between them over fiscal, monetary, and/or exchange-rate policy. The systemic monetary environment is not neutral with respect to this conflict but confers an advantage on one disputant over the other.

Suppose, for example, that one small state pursues a substantially more expansionary monetary policy than the other. While the two countries are sufficiently integrated through trade and investment to benefit from exchange-rate stabilization, their different preferences block agreement on currency arrangements. When the large state embarks on a monetary expansion, the currency of the expansionary small country will remain unchanged (if the degree of expansion is similar), whereas the currency of the monetarily restrictive country will appreciate substantially against that of the large state. Pressures for policy adjustment thus fall more heavily on the restrictive than on the expansionary state, spurring the restrictive state to ease and to conclude a regional monetary agreement on more expansionary terms.

When the dominant state shocks the system, it thus applies particular pressure on the outlier to cooperate with its regional partners. Because regional arrangements provide defenses against systemic disruption, the outlier is inherently more exposed and vulnerable to pressures for policy adjustment emanating from the dominant state. The situation is analogous to a herd of cattle on the open range. In fair weather, cattle maximize their grass consumption by grazing apart; when a storm approaches, they gather together for shelter against the wind. The animal that stands aloof will be driven by wind and rain into the fold. It does not lose its appetite for grass but trades off maximizing this commodity for the shelter of the herd. So it is for secondary states buffeted by international monetary storms.

In the preceding scenario, the expansionary small state benefits in its regional cooperation from the pressures exerted by the large state on its regional partner. It might be tempted to forgo regional cooperation in favor of consolidating ties with the dominant state, “bandwagoning” rather than “balancing,” in the lexicon of alliance politics.²⁹ If the dominant state consistently sided with the expansionary small state, bandwagoning might be a superior strategy. But if the dominant state directs economic policies toward domestic requirements to the neglect of the international regime and shocks the system by shifting those policies, the coincidence of interests

29. See, for example, Walt 1987.

with the expansionary small state is just that, a coincidence. A small state with rational expectations knows that a substantial probability exists that during subsequent shocks it, rather than its partner, will face the greater pressure to make policy concessions. Under such circumstances, pursuing regional cooperation would be the superior strategy.

Although the international context can contribute to an explanation of the terms for achieving regional integration, this observation should not obscure the more fundamental fact that systemic disruption by the dominant state induces *both* small countries to cooperate with one another. The five incentives enumerated earlier operate *irrespective* of the particular macroeconomic preferences of the large and small states. The state whose preferences match those of the dominant state suffers as much as the state whose preferences conflict from the disruption of trade and investment spawned by instability in the exchange rate between the currencies of the small states. Strengthening monetary cooperation with its small-state partner can provide a greater measure of currency stability, insurance against being targeted in the future by the large state, and enhanced influence in the international system. The two secondary states need not bury their differences or share identical preferences to benefit from regional integration. Systemic disruption casts intraregional conflicts in a new light, increasing the payoff to regional cooperation.

A Testable Hypothesis

This international monetary thesis, formulated generally, predicts that when a large state produces instability in the international monetary system, smaller countries that have achieved substantial integration of markets on a regional basis will launch initiatives for regional monetary integration as well. Formulated specifically, the international thesis predicts that when the United States disturbs the international monetary system with policy change, neglects an unstable dollar, or presses European states for macroeconomic policy adjustments, European states will attempt to strengthen regional monetary integration. In addition, because the thickness of regional institutions suggests a capacity for institutionalized learning, the learning variant of the thesis predicts that the European response to multiple shocks will be cumulative.

Progress toward European monetary integration can be measured by institution and regime building, exchange-rate stabilization, and convergence of monetary and other economic policies. Empirical support for the international thesis could thus be found in proposals for building regimes and institutions for regional exchange-rate and monetary cooperation during and after a period of global instability. The actual introduction of new institutions and regimes and the achievement of currency stability and monetary convergence would, of course, constitute even stronger support. Regional monetary integration will occur with a significant and variable lag after a U.S. disturbance but must have a traceable causal connection to the shock.

Conversely, the absence of progress after periods of intense transatlantic monetary conflict would clearly weaken the thesis. Transatlantic monetary conflict creates short-

term problems that might have to be accommodated by European officials through, for example, greater exchange-rate flexibility on a temporary basis. But the international thesis clearly predicts that, subsequently, when market pressures subside, European officials will renew attempts to build institutions, stabilize exchange rates, or coordinate monetary policy. A case where no such attempts followed serious transatlantic conflict would substantially weaken, perhaps falsify, the thesis.

This argument does *not* predict that European monetary integration will halt completely in the absence of transatlantic monetary conflict. Factors identified in the literature surveyed earlier, such as market integration and domestic politics in particular, play substantial roles and could sustain monetary integration in such periods. But the international thesis presented here predicts that, other things being equal, the drive toward European monetary integration will be considerably stronger following periods of transatlantic conflict than following periods of transatlantic tranquillity.

U.S. Disturbances and European Responses

The Bretton Woods regime, led and sustained principally by the United States and institutionally embodied in the International Monetary Fund (IMF), governed the postwar relationships among the European countries as a subset of all regime adherents. As long as the international monetary regime provided a stable framework within which to resolve intra-European monetary problems, European states had little incentive to establish a mechanism for regional cooperation separate from the global framework.

Rather than consistently providing stability to the international monetary system, however, U.S. international monetary policy alternated between neglect and activism over the subsequent decades.³⁰ Periodic American neglect of the dollar and the balance of payments thrust the burden of exchange-rate stabilization and payments financing on other, largely European, governments. Worse yet for Europe, when U.S. policy entered its aggressively active phases, which preceded cooperatively active phases, U.S. officials often exploited the United States' dominant, or at least stronger, position through the "dollar weapon." U.S. officials "talked" the dollar down or up as part of a conscious strategy to extract a change in macroeconomic policy from European governments and central banks.

The following section divides the history of postwar U.S.–European monetary relations into periods of stability and periods of disturbance. When the United States' balance of payments deteriorated sharply, the exchange rate for the dollar changed abruptly, and/or the U.S. government pressed partners for policy change—usually associated with abrupt changes in U.S. domestic macroeconomic policy—the episode is classified as a shock. When the United States acted to stabilize the system by reducing payments imbalances, stabilizing the exchange value of the dollar, and/or refraining from pressing for policy adjustments—often associated, conversely, with

30. See Cohen 1983; Bergsten 1986; Henning 1987, 50–52; and Henning 1994, 253–308.

continuity in domestic macroeconomic policy—the episode is coded as one of stability.

Applying these criteria, postwar history is divided into four periods of stability and seven (in some cases, consecutive) periods of U.S. disturbances. The significant periods of relative stability are (1) the recovery and renewal of the late 1940s through the mid-1950s, (2) the reasonably smooth operation of the Bretton Woods regime from mid-1961 through 1966, (3) the flexible rate regime from 1973 through 1976, and (4) the currency stabilization and inflation fighting of late 1978 through early 1981. U.S. policy was stabilizing at certain points thereafter as well, such as during 1988, but these episodes are brief, ephemeral, and less distinct from the cases of disruption.

