

International Constraints and Domestic Choices: Economic Convergence and Exchange Rate Policy in France and Italy

JAMES I. WALSH*

The American University, Washington D.C.

As tensions in the European Monetary System demonstrate, international capital flows can have a decisive influence on countries' economic policies. The external constraint of high international capital mobility led the countries of Western Europe in the 1980s to attempt to stabilize their exchange rates and converge toward low levels of inflation. Yet this process was not uniform: French governments pursued a rigorous anti-inflationary policy of high interest rates and a strengthening currency, while Italian governments had difficulty controlling inflation and maintaining the lira in the European Monetary System. This difference is best explained by comparing political institutions and policymaking processes in the two countries. Particular attention is given to political leaders' access to economic policy tools and their capacity to design and implement long-term goals.

An important theme in recent discussions of economic policymaking is that international interdependence provides countries with little room to pursue autonomous economic policies. Increases in international flows of goods, capital, and knowledge have led a number of analysts to argue that national economies must adapt to a new global marketplace or suffer the consequences of becoming a poor site for investment and production. The comments of Peter Drucker exemplify this view: 'From now on any country . . . that wants to do well economically will have to accept that it is the world economy that leads and that domestic economic policies will succeed only if they strengthen, or at least not impair, the country's economic position'.¹

Such arguments have been particularly notable for monetary and exchange rate policies, since worldwide daily turnover in foreign exchange, including derivatives, was estimated to be roughly \$880 billion in 1992.² As capital

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¹ P. F. Drucker, 'The changed world economy', in *Frontiers of Management* (New York, Dutton, 1986), p. 49.

² P. Norman, 'Getting their breath back', *Financial Times*, 26 May 1993, p. 1.

mobility increases, policymakers' ability to adjust to changing international and domestic conditions by pursuing an autonomous monetary policy is reduced. Instead, successful countries focus on increasing competitiveness by implementing stable macroeconomic policies, while instituting microeconomic reforms in domestic markets to facilitate adjustment of resources to changes in international supply and demand.³

This process has been particularly interesting among the highly interdependent countries of western Europe, which have undergone significant shifts in economic policy in response to the internationalization of economic production, exchange, and finance. Here the process has taken the form of greater exchange rate stability and macroeconomic convergence toward low German inflation rates. Yet the responses of European countries to this common challenge have not been uniform. France and Italy, which both experienced high inflation and constant pressures on the values of their currencies in the 1970s, have since parted ways. French inflation has come in line with the inflation rate in Germany (and since 1991 inflation in France has been lower than German inflation), while Italy consistently has had higher inflation than both France and Germany (see Figure 1).

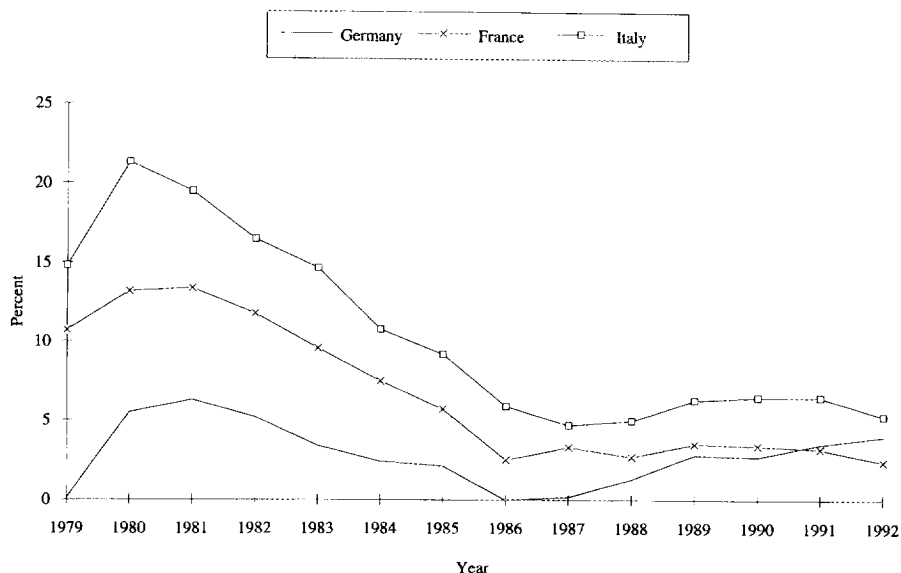


Figure 1. Inflation Rates in Germany, France, and Italy, 1979–92.

Note: Inflation is annual percentage change in consumer prices.

Source: OECD, *OECD Economic Outlook*, various issues.

³ See R. N. Cooper, 'Economic interdependence and coordination of economic policies', in R. W. Jones and P. B. Kenen, (eds), *Handbook of International Economics*, vol. II (Amsterdam, Elsevier, 1985). For an analysis of the role of supply shocks and other issues in the 1970s and 1980s, see M. Bruno and J. D. Sachs, *Economics of Worldwide Stagflation*, (Cambridge, Harvard University Press, 1985).

Furthermore, since the creation in 1979 of the exchange rate mechanism (ERM) of the European Monetary System (EMS), which pegs the currencies of most members of the European Community, the French franc has experienced fewer and smaller devaluations than the Italian lira.⁴ These differing levels of convergence became all the more clear in September 1992, when the franc and lira came under intense speculative attack in the foreign exchange markets. While both the French and Italian governments attempted to maintain their currencies in the EMS and received extensive assistance from other countries, only the French were able to do so. The Italian lira was withdrawn from the EMS, and soon fell to historic lows against other major currencies.⁵

Giavazzi and Pagano argue that the EMS played an important part in the disinflation process in Western Europe by imposing an external constraint on monetary policy.⁶ By effectively fixing the value of the currency to that of a low inflation country such as Germany, domestic interest rates must be kept relatively high to persuade investors to hold the currency. Higher interest rates, in turn, should force down inflation. Their theoretical approach is consistent with studies that find the EMS has operated asymmetrically, with Germany setting its monetary policy independently and the other members of the EMS following the Bundesbank's lead.⁷ Other analysts have emphasized the role of *domestic* political changes which place greater emphasis on fighting inflation, rather than the institutional development of the EMS.⁸ The increased credibility of economic policy has been based primarily on these new political arrangements. However, it has taken time for the authorities' anti-inflationary credibility to be established in the eyes of the public and the market, primarily by consistently undertaking policies of monetary and fiscal restraint.⁹

Yet we are still left with the puzzle of why the process of economic convergence and exchange rate stability has been uneven across the members of the EMS. I argue that the structure of domestic policymaking institutions acts as a crucial intervening variable in an explanation of economic convergence and exchange rate policy. Differences in the access to policy instruments and differing state-society relations influenced the ability of policymakers to respond to common economic policy challenges. My criteria for testing this proposition follow those laid down by Peter Gourevitch: 'The perfect test of the consequences of structure . . . is to find two countries with similar positions or interests in relationship to some policy area but with differing political structures: if the policy is the same, structures do not matter; if the policies differ,

⁴ See A. A. Weber, 'Reputation and credibility in the European Monetary System', *Economic Policy*, 12 (1991), 65-7.

⁵ R. Graham, 'Lira slides after uncertainty over Italian confidence vote', *Financial Times*, 25 February 1993, p. 12.

⁶ F. Giavazzi and M. Pagano, 'The advantage of tying one's hands: EMS discipline and central bank credibility', *European Economic Review*, 32 (1988), pp. 1055-82.

⁷ B. Herz and W. Roger, 'The EMS is a greater deutschmark area', *European Economic Review*, 36 (1992), 1413-25.

⁸ J. T. Woolley, 'Policy credibility and European monetary institutions', in A. M. Sbragia (ed.), *Europolitics: Institutions and Policymaking in the New European Community*, (Washington, Brookings, 1992).

⁹ R. C. K. Burdekin, J. R. Westbrook and T. D. Willett, 'Exchange rate pegging as a disinflation strategy: evidence from the European Monetary System', in P. L. Siklos (ed.), *Varieties of Monetary Reform: Lesson and Experiences on the Road to Monetary Union*, (Boston, Kluwer, 1993).

structures may well be the explanation'.¹⁰ This approach best explains why France and Italy have had different experiences with economic convergence during the EMS period, since they have similar economic profiles but differ significantly in the degree of control exerted over economic policy by political leaders.