The seven instances in which the United States produced significant disturbances are (1) the shift to balance-of-payments deficits at the end of the 1950s, (2) expansionary macroeconomic policies and benign neglect of the dollar during the late 1960s, (3) suspension of gold convertibility and transition to flexible exchange rates in the early 1970s, (4) the locomotive dispute of 1977–78, (5) high interest rates and dollar appreciation during 1981–84, (6) dollar depreciation and pressure for reflation during 1985–87, and (7) renewed neglect and pressures for policy adjustment during the late 1980s and early 1990s. The following review does not judge U.S. policy normatively, but instead uses these episodes to test whether U.S. policy behavior contributed substantially to European monetary integration.

Recovery and Restoration

From the late 1940s through the mid-1950s, the United States sought recovery of the war-torn European economies and stabilization of the international economy. U.S. officials supported in particular the establishment of the international monetary regime that their predecessors defined at the Bretton Woods conference in 1944. As is well known, the United States was the strongest industrial country, and its balance of payments was in large surplus. The dollar price of gold, which had been \$35 per ounce since 1934, was regarded as immutable, and the dollar had no rival as an international currency.

During 1948–52, U.S. support for international stability took the form of extraordinary assistance under the Marshall Plan, which alleviated a “dollar shortage” and eased a balance-of-payments constraint on European recovery. In 1949, the United States orchestrated a joint devaluation of European currencies against the dollar to avoid later disruptions. Relative to subsequent decades, U.S. macroeconomic policy was extraordinarily tranquil; it did not disturb the system with excessively tight or expansionary fiscal or monetary policies. Although the U.S. economy experienced the Korean War boom and recessions in 1953–54 and 1957–58, these had little adverse impact on the European economies.³¹

European governments cast their monetary lot with the Bretton Woods regime. Their acceptance of monetary multilateralism was not immediate; they initially sought,

31. Solomon 1982, 21–22.

with U.S. cooperation, a regional solution to the shortage of foreign exchange. The European Payments Union (EPU) cleared bilateral imbalances among the countries receiving Marshall Plan aid and provided a conduit for settlement of remaining imbalances in gold or dollars. As they became more confident of defending their parities to the dollar, though, European countries retired the EPU and accepted full current-account convertibility of their currencies at the end of 1958.³²

With the creation of the European Coal and Steel Community and the negotiation and ratification of the Treaty of Rome, European integration surged impressively. However, despite the fact that in the EPU they had an operational regional institution, European governments chose to effectively exclude monetary cooperation from their integration plans. Although Articles 104–108 addressed the balance of payments and exchange rates, they were largely ignored in practice, and the Monetary Committee, created by the Treaty of Rome, remained purely consultative. European governments were content with the Bretton Woods regime and IMF as the focal point for monetary cooperation. As Loukas Tsoukalis has written, “in 1957, when the Treaty was signed, it seemed unthinkable to attempt to establish an independent monetary system within the context of the EEC.”³³

U.S. Deficits and Dollar Glut

Beginning in 1958, the United States entered a period of substantial balance-of-payments deficits (on an official settlements basis). This change not only eliminated the dollar shortage in Europe but raised the specter of a dollar glut. Concern surfaced for the first time about the credibility of the United States’ commitment to redeem foreign-held dollars with gold. Robert Triffin warned of a fundamental flaw in the international monetary system: provision of sufficient international liquidity through U.S. balance-of-payments deficits could undermine confidence in the dollar.³⁴

As a consequence of this shift, Europe experienced its first foreign exchange crisis since the transition to convertibility. As U.S. deficits and German surpluses became entrenched during 1958–61, Germany experienced capital inflows and upward pressure on the deutsche mark. This pressure was unwelcome and was resisted by the German government and the Bundesbank, with the strong support of the German industrial and banking sectors.³⁵ In March 1961, however, the German government under Chancellor Konrad Adenauer revalued the deutsche mark by 5 percent against the U.S. dollar and the currencies of Germany’s European partners. The Netherlands revalued the guilder by 5 percent as well.

Beginning in 1961, the U.S. government also began to press the German government to “offset” part of the balance-of-payments burden of maintaining U.S. troops in Germany. Thus, in addition to the revaluation of the deutsche mark, Germany reluctantly agreed to make cash payments and loans to the United States and to

32. See, for example, Solomon 1982; Kaplan and Schleiminger 1989; and Helleiner 1994.

33. Tsoukalis 1977, 52.

34. Triffin 1960.

35. Kaufmann 1969.

maintain investments in U.S. Treasury bonds, beginning in July 1961. This agreement, which would be renewed six times over the following twelve years, was Germany's first encounter with U.S. arm-twisting in the international monetary field.³⁶

Under the leadership of Walter Hallstein, former state secretary in the German foreign ministry, the European Commission prepared its first report on monetary integration, issued in October 1962, which attempted to place currency matters on the EC's agenda. The Commission was acutely aware of the international monetary environment, and Hallstein was critical of the unilateralism with which Germany decided to revalue the deutsche mark.³⁷ The Commission argued that the international monetary system was fragile and would benefit from the Community functioning as a single unit and creating a European reserve currency. In addition, the report noted, the "cohesion" of the Common Market "would inevitably be deeply affected by serious monetary difficulties even if these primarily concerned countries outside the Community." With the elimination of intra-European trade barriers, changes in exchange rates could be so disruptive "that the Common Market itself could be imperiled." Thus, in this and a subsequent report of June 1963, the Commission proposed the creation of a Committee of Central Bank Governors, prior consultation among European governments on parity changes, and institutionalized cooperation on monetary, exchange rate, and financial policies.³⁸

Although EC member states maintained a commitment to the Bretton Woods institutions as the primary fora for monetary cooperation, these proposals generated significant concrete results for regional monetary cooperation. First, the Committee of Central Bank Governors was created and the principle of prior consultation on parity changes was established in 1964. Second, in issuing its report the Commission established a road map for monetary integration, to which national governments would return when their faith in the global regime later waned. The Community had taken its first tentative and halting steps toward monetary integration when the capacity of the United States to maintain the stability of the system was first questioned.

Regime Defense

During 1961–66, U.S. policy returned to a stabilizing mode. President John F. Kennedy was deeply concerned about balance-of-payments problems and oversaw a sustained effort to preserve the gold parity of the dollar. That effort included creating the Group of Ten (G-10) and General Arrangements to Borrow; issuing foreign-currency denominated bonds; opening up swap agreements with foreign central banks; initiating foreign exchange intervention; and introducing capital controls in the form of the Interest Equalization Tax. The Johnson administration expanded capital controls, acceded to the creation of Special Drawing Rights at the IMF, entered a series of agreements on gold, and supported the British pound.³⁹ U.S. trade and current account balances

36. See Odell 1982, chaps. 3 and 4, and 355–56; and Gowa 1983, 53–55.

37. Hallstein 1972, 127, 131.

38. See Commission of the European Community 1962, 63–67; and Hallstein 1972, 128–29.

39. See, among others, Roosa 1967; Solomon 1982; Odell 1982; and Conybeare 1988.

registered healthy surpluses, and net capital outflows abated. This was thus the stable period of the operational years of the Bretton Woods regime.