State Structure and Capacity

The explanation I suggest for differing French and Italian experiences with economic convergence and exchange rate policy focuses on the capacity of political leaders to design and implement adjustment strategies in the face of international changes. In the literature on state-society relations, France is depicted as having a 'strong' state able to act somewhat autonomously of societal demands, while Italy has a 'weak' state, one which merely responds to the demands of societal actors.¹¹ A crucial aspect this literature highlights is cross-national differences in policymakers' capacity to design and implement economic policies.¹² The reactions of policymakers to international changes is conditioned by the policy tools to which they already have access. While certain policy instruments may be the most effective for tackling a particular problem, if they do not exist, policymakers will find it difficult to create them quickly and without encountering significant political opposition.¹³

In France, policymakers have access to a number of important policy tools to facilitate convergence. The state owns a significant share of large industry, and French policymakers have a long tradition of using state funds and management control to influence the development and restructuring of industry.¹⁴ While Peter Hall has argued that the French state has developed close links to large firms which hinder its ability to act autonomously of societal pressures, this relationship is clearly interactive: not only has the state come to share many of the goals of such firms, but it is able to act on these goals in a decisive manner.¹⁵

Italian policymakers have fewer policy instruments with which to promote convergence, and those instruments which they do possess tend to be of a global nature, rather than the more sector-specific instruments common in France. While the Italian state owns a large number of important industrial and banking firms, political leaders find it difficult to utilize these public holdings for national policy ends since each firm tends to be dominated by particular political parties

¹⁰ P. Gourevitch, 'The second image reversed: international sources of domestic politics', *International Organization*, 32 (1978), 906.

¹¹ P. J. Katzenstein, 'Conclusion: domestic structures and strategies of foreign economic policy', in P. J. Katzenstein (ed.), *Between Power and Plenty*, (Madison, University of Wisconsin Press, 1978), especially pp. 305–7 and pp. 316–23.

¹² See G. J. Ikenberry, 'The irony of state strength: comparative responses to the oil shocks in the 1970s', *International Organization*, 40 (1986), 105–37 and P. Pierson and M. Smith, 'Bourgeois revolutions? The policy consequences of resurgent conservatism', *Comparative Political Studies*, 25 (1993), 487–520.

¹³ K. Thelen and S. Steinmo, 'Historical institutionalism in comparative politics', in S. Steinmo, K. Thelen and F. Longstreth (eds), *Structuring Politics: Historical Institutionalism in Comparative Analysis*, (New York, Cambridge University Press, 1992).

¹⁴ See J. Zysman, *Governments, Markets, and Growth* (Ithaca, Cornell University Press, 1983) and Zysman, 'The French state in the international economy', in Katzenstein, *Between Power and Plenty*.

¹⁵ P. A. Hall, *Governing the Economy: the Politics of State Intervention in Britain and France* (Oxford, Oxford University Press, 1986).

or factions.¹⁶ The government also is constrained in the area of fiscal policy; the politics of budgeting are dominated by factional struggles over the marginal allocation of state resources, with little overall direction or spending targets.¹⁷ The weight of adjustment, then, has tended to fall on monetary policy almost exclusively.¹⁸ Unlike in France, however, monetary policymaking in Italy is split between the government and the central bank, the Banca d'Italia. The Banca d'Italia, unlike the government-dependent Banque de France, throughout the 1980s increasingly asserted its autonomy from the government. Political leaders have depended on the Banca d'Italia to design and implement austerity measures to offset continuing fiscal deficits, making the Banca d'Italia a central player in managing the economy, especially during economic and political crises.

A second dimension of state capacity concerns policymakers' relationship with the legislature. Exchange rate policy is an area primarily reserved for executive decisionmaking, because of the public goods nature of the exchange rate and its relationship with overall foreign economic policy goals.¹⁹ However, the executive's willingness to implement austerity measures is influenced by its support in the legislature. If the executive branch is relatively insulated from legislative pressures, it is more likely to implement austerity in order to reinforce the country's relative economic competitiveness. The executive is thus more willing to pay the short-term political and economic costs necessary to maintain a fixed exchange rate.

If the executive is relatively exposed to pressures from the legislature, then domestic goals – re-election, party cohesion, and reinforcing the power of its political coalition – will dominate policy considerations. In this case, policymakers are likely to define the costs and benefits of various exchange rate strategies in terms of internal political goals and the retention of policy autonomy, in order to be able to use changes in the exchange rate to respond to domestic developments which may threaten the government's position. A government whose hold on office is weak, which faces (planned or unplanned) elections in the near future, or faces significant challenges to its authority (e.g. through votes of confidence) will tend to discount the long-term economic benefits, and focus on the short-term costs, of maintaining a stable exchange rate.

While both the French president and the Italian prime minister play important roles in formulating economic policy, they face different constraints at home. The French president is directly elected for a fixed seven-year term, and is

¹⁶ A useful summary of the relationships between political leaders and industry is J. Chubb and M. Vannicelli, 'Italy: a web of scandals in a flawed democracy', in A. S. Markovits and M. Silverstein (eds), *The Politics of Scandal* (New York, Holmes & Meier, 1988). See also G. Di Palma, 'The available state: problems of reform', *West European Politics*, 2 (1979) 149–65. For a comparison of industrial structure and ownership in France and Italy, see P. Bianchi, 'Un capitalismo senza concentrazione', *Il Mulino*, 340 (1992), 307–18.

¹⁷ V. Della Scala, 'The Italian budgetary process: political and institutional constraints', *West European Politics*, 11 (1988), 110–25.

¹⁸ A. R. Posner, 'Italy: dependence and political fragmentation', in Katzenstein, *Between Power and Plenty*; G. Tabellini, 'Monetary and fiscal coordination with high public debt', in F. Giavazzi and L. Spaventa, (eds), *High Public Debt: The Italian Experience* (New York, Cambridge University Press, 1988). For a critique of the utility of macroeconomic adjustment in Italy, see I. Musi, 'Per una riforma della spesa pubblica e delle istituzioni economiche', *Il Mulino*, 341 (1992).

¹⁹ See J. Gowa, 'Public goods and political institutions: trade and monetary processes in the United States', *International Organization*, 42 (1988), 15–32.

not dependent on legislative support to remain in office. The president may appeal directly to the electorate through referenda,²⁰ as Mitterrand did regarding the Maastricht treaty on European Union in September 1992. The French government also has much greater control over the activities of the legislature than the Italian prime minister,²¹ and the president's 'power of dissolution is his key weapon against a hostile parliamentary majority',²² while Italian prime ministers have rarely used this tool. Whereas the French president can remain in office and influence policy, particularly foreign policy, without a supporting majority in the National Assembly, he or she of course prefers parliamentary support. The point is that the president is less vulnerable, especially when elections are not in the offing, to parliamentary revolts and pressures.²³

The Italian prime minister depends on the support of parliament to remain in office. The prime minister's primary political concern is thus to maintain the allegiance of coalition members, particularly when the government's parliamentary majority is small or threatened by internal divisions. The prime minister must manage parliamentary relations so as to avoid challenges from backbenchers and political figures inside and outside the government. The consequence is that:

The emphasis is inevitably placed on administrative co-ordination, short-term conflict resolution, especially in the legislative area, and coalition troubleshooting. The prime minister has little chance to impose a distinctively personal policy imprint on his government, still less to spend large amounts of time on long-term policy analysis.²⁴

Thus while both French and Italian governments have pursued progressively more stringent macroeconomic policies since the 1970s aimed at stabilizing exchange rates with other countries in Western Europe, Italian policymakers have been hobbled by institutional and political factors. First, they were unable to pursue as restrictive an overall macroeconomic policy (incorporating both fiscal and monetary policies) aimed at stabilizing the exchange rate because of the factional nature of policymaking in the area of fiscal policy. This meant that the burden of stabilization fell on monetary policy alone, limiting the effectiveness of convergence. Second, and in contrast to the French experience, Italian policymakers were unable to pursue a coherent set of sectoral policies aimed at increasing industrial competitiveness, since effective control of industrial policy instruments, including state-owned enterprises, is widely dispersed throughout the political system.

²⁰ E. Suleiman, 'Presidential government in France', in R. Rose and E. Suleiman (eds), *Presidents and Prime Ministers*, (Washington, American Enterprise Institute, 1980), p. 104.

²¹ See J. R. Frears, 'Parliament in the Fifth Republic', in W. G. Andrews and S. Hoffmann (eds), *The Impact of the Fifth Republic on France* (Albany, State University of New York Press, 1981) and F. Dreyfus, 'The control of governments', in P. A. Hall, J. E. S. Hayward, and H. Machin (eds), *Developments in French Politics* (New York, St. Martin's Press, 1990).

²² Suleiman, 'Presidential government in France', p. 101.

²³ D. Wilsford, 'Tactical advantages versus administrative heterogeneity: the strengths and weaknesses of the French state', in J. A. Caporaso (ed.), *The Elusive State: International and Comparative Perspectives*, (Newbury Park, Sage, 1989).

²⁴ D. Hine and R. Finocchi, 'The Italian Prime Minister', *West European Politics*, 14 (1991), 79–80.