European governments set aside their concerns about regional monetary stability and gave priority to other projects, such as establishing the Common Agricultural Policy, completing the Common Market, and deciding on Britain's first application for EC membership. The follow-through on the Commission's monetary report was therefore limited. Monetary and financial cooperation was certainly not institutionalized. By the end of this episode, monetary integration was virtually completely off the agenda.⁴⁰

Benign Neglect

After 1966, as is extensively analyzed elsewhere,⁴¹ conflict erupted between the United States and its European partners over the management of the international monetary system. The United States, which until then had had a superior record of price stability, embarked on macroeconomic expansion. The resulting increase in U.S. inflation and trade deficits damaged international confidence in the dollar and contributed to periodic crises in foreign exchange markets. The Johnson and early Nixon administrations, moreover, let the European and Japanese authorities bear the brunt of the foreign exchange intervention and macroeconomic policy adjustments necessary to keep the Bretton Woods regime intact—a policy that came to be labeled “benign neglect.” When the United States' partners objected to these arrangements, fissures within the Bretton Woods regime grew too deep for the G-10 to patch.

This episode was a paradigmatic example of unwelcome monetary spillover under fixed exchange rates and increasingly mobile capital (Figure 1, upper-left quadrant). Possessing a domestic price-stability orientation, Germany in particular chafed under the obligation to ease monetary policy. In December 1969, the heads of government of the six member states of the EC met at The Hague to discuss the EC's future, an auspicious occasion for a new monetary initiative.⁴² The summit endorsed the drawing up of plans for EMU, based on the harmonization of economic policies, and the consideration of a European reserve fund.⁴³ A committee chaired by Prime Minister Pierre Werner of Luxembourg produced the subsequent report, sweeping in scope, that defined EMU as the irrevocable convertibility of national currencies, the fixing of their exchange rates, and complete liberalization of capital controls and laid out a plan for achieving all this in three stages. The report stressed the harmonization of monetary policy as well as the importance of coordinating fiscal policy and implementing regional structural policies. Monetary policymaking would take place within

40. See, for example, Tsoukalis 1977; and Dyson 1994.

41. See, among other works, Cohen 1977; Solomon 1982, 100–72; Odell 1982; Gowa 1983; and Coombs 1976.

42. The completion of the Common Market, German chancellor Willy Brandt's *Ostpolitik*, and Georges Pompidou's replacement of Charles de Gaulle as president of France also contributed momentum to European integration. Dinan 1994, 69, 73, 76.

43. Summit communiqué, reproduced in Werner Report 1970, 32–33.

a system of central banks similar to the Federal Reserve System. The committee proposed 1980 as the target year for completing EMU.⁴⁴

Although the timetable for EMU in the Werner Report proved to be wildly optimistic, the three-stage approach and many of the principles would be echoed by the Delors Report nineteen years later and incorporated into the Maastricht Treaty.⁴⁵ More immediately, the Werner Report established a concrete agenda for exchange-rate cooperation and suggested among other things that European central banks should, on an experimental basis, tighten the range of fluctuation of their currencies against one another more narrowly than their ranges against the dollar would allow.⁴⁶ As the Bretton Woods regime unraveled, Europe implemented portions of the Werner plan.

Nixon Shocks

The conflict between U.S. macroeconomic policy and the requirements of the Bretton Woods regime finally came to a head in the early 1970s. In 1971, the United States ran its first trade deficit of the postwar period and, indeed, of the century. Rather than tighten monetary policy, however, the Federal Reserve reduced interest rates to accommodate President Richard M. Nixon's wish to stimulate economic growth, causing an increase in capital flows from the United States to Europe (Figure 1, upper-left quadrant). In May 1971, a wave of speculation rocked the currency markets. Germany, which had continued to complain bitterly of "imported inflation" since the mid-1960s, experienced strong upward pressure on the deutsche mark.⁴⁷ The German minister of economics and finance, Karl Schiller, proposed that the European currencies float jointly against the dollar, maintaining relatively stable cross rates. Erik Hoffmeyer, the long-serving governor of the central bank of Denmark and frequent partner of German officials in European monetary cooperation, reflects on this episode:

Germany's number one objective [was] to unwind the dependence on the dollar, and this attitude was the foundation of the policy that set out the path to the confrontation [with the United States]. . . . The genuine European support for international cooperation in the early 1960s changed in the latter part of the 1960s to animosity or even hostility towards what was conceived as dollar hegemony—in parallel with reservations towards the U.S. engagement in Vietnam. The German idea of creating a zone of monetary stability independent of the dollar—even though unprofessional—was an economic expression of this political attitude.⁴⁸

The six members of the EC, however, were far from united on the question of a joint float. Although Germany was in favor, the other European countries feared losing competitiveness by allowing their currencies to float upward with the deutsche mark

44. Werner Report 1970, 1–29.

45. Baer and Padoa-Schioppa 1989.

46. Werner Report 1970, 22–23.

47. Emminger 1977 and 1986.

48. Hoffmeyer 1992, 194.

against the dollar. Although tempted by the prospect of using European solidarity to force the United States to accept a devaluation, France opposed the joint float and proposed instead more extensive reliance on capital controls. Italy joined France in opposing the joint float. Belgium tended to side with France as well, and the Netherlands with Germany. In the end, the German and Dutch governments decided to float their currencies while the other members reintroduced capital controls.⁴⁹

In August 1971, as part of his New Economic Program, President Nixon jettisoned gold convertibility, scuttling the Bretton Woods regime, and imposed a hefty 10 percent import surcharge—dramatic measures by the dominant state that shocked its partners economically and politically. By the end of August, all of the major currencies were floating except for the French franc. Freed of the regime's constraints, the United States, represented by Treasury Secretary John B. Connally, aggressively negotiated a devaluation of the dollar with its European partners.

Resentful of the duress applied by Connally, the European governments struck a common position in these negotiations. Acting on agreement with Chancellor Willy Brandt of Germany, President Georges Pompidou of France met Nixon in the Azores in December 1971 and concluded an accord on a dollar devaluation against gold. This accord was generalized to the G-10 at a meeting a few weeks later at the Smithsonian Institution in Washington, D.C., and briefly extended the life of the fixed-rate regime.⁵⁰

The Smithsonian Agreement, however, permitted fluctuations of European currencies against one another, which threatened the system of common prices for agricultural goods within the EC.⁵¹ European governments, therefore, decided among themselves to restrict the fluctuation of their currencies more narrowly than permitted by the agreement against the dollar, creating the so-called snake in the tunnel. The snake was part of a broader monetary bargain that included the use of capital controls, particularly in Germany, a revival of economic policy coordination, the creation of the European Monetary Cooperation Fund, and the advent of financial assistance to regions. These measures were endorsed at the Paris Summit of October 1972, which affirmed the Werner Report's plan for EMU as a top priority of the EC.⁵²

Meanwhile, the United States persisted in a lax monetary policy, despite continued weakness of the dollar and rising domestic inflation. A tightening of monetary policy would have preempted inflation, spared Europe capital inflows, and prolonged the fixed-rate regime. However, Federal Reserve Chairman Arthur Burns explicitly refused to tighten monetary policy to support the dollar, although he would soon do so in the spring of 1973 to fight domestic inflation.⁵³

As speculation mounted, the dollar was devalued for a second time in February 1973. At that time, Treasury Secretary George P. Shultz announced that the United States would no longer intervene in the foreign exchange markets and would abolish

49. Tsoukalis 1977, 112–13.

50. *Ibid.*, 116–17. See also Bloomfield 1973.