Economic Convergence and Exchange Rate Policy

Economic policy in France and Italy between the collapse of the Bretton Woods system and the creation of the EMS in 1979 was largely aimed at delaying adjustment. Both countries used a variety of tools, including foreign borrowing, capital controls, and depreciation to insulate the domestic economy from international shocks. As the 1970s wore on, however, the efficiency and inflationary effects of these tools increasingly came to be questioned, and by 1979 both countries were committed, at least in principle, to maintaining a stable exchange rate within the EMS as a primary economic policy goal.²⁵

The commitments of French and Italian governments to stable exchange rates as the cornerstone of economic policy was strengthened throughout the 1980s; in both countries, the exchange rate, earlier viewed as a secondary concern, would increasingly dictate macroeconomic policy. But the mix of fiscal and monetary policies pursued differed greatly. The French commitment to the EMS was quite strong (especially after 1983) and led to a tight monetary policy of high interest rates to reduce pressure on the franc, combined with significant microeconomic reforms in financial, industrial, and labour market structures. Italian policy instruments, in contrast, pursued contradictory goals: monetary policy was tightened with the aim of stabilizing the exchange rate and lowering inflation, while fiscal policy remained quite loose, limiting the amount of convergence achieved with other European countries. The structure of domestic policymaking institutions in France and Italy provides an important part of the explanation for these differences.

France

President Valéry Giscard d'Estaing's goals in negotiating the EMS in 1978–9 were based on his interpretation of France's economic and political position relative to Germany. He feared that unless France could lower its inflation rate and become more competitive, the country would no longer stand as co-equal with Germany on economic, political, and security matters. As he put it in an interview: 'It would not be a good idea for Europe to be dominated by one country . . . What I want France to achieve is to make sure that there are in Europe at least two countries of comparative influence, . . . Germany and France'.²⁶ The EMS had two principal advantages in meeting these goals compared to floating exchange rates. First, it would be a negotiated regime, an international commitment which the French president could use to influence domestic political actors. Second, as originally envisioned, the EMS would provide greater financing to deficit countries such as France, and allow them to influence the economic policies of surplus countries, thus easing the process of adjustment and convergence.²⁷

²⁵ See M. Loriaux, *France after Hegemony: International Change and Financial Reform* (Ithaca, Cornell University Press, 1991), pp. 183–213 and J. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca, Cornell University Press, 1992), pp. 142–81.

²⁶ Quoted in Ludlow, *The Making of the European Monetary System*, (London, Butterworth, 1982), p. 200. Frears reports that this 'is a theme to which [Giscard returned] constantly, almost obsessively, in his speeches'. See J. R. Frears, *France in the Giscard Presidency*, (London, George Allen & Unwin, 1981), p. 106.

²⁷ See Loriaux, *France after Hegemony*, pp. 251–2 and *L'Année Politique, Economique, Sociale et Diplomatique en France 1978*, (Paris, Moniteur, 1978), p. 391.

But Giscard faced significant political opposition at home prior to the EMS negotiations, directed primarily at his economic policies. While the Socialists and Communists naturally opposed his policies, his greatest challenge was from the *Rassemblement pour la République* (RPR) under Jacques Chirac, the largest party in the ruling conservative coalition. In the run-up to parliamentary elections in March 1978, the conservative coalition was rent by political disputes, as both the RPR and Giscard's party, the *Union pour la Démocratie Française* (UDF), attempted to take votes from the other. Surprising everyone, the right won the 1978 election, and the UDF significantly increased its number of seats in the National Assembly. This electoral mandate reinforced Giscard's domestic political power and allowed him to complete the EMS negotiations.²⁸

The election of Francois Mitterrand as President in May 1981 would lead to an important shift in French economic policy, although in a direction completely unexpected at the time. Mitterrand was elected on a programme of significant change in social and economic policies oriented toward the interests of the working and middle classes. More specifically, Mitterrand's Socialist Party advocated extensive nationalization and the use of an expansionary fiscal policy to restore growth to the French economy, while at the same time improving competitiveness and social equity. Mitterrand's power to influence French economic policy was strengthened in June 1981 when the left won a majority in the National Assembly, allowing the President to form a government with ministers from the Socialist and Communist parties.