51. See Tsoukalis 1977, 120; and McNamara 1993.

52. Tsoukalis 1977, 119–26.

53. See Volcker and Gyohten 1992, 113–14; and Henning 1994, 263–66.

all capital controls, and that domestic monetary policy would continue to ignore “international concerns.”⁵⁴ As a result, within weeks of the devaluation, U.S. and European officials were forced to float the dollar, marking, in March 1973, the advent of the flexible exchange-rate regime. European governments, however, continued to float their currencies jointly; the tunnel was removed but the snake remained.

European governments thus had taken an important step forward that contrasted with the failure of the spring 1971 proposal to float jointly. They took this step in the presence of aggressive U.S. policies and notwithstanding the formidable challenges posed by the differences among their economies. Such cooperation held the prospect of stabilizing exchange rates, spreading the effects of dollar fluctuations over a larger monetary area, and limiting regional disintegration.

Pressure Abates

Although U.S. international monetary policy had become *laissez-faire*, as Secretary Shultz indicated, U.S. macroeconomic policy during the remainder of 1973 and through 1976 did not shock the international system. Oil price increases, a deep recession, and exchange-rate fluctuations strained the international economy, but U.S. domestic policies were relatively stabilizing. The Ford administration restrained fiscal deficits and fought domestic inflation.⁵⁵ The absence of disruptive policy shifts differentiated the policies of the Ford administration from those of other administrations with *laissez-faire* external policies, such as the Nixon and first Reagan administrations.

The United States led negotiations over reform of the fixed-rate regime, pressing for more symmetrical adjustment rules, but ultimately codified the flexible-rate regime at the Rambouillet summit in 1975. Meanwhile, the Department of the Treasury reinstated foreign exchange intervention, usually in small quantities as exchange-rate smoothing operations. U.S. trade and current account balances improved substantially, with the current account posting a record surplus in 1975. The Ford administration was consistent in one respect that European governments welcomed: its predominantly *laissez-faire* posture toward the dollar was replicated in its attitude toward the macroeconomic policies of European governments. The United States declined in particular to pressure foreign governments to stimulate aggregate demand.⁵⁶

European monetary integration regressed during this period. At the time of the switch to floating at the global level, the membership of the snake comprised Belgium, Denmark, France, Germany, Luxembourg, and the Netherlands, plus Norway and Sweden as associate members. Germany, the Netherlands, and Norway each revalued within the snake during 1973. Modest institutional changes were insufficient to prevent the withdrawal of the French franc in January 1974, its reentry in

54. Cited by Tsoukalis 1977, 127.

55. U.S. Council of Economic Advisors 1977, 76–83.

56. *Ibid.*, 118.

July, and its withdrawal again in March 1976, at which time plans for EMU were effectively shelved.⁵⁷ Successful intra-European exchange-rate cooperation in the early and mid-1970s was thus limited to stabilization between the deutsche mark and the currencies of Germany's smaller neighbors.

Locomotive Dispute

In 1977, the Carter administration sought to stimulate the U.S. and world economies. Its officials devised the so-called locomotive strategy, whereby countries running trade surpluses would embark on expansionary fiscal programs and thereby bring themselves and deficit countries out of the lingering economic stagnation of the 1975–76 period. Carter's aides pressed fiscal expansion on Germany, whose trade surplus was growing at that time. They made it clear, moreover, that their own plans for increasing U.S. growth would proceed irrespective of Germany's and other surplus countries' compliance with the administration's request. If surplus countries did not comply, the dollar would depreciate, a development that administration officials said they would view as appropriate and would not oppose.⁵⁸

Chancellor Helmut Schmidt of Germany resisted U.S. pressure for reflation. Accordingly, as U.S. officials had foreseen, the dollar fell from around DM 2.50 in Autumn 1976 to DM 2.00 in early March 1978. Schmidt had assured his counterparts at the London summit in May that the German economy would grow by 5 percent in 1977; in fact, German growth registered only 2.5 percent for that year. The appreciation of the deutsche mark reduced the prospects for German exports and employment, threatened to prolong weakness in the recovery, and increased political pressure within Germany for offsetting stimulative policies (Figure 1, upper-right quadrant). The rise of the deutsche mark also reduced import prices, softening opposition to expansionary policies on inflation grounds, from the Bundesbank in particular.

Thus, the depreciation of the dollar provided the Carter administration with strong leverage over the Schmidt government. Although he deftly used it to his political advantage within Germany, Schmidt deeply resented the United States using the dollar weapon. For one thing, foreign pressure to reflate greatly complicated the political management of his social-liberal coalition. Moreover, officials at the Bundesbank were forced to intervene and ease domestic monetary policy in order to stem the rise of the deutsche mark against the dollar and thus shared Schmidt's resentment.

Therefore, as the dollar fell to record lows against the deutsche mark in 1978, Schmidt and President Valéry Giscard d'Estaing of France launched negotiations to create the EMS. Schmidt was explicit about seeking a wider European area of monetary stability over which pressures for currency appreciation, previously concen-

57. See Gros and Thygesen 1992; and Katz 1979.

58. This and the next two paragraphs draw from Putnam and Henning 1989; for the resolution of this dispute, see 75–98.

trated on the deutsche mark, the so-called counterpole to the dollar, could be spread.⁵⁹ The instability of the dollar and the changeability of U.S. international monetary policy greatly enhanced the attractiveness of the deutsche mark as a secondary reserve currency, which the German government and Bundesbank feared would compromise domestic monetary control. Stabilizing exchange rates among the European currencies and creating the European Currency Unit (ECU) within the new system was also, for several German officials, a strategy for avoiding large increases in deutsche mark holdings in official and private portfolios outside Germany.⁶⁰

At their meeting in Brussels in early December 1978, the European Council decided to create the EMS, and the new system began operating at the beginning of March 1979. The EMS restricted fluctuations of most member currencies to ± 2.25 percent around central rates and formally required unlimited intervention at the margins. The system also augmented (compared to the snake) the financing facilities that the central banks could draw on to support intervention. Although Schmidt and d'Estaing were unable to persuade Prime Minister James Callaghan of Britain to participate in the system, Belgium, Denmark, Ireland, Italy, Luxembourg, and the Netherlands all joined Germany and France in the new regime.

When asked later about his purpose in creating the EMS, Schmidt responded that it was an instrument to strengthen European economic and political integration and "an incentive for the Americans to understand that they must not let the dollar go down the drain."⁶¹ "[T]he reckless conduct of the United States with respect to monetary policy and the dependence of the monetary policy of the European countries on the dollar, on dollar interest rates, and dollar speculation had had painful effects," Schmidt wrote. "We knew that the national European economies individually were not in a position to arm themselves sufficiently against the turbulences of the world. For that reason we wanted union and common success."⁶²

The French, British, and Italian governments had not objected to the locomotive strategy of the Carter administration as had the German government. To the contrary, as deficit countries they stood to gain from German reflation and tacitly approved of U.S. pressure. Thus, transatlantic conflict in the late 1970s did not spur European monetary integration primarily through the objections of deficit countries. Rather, differences with the U.S. administration were most critical in shifting the *German* calculus of the costs and benefits of regional monetary integration. As long as U.S. monetary authorities refused to give primary emphasis to fighting inflation, weakness in the dollar would strengthen the attractiveness of the deutsche mark as an international currency, raise its value, and harm German competitiveness—problems that the creation of a regional zone of monetary stability would help address. The

59. See Helmut Schmidt, "Die burokraten ausgetrickst," *Die Zeit*, 24 August 1990; and "Kampf gegen die nationalistischen," *Die Zeit*, 31 August 1990; Giscard d'Estaing 1988, 135–61; Ludlow 1982; and Eminger 1986, 364.

60. Nölling 1993, 50. See also Schmidt 1990, 138, 226–27, 230, as cited in Nölling 1993, 48–49, n18, 20; and Hanrieder 1989, 299–306.

61. Hanrieder 1982, 211.

62. Helmut Schmidt, "Die burokraten ausgetrickst," *Die Zeit*, 24 August 1990. These statements confirm the interpretation provided in Ludlow 1982, 63–64.

German government and Bundesbank did not abandon their concerns about inflation in the economies of the European partners, but the international environment averse to German preferences caused the risks of regional cooperation to fade relative to the benefits.

Active Cooperation

At the end of October 1978, the dollar reached an all-time low of DM 1.71, at which point the Carter administration and the Federal Reserve finally intervened with determination in concert with European central banks to rescue the American currency.⁶³ The operation proved successful and signaled the passage of U.S. policy into another phase of active cooperation. Between late 1978 and spring 1981, the United States intervened with regularity to stabilize exchange rates. U.S. trade and current account balances improved. Carter administration officials desisted in efforts to force policy adjustment onto partners. Several months after the second set of oil price increases, the Federal Reserve tightened monetary policy decisively beginning in October 1979. Although this move also increased interest-rate variability, several European officials, the Germans in particular, had strongly advocated and subsequently applauded the tightening.⁶⁴

The EMS, although a significant accomplishment, provided very little stability in its early years. European inflation differentials remained large, and realignments within the system were frequent and substantial. Daniel Gros and Niels Thygesen argue that, if the decision to launch the EMS had not already been made, it could not have been agreed to during this period. Avoiding serious misalignments and making comprehensive realignments a joint responsibility represent minimal achievements. However, the second, institutional stage of the EMS plan, which envisioned a European Monetary Fund, was abandoned in December 1980.⁶⁵

Dollar Appreciation

The Reagan administration embarked in 1981 on a fiscal expansion that rekindled transatlantic arguments over macroeconomic policy. Unprecedented budget deficits and tight monetary policy combined to produce record interest rates in the United States. European central banks responded by tightening monetary policy, which, as Schmidt complained, produced the highest interest rates “since the birth of Christ” in Germany. Moreover, despite appreciation of the dollar, Reagan administration officials declared that they would suspend intervention in the foreign exchange market.⁶⁶

In this case, France rather than Germany encountered the strongest pressure for policy adjustment. Under the leadership of President François Mitterrand, the Socialist government administered a strong fiscal stimulus to the French economy in 1981 and 1982. This choice of reducing unemployment over reducing inflation was dia-

63. See Putnam and Henning 1989, 84–87; and Volcker and Gyohten 1992, 158–59.

64. Volcker and Gyohten 1992, 168.

65. Gros and Thygesen 1992, 72–73.

66. U.S. Joint Economic Committee 1981, 27–28.

metrically opposed to the choices of most other countries, particularly the United States. The divergence placed downward pressure on the French franc.

When European governments complained about U.S. macroeconomic policy and the rising dollar, Treasury Secretary Donald T. Regan promulgated the doctrine of convergence. Regan stated that the goal of the United States at the Versailles summit in June 1982 would be “convergence of our economies with each more stable and with less inflation. If that happens,” he added, “that will stabilize exchange rates.”⁶⁷ His undersecretary for monetary affairs, Beryl W. Sprinkel, was more direct:

If [the Europeans] want to opt for slower inflation and more real growth as we’re doing, we certainly would welcome it. But if they don’t opt in that direction, it’s understandable their exchange rates are going to decline vis-à-vis the dollar.⁶⁸

Thus, the United States used, and benefited from, the dollar weapon again. Although the direction of movement of the exchange rate had reversed, it nonetheless remained a source of U.S. leverage. The depreciation of the franc against the dollar, as well as against the other European currencies, increased French inflation at a time when it was already high and stimulated French exports, easing the pain of a shift in policy toward austerity—thus providing both a stick and a carrot to prod the Socialist government into reversing its course (Figure 1, lower-right quadrant).

Feeling this pressure, the French president criticized U.S. policy at the Ottawa G-7 summit in 1981 and the Versailles summit in 1982. In 1982, he and Jacques Delors, then finance minister, proposed a joint “decoupling” of European from U.S. interest rates, which German officials rejected.⁶⁹ Mitterrand also proposed an international conference akin to the Bretton Woods conference of 1944 to discuss reform of the global monetary system. This idea was scuttled by, among others, the Reagan administration.

By early 1983, therefore, the French government was running out of options. The franc had already been devalued twice within the EMS since the Socialist government came to power, and speculation against the currency was intensifying once again. Mitterrand and his government faced a choice between continuing the Keynesian expansionary program on which they had embarked in 1981 and leaving the ERM, on the one hand, or remaining within the ERM, after a devaluation, and implementing restrictive policies to control inflation, on the other hand.⁷⁰

The Reagan administration had created a very inhospitable international environment for a franc outside the ERM. Delors advised Mitterrand that the currency would depreciate by at least 20 percent if removed from the ERM, an analysis supported by Michel Camdessus, then director of the *Trésor*. Other counselors advised the president that, after an exit from the ERM, an absence of foreign exchange reserves and

67. *International Herald Tribune*, 18 May 1982.

68. *International Herald Tribune*, 2 March 1982, see also 26 April 1982.

69. Interviews (not for attribution) by the author with ministerial and central bank officials in Bonn, Frankfurt, and Paris, February 1982–January 1983. See also Helleiner 1994, 141.

70. See, for example, Sachs and Wyplosz 1986; and Cameron 1996. For treatments of this episode as part of a broader review of French monetary and exchange-rate policy, see Loriaux 1991; Goodman 1992; and de Boissieu and Pisani-Ferry 1998.

financing to cover trade deficits would force France to seek loans from the IMF with stringent conditions attached.⁷¹ Had a different U.S. policy mix produced low interest rates and a stable dollar instead, withdrawal of the franc would almost certainly have produced a far more moderate, and acceptable, depreciation.