Mitterrand's economic policy in 1981 was based on the assumption that the world economy would recover from recession within a year. Accordingly, the Socialists planned to spend their way out of recession by administering a large fiscal stimulus to the economy. This 'redistributive Keynesianism' aimed to use government spending to boost overall demand by increasing the incomes of low-paid workers and putting the unemployed back to work.²⁹

The Mitterrand administration focused on solving significant domestic economic problems; little regard initially was given to the external sector. As one Socialist economist noted in regard to this period, 'we were thinking more about growth, protecting employment, and structural reforms . . . Defending the franc was a secondary consideration'.³⁰ Yet the government soon encountered crucial problems in precisely this area. The prospect of Mitterrand's election in May 1981 had triggered a run on the franc, forcing the Banque de France to draw down its reserves by \$5 billion in two weeks in March 1981 to defend the currency's parity in the EMS. The roots of this crisis went back to before the election. The parity between the franc and the deutschmark had not been changed since 1979, although French inflation during these two years was twice the level in Germany, leading the franc to become overvalued by about 10 percent. To resolve this dilemma, Mitterrand was presented with a choice that would haunt French economic policy for the next two years: withdraw from the EMS and pursue an autonomous economic policy, or remain in the system

²⁸ Ludlow, *The Making of the European Monetary System*, pp. 199–200; Frears, *France in the Giscard Presidency* pp. 60–1; R. Formesyn, 'Europeanisation and the pursuit of national interests', in V. Wright (ed.), *Continuity and Change in France* (London, George Allen & Unwin, 1984), pp. 225–6.

²⁹ P. A. Hall, 'Socialism in one country: Mitterrand and the struggle to define a new economic policy for France', in P. G. Cerny and M. A. Schain (eds), *Socialism, the State and Public Policy in France* (London, Pinter, 1985), pp. 84–5.

³⁰ Quoted in Goodman, *Monetary Sovereignty*, p. 127.

while abandoning the government's ambitious plan for economic revival. At this point, Mitterrand was not prepared to make such a difficult choice. Instead, he postponed the problem by strengthening capital controls and raising market interest rates slightly, while continuing to hope that worldwide economic recovery would soon emerge.³¹

The next part of the government's exchange rate policy was to negotiate a series of devaluations of the franc within the EMS. Between October 1981 and March 1983, the franc was devalued three times. This strategy became all the more necessary as France began to experience serious balance of payments problems brought on by the country's expansionary fiscal policy.³²

The government soon realized, however, that devaluation would not solve the country's balance of payments problems, as world economic recovery did not materialize in 1982. The devaluation of the franc in June 1982 marked the decisive shift in Socialist economic policy from demand-led expansion to austerity. In order to secure a negotiated devaluation within the EMS, the government promised Germany that it would institute a policy of economic retrenchment. The government's 1982 economic plan aimed to limit the fiscal deficit to 3 percent of gross domestic product by cutting public spending and imposing widespread freezes on the growth of wages, prices, and employers' social security payments, while corporate taxes were cut. These austerity measures were an important turning point for two reasons. First, they marked the end of the policy of fiscal reflation which had formed the core of Mitterrand's economic policy. Second, they indicated that the government was now more interested in redistributing income not to the low-paid and unemployed but to the French business community, whose competitiveness had suffered under the costs of increased social contributions. The year 1983 saw the introduction of further austerity measures, including significant tax increases and spending cuts, while unemployment continued to rise.³³

Why did Mitterrand reject the possibility of leaving the EMS and pursuing an autonomous economic policy? The government did consider the option of withdrawal from the EMS. Certain members of the Mitterrand government advocated a policy of protection including unilateral devaluation, withdrawal from the EMS, and import taxes combined with loose fiscal and monetary policies that would redistribute income and promote growth in France.³⁴ What seemed to decide the issue for Mitterrand were the economic studies, presented by ministers in favour of continued austerity, that protectionist policies would have to be accompanied by even greater deflation, since higher import prices would lead to an inflation-depreciation spiral and inflationary demand for domestic products.³⁵

Monetary policy since 1983 has been described in the following terms: 'the overriding goal of France's monetary policy continues to be the maintenance of

³¹ J. Sachs and C. Wyplosz, 'The economic consequences of President Mitterrand', *Economic Policy*, 2 (1986), 270-1.

³² Hall, 'Socialism in one country', p. 86.

³³ Hall, 'Socialism in one country', pp. 86-7.

³⁴ Hall, 'Socialism in one country', p. 88.

³⁵ See Hall, 'Socialism in one country', p. 88, Philippe Bauchard, *La Guerre des Deux Roses* (Paris, Grasset, 1986), pp. 142-53, and Serge July, *Les Années