After intense negotiations with Germany, therefore, the Socialist French government decided in March to remain within the ERM and institute austere macroeconomic policies. Mitterrand suffered politically from the reversal of his domestic stimulus program. In explaining this reversal he said, "I overestimated the goodwill of the Americans. I don't expect anything anymore from Reagan."⁷² The French shift nonetheless marked the beginning of serious convergence toward stability-oriented policies and a quantum strengthening of the EMS.

Reflation Conflict Renewed

Throughout the first Reagan administration the dollar continued to appreciate. Treasury officials took a benign view of this appreciation and President Reagan cheered the dollar upward in his state of the union address in January 1985. The predictable trade consequences of the overvalued dollar, however, produced a groundswell of protectionism in Congress. In an effort to limit the damage to open trade policies, the second Reagan administration abruptly shifted course and sought a realignment of the dollar against European and Japanese currencies. This new goal was enunciated with the other members of the Group of Five (G-5) in the Plaza Accord of September 1985.⁷³

However, after the dollar had fallen a mere 7 percent against the deutsche mark—to a level still much too high to reduce the U.S. external deficit—European governments ceased to cooperate with the Reagan administration. The German government, fearing that appreciation of the deutsche mark would reduce exports among other things, and the Bundesbank were the first to break ranks with the United States. Treasury Secretary James A. Baker III, again cognizant of trade politics on Capitol Hill, pressed European governments for expansionary fiscal and monetary policies. Germany, with the biggest external surplus, was again singled out for special attention. Baker attacked the Bundesbank directly and publicly in the autumn of 1986 for failing to ease monetary policy more quickly.

In the absence of expansionary policies in Germany, Baker declared, a depreciation of the dollar would be desirable to reduce the U.S. trade deficit. Baker adeptly employed the dollar weapon to press the German government to expand domestic demand throughout 1986 and into 1987. The resulting appreciation of the European currencies reduced growth prospects and inflation and thereby pressed European governments to reflate.

Whereas France and the United Kingdom had sided with the United States in urging Germany to undertake a fiscal stimulus during the locomotive dispute, European governments closed ranks in 1986. On this occasion, when U.S. pressure on

71. Cameron 1996, 67–72.

72. *New York Times*, 11 October 1983.

73. See Funabashi 1988; and Henning and Destler 1988.

Germany and the Bundesbank was similarly intense, the European partners sided with Germany at a meeting at Gleneagles, Scotland, and criticized the U.S. administration.⁷⁴ The shift marks important progress in the convergence of European preferences and willingness to resist U.S. political pressure collectively.

Dollar weakness, moreover, forced a European review of the financing mechanisms of the EMS. By placing differential pressures on the European currencies, the depreciation of the dollar forced a general realignment of the ERM in January 1987 and in the process created a bitter intra-European dispute. Prime Minister Jacques Chirac of France sharply criticized the German refusal to intervene, or to extend deutsche mark financing to the French and other central banks for intervention, before the deutsche mark–franc exchange rate reached the margins.⁷⁵ The German government and Bundesbank were of course concerned about the domestic liquidity effects of extending such credits for “intramarginal” intervention. Macroeconomic conflict with the United States, however, while contributing to instability among European currencies, again placed the inflationary risks associated with intramarginal interventions in a new light.

Secretary Baker agreed to attempt to call a halt to the depreciation of the dollar in exchange for fiscal expansion in Germany (and Japan) in February 1987. But, despite the signing of the Louvre Accord, and despite pleas by German finance minister Gerhard Stoltenberg and Bundesbank President Karl Otto Pöhl,⁷⁶ the United States refused to take responsibility for the financing of its current account deficit. More importantly, the Louvre Accord, which established secret target ranges for the dollar–deutsche mark and dollar–yen exchange rates, threatened to constrain the Bundesbank from raising interest rates. A tightening of German monetary policy, which Bundesbank officials planned for the autumn of 1987, would renew downward pressure on the dollar, already now close to the record lows set against the deutsche mark in late 1978. Bundesbank officials were keenly aware that this tightening would intensify transatlantic conflict.

German officials were therefore more inclined to reach an accommodation with the French over the financing arrangements within the EMS. The agreement with the European partners was laid down in the Basle–Nyborg Accord of September 1987. This agreement contained notable concessions on the part of Germany and the Bundesbank in particular.⁷⁷ By acceding to it, German government and Bundesbank officials promoted European monetary solidarity at a moment when such cohesion helped to deflect pressure for policy adjustment from the United States.

In October the Bundesbank raised interest rates—a move that Secretary Baker harshly criticized. His criticisms, in part, precipitated the 1987 worldwide stock mar-

74. See *Financial Times*, 22, 23 September 1986; and *Wall Street Journal*, 23 September 1986.

75. *Financial Times*, 7–8 January 1987.

76. See Karl Otto Pöhl, “Are We Moving Towards a More Stable International Monetary Order?” speech given at the American Institute for Contemporary German Studies, Washington, D.C., 7 April 1987; and Gerhard Stoltenberg, “The United States and Europe: Main Objectives for Economic Policies and International Cooperation,” speech given at Georgetown University, Washington, D.C., 10 April 1987.

77. The accord is described in *Deutsche Bundesbank* 1987, 64–70.

ket crash and a depreciation of the dollar to new record lows at the end of the year. The European central banks used the expanded access to Bundesbank credit to successfully ward off turmoil within the ERM that resulted from global monetary instability.⁷⁸ Transatlantic macroeconomic conflict and the use of the dollar weapon had again accompanied a quantum strengthening of the EMS.

Renewed Neglect and Pressure

To some extent, U.S. policy reverted to a more cooperative stance in 1988. Treasury operated secret target ranges for the dollar against the deutsche mark and yen and ceased pressing allies for policy change. But the reversion toward cooperation was partial and brief and soon gave way to renewed neglect. In August 1988, George Bush handicapped his future administration's efforts to reduce the U.S. federal budget deficit with his "read my lips" pledge not to raise taxes under any circumstances. As president, he and his treasury secretary, Nicholas F. Brady, were openly agnostic with respect to the exchange rate for the dollar and allowed the target ranges to unravel.⁷⁹

Aware that large U.S. budget deficits and associated trade deficits had been the ultimate cause of aggressive American advocacy of reflation in Europe during the Reagan administration, European officials had ample reason to expect further exchange-rate movements and pressure from the United States for policy adjustment. American belligerence on macroeconomic policy, Helmut Schmidt wrote in 1989, has "grown into a monster of the Loch Ness type: It keeps coming up for air."⁸⁰

European officials, meanwhile, tightened regional monetary cooperation further. At the beginning of 1988, the French government was dissatisfied with monetary arrangements in two respects: The EMS remained asymmetrical, notwithstanding the Basle–Nyborg reforms, and the deutsche mark reached a new record of DM 1.56 against the dollar, raising the value of the other European currencies in the ERM along with it. The French finance minister, Edouard Balladur, argued that the appreciation of the European currencies was "contrary to the fundamental interest of Europe and of its constituent economies" and concluded that "rapid pursuit of the monetary construction of Europe is the only possible solution."⁸¹ The proposal was enthusiastically seconded by the Italian minister of the treasury, Giuliano Amato.

Senior German officials responded with constructive counterproposals. Foreign Minister Hans-Dietrich Genscher proposed the creation of a European central bank and currency area, subject to strict conditions, and set down a procedure for achieving these goals. Finance Minister Gerhard Stoltenberg also responded positively. Genscher's memorandum to the Ecofin Council on this subject identified two motives, among several: the reduction of European dependence on the dollar and "the

78. Deutsche Bundesbank 1987, 67.

79. See Destler and Henning 1989, 71–73; and Henning 1994, 290–97.

80. Schmidt 1989, 266–67. See also Commission of the European Communities 1990b, Annex A, 5–6.

81. Quoted in Gros and Thygesen 1992, 312.

management of exchange rates to third currencies closer to equilibrium.”⁸² The European Council then commissioned a report on EMU to be written by a committee of experts chaired by Jacques Delors. The study, christened the “Delors Report,” presented a detailed three-stage plan on EMU, reminiscent of the Werner Plan, to the European summit at Madrid in June 1989.⁸³

Shortly after the European governments convened an intergovernmental conference to negotiate over the proposals of the Delors Report—and as Schmidt’s metaphor foretold—Treasury Secretary Brady launched an offensive for an easing of European monetary policies in the spring of 1991. Vexed by high German interest rates attending German unification, and the determination of other European countries to follow suit, Brady pressed the Bundesbank in particular to lower interest rates and secured President Bush’s participation in that effort. The intergovernmental conference resulted, as is now well known, in the Treaty on European Union, agreed at Maastricht, the Netherlands, in December 1991. The Maastricht Treaty committed the member states to creating a monetary union by the end of the decade and laid down an elaborate procedure for achieving this goal.⁸⁴

The literature surveyed earlier offers several explanations for the conclusion of the Maastricht Treaty: progress toward liberalization of capital controls, the prospective completion of the single market, a grand political bargain stemming from German unification, and linkage politics in European institutions. Evidence presented here, though, suggests that U.S. pressure and dollar instability reminded European governments—at several points along the path to agreement on monetary union, from the establishment of the Delors Committee through the Maastricht summit and beyond—of the desirability of monetary insulation from the United States.

The international motive was expressed most clearly by the European Commission and French officials. In its October 1990 report, entitled *One Market, One Money*, the Commission argued that enhancing European bargaining power in global monetary affairs was one of the important arguments in favor of EMU.

As long as Community governments and central banks set their policy in a non-coordinated way, Europe appears as a collection of medium-sized policy centres facing two major poles, the U.S. and Japan. . . . To some extent, the United States can exploit this asymmetry by making its policy choices in a non-coordinated fashion without suffering much from a similar behaviour of European nations. The effect of EMU would be to aggregate 12 economies into a single major block whose degree of interdependence with the U.S., Japan, and the rest of the world would be meaningful.⁸⁵

This analysis was not confined to the elite within Community institutions or member governments. On the eve of the referendum in France on the Maastricht Treaty, the newspaper *Libération* conducted a poll of the electorate’s attitudes. The poll found that 62 percent of the French electorate, and 77 percent of those voting in favor of the treaty, believed that the European Union would provide equal strength in conflicts

82. *Ibid.*, 314.

83. Delors Report 1989.

84. Maastricht Treaty 1992.

85. Commission of the European Communities 1990a.

with the United States and Japan. Among reasons supporters voted “oui,” collective strength ranked at the top, along with the belief that the European Union would assure peace in Europe.⁸⁶ Given the narrowness of the “oui” margin, the treaty would almost certainly have failed in France without the international motivation and thus would have failed in Europe as a whole.

By the time the Maastricht Treaty entered into force in November 1993, the prospects for EMU had been clouded by a succession of currency crises in 1992–93 that forced the British pound and Italian lira from the ERM and the widening of its bands to ± 15 percent. Although continued weakness of the dollar contributed to these crises, it also, as in previous episodes, galvanized European officials to counteract the destabilizing impact on European cross rates and mobilized important constituencies for the completion of monetary union.

At one point during the ERM crises, Prime Minister Pierre Bérégovoy, ex-Prime Minister Raymond Barre, and other French officials lashed out at an “Anglo-Saxon conspiracy” as the source of the franc’s problem.⁸⁷ Regardless of its merits, the accusation suggests that senior French officials continued to perceive monetary integration as a contest between a Franco-German commitment to stability, on the one hand, and the forces of instability, including the United States, on the other. Undaunted by the switch to wide bands, Delors reaffirmed an enduring motive for monetary integration:

With a single currency founded on an economic base accounting for a quarter of world production, the European Community could weather the turbulence on the world’s capital markets. It would be strong enough to force the United States and Japan to play by rules which would ensure much greater monetary stability around the world.⁸⁸

The general weakness of the dollar persisted into the Clinton administration. The currencies of the low-inflation countries, principally Germany and France, thus appreciated against both the dollar and the European currencies that had been devalued within the ERM or driven from it. Suffering from appreciation, especially during 1995 and early 1996, tradable goods producers within the hard core thus became stalwart proponents of EMU as a strategy to prevent “competitive depreciation” by partners within the single market.⁸⁹ The intensification of their preferences thus helped to renew the political commitment to EMU at a moment when its prospects seemed particularly dim.

Summary and Conclusion

The preceding section tested the international thesis by reviewing the postwar behavior of the United States—four cases of stabilization and seven cases of disruption of the international monetary system—and by examining the response of European

86. *Libération*, 12–13 September 1992, 4.

87. See, for example, *Financial Times*, 11 February 1993.

88. Jacques Delors, “Our Europe in the Global Village: Survival or Decline,” speech given at Lorient, France, 29 August 1993. See also *Financial Times*, 18 September 1993.

89. See, for example, *Financial Times*, 28 February and 27 April 1995; and *Corriere Della Sera*, 24 May 1995, as reported in Eichengreen 1996, 4.

TABLE 1. *Summary of four periods of stability*

<i>U.S. behavior</i>	<i>System</i>	<i>European response</i>
Late 1940s through mid-1950s: U.S. macroeconomic policy stable; U.S. supports European recovery and return to convertibility	Bretton Woods regime becomes operational, and monetary system is stable	European states cleave to Bretton Woods regime; restore convertibility; retire European Payments Union; forgo substantial monetary commitments in Treaty of Rome
1962–66: Kennedy and early Johnson administrations address balance-of-payments problems	System is stable	Minimal follow-through on Commission proposals
1974–76: U.S. macroeconomic policy restrictive; U.S. declines to press partners for expansion	Dollar fluctuates, but trend is flat; U.S. external balances improve	Snake unravels; EMU plans shelved
1979–80: U.S. tightens monetary policy, intervenes in foreign exchange market	Dollar relatively stable; current account in slight surplus	New EMS exercises little discipline; multiple realignments; EMF abandoned

governments and central banks. Tables 1 and 2 summarize the findings of this review. The four cases in which the United States acted in a stabilizing fashion demonstrated clear, though partial, retrogression in European monetary integration. Every major step forward in regional exchange-rate and monetary cooperation was associated with U.S. disturbances. In every case of disruption, U.S. shocks were followed by efforts to strengthen intra-European monetary cooperation. Each of those efforts resulted in some measure of institution building, exchange-rate stabilization, and/or monetary policy coordination.

In addition to finding a strong correlation between U.S. disturbances and European monetary integration, this review provides evidence that the relationship is causal rather than coincidental. In each case, community documents, commentary of key participants, and/or a particularly tight sequencing of events support the inference that outside disturbances and pressures caused the higher level of regional monetary integration observed and did so through providing at least two of the five incentives identified by the thesis.

Of the seven cases of disturbance, the most complex is renewed American neglect in the late 1980s and early 1990s and the conclusion of the Maastricht Treaty. Other factors, of course, were also at work in this case. Abundant evidence nonetheless clearly supports the contention that international monetary considerations were important determinants of European monetary integration. Such evidence includes the close correlation between transatlantic conflict, the creation of the Delors Commit-

TABLE 2. *Summary of seven disturbances*

<i>U.S. disturbance</i>	<i>Causal link</i>	<i>European response</i>
1958–61: U.S. overall balance of payments shifts from surplus to deficit	Capital flows to Europe, causing a revaluation of the deutsche mark in 1961	Hallstein initiative; Committee of Central Bank Governors created
1967–71: U.S. expands; adopts “benign neglect”	Transmission of inflation to Europe; chronic international monetary crises; instability in European cross rates	Werner Report of 1970 proposes EMU
U.S. suspends gold convertibility in 1971 and switches to flexible exchange rates in 1973	Currency instability threatens the Common Market	Creation of the snake
Locomotive conflict of 1977–78; U.S. presses German government to reflate	Dollar depreciation drives wedges between European currencies	Creation of the EMS
Reagan policy mix drives U.S. interest rates upward	Dollar appreciation aggravates European inflation and supports growth	France chooses to remain in the ERM in March 1983
Reflation controversy of 1985–87	Dollar depreciation places pressure on the EMS	Basle–Nyborg agreement and creation of Delors Committee
Late 1980s and early 1990s: continued fiscal deficits, renewed neglect, and pressure for policy adjustment	Dollar weakness contributes to weakness of European periphery relative to core	Maastricht Treaty negotiated, ratified, and pursued

tee, and the negotiations within the Intergovernmental Conference; statements by key participants and official documents; and the salience of transatlantic competition as a source of support for the treaty in its whisker-thin ratification in France. The Maastricht commitment was also dependent on a path that had been paved in large measure by transatlantic monetary conflict: it would not have been possible without the extraordinary success, to that point, of the EMS. This particular case thus presents, at a minimum, moderate support for the international thesis. Taken as a whole, the empirical evidence supports the thesis strongly.

These eleven episodes also reveal institutionalized learning on the part of European actors. Officials, ministries, central banks, and private markets learned from repeated shocks to the system that the United States would direct macroeconomic policy to domestic concerns almost exclusively and that when neglect of the dollar or balance of payments created problems for U.S. policymakers, U.S. officials were

likely to press policy adjustments on foreign partners. That lesson is most clearly, and candidly, expressed by Helmut Schmidt:

Whenever the United States enthusiastically launched a new economic experiment, its administration invited the world's other industrial nations to follow suit. This occurred in the early 1970s, when the system of pegged (but adjustable) exchange rates based on the Bretton Woods model was abandoned; it occurred again in the second half of the 1970s with the introduction of Carter's form of Keynesianism; and it occurred a third time at the beginning of the 1980s, with Reagan's form of Keynesianism, which became known as supply-side economics. In all these cases we were first invited to follow the allegedly good example of the United States. But in each case some time later we were even more urgently requested to participate actively in repairing the undesirable consequences. . . . The first optimistic call for a new beginning is invariably followed by a second call to change course, and the other nations are asked to help while their national economic interests are ignored. The third act then consists of dramatically aggravated conflicts of interest. These cannot be genuinely resolved in the fourth and final act but are more or less swept under the rug with mere declarations of intention.⁹⁰

By providing a springboard for successive advances in monetary integration with each shock, institutionalized cooperation reinforced the lessons of historical experience. The Werner Report, for example, proposed what became the snake, which in turn provided a foundation for the EMS, the successful operation of which made possible the agreement at Maastricht on EMU. Backsliding during periods of systemic stability was thus never complete. Europe exhibited a cumulative, upward ratcheting of monetary integration.

When, over the decades, the members of the Community were divided over or uncertain about currency stabilization, global monetary and exchange-rate instability helped to nudge the most reticent among them along the path toward monetary integration. Although systemic instability created incentives for all European states to augment regional cooperation, it placed particularly strong pressure on France in 1973, Germany in 1978, France in 1983, and Germany in 1987, for example.⁹¹ That pressure biased the terms of European cooperation, in favor of France in 1978 and 1987 and in favor of Germany in 1973, 1983, and 1991, and helps to explain the content of regional agreements (a topic beyond the scope of this article).

As far as the international thesis is concerned, however, the basic point is that this process forced or contributed to an intraregional accommodation. France gradually relinquished its attachment to monetary autonomy and accepted a price-stability orientation. The Bundesbank, hostile to the EMS at the time of the creation of the system, became a defender of the system by the mid-1980s. Germany gambled on the durability of the stability orientation of its partners when concluding the Maastricht Treaty. U.S.-generated disturbances did not extinguish intra-European disputes, but

90. Schmidt 1989, 266–67.

91. See also Loriaux 1991, 248.

rather increased the payoff to European monetary integration for states on both sides of those disputes.

The international monetary thesis complements rather than substitutes for other explanations identified in the literature survey, such as the market-integration and issue-linkage approaches. A certain degree of intraregional trade and investment, at the heart of the market-integration approach, is necessary for U.S. shocks to disrupt economic relations within the area and to inflict domestic costs. National governments might well ultimately have the political objective of ensuring peace in Europe that the grand-bargains variant of the issue-linkage approach ascribes to it. But that approach cannot explain why monetary integration—rather than transportation infrastructure, telecommunications deregulation, European institutional reform, or Common Foreign and Security Policy, for example—became the chosen vehicle for political integration. The international thesis explains the choice of vehicles.

The necessity of a certain level of regional integration raises the question of the applicability of the international thesis beyond Europe. Clearly, other regions that develop the density of integration of Western Europe must also strengthen monetary cooperation in the face of external shocks for the general argument to be valid. At the moment, there are no such regions beyond Europe. With the regionalization of trade and investment relationships, however, others might reach the threshold at which the international thesis would apply. The next region to do so, and thus present another test of the thesis, could be East Asia.

Economic and Monetary Union, if it is completed and endures, will be the most profound transformation of the structure of international monetary relations since the early 1970s or perhaps even since World War II. It will have succeeded in large measure because the United States induced European states to cooperate by neglecting the stability of the international monetary system and exploiting the asymmetry in vulnerability to systemic disruption on numerous occasions over the last four decades. Such an achievement would demonstrate that, over the long run, even the structure of the system can respond to the policy behavior of the dominant state.

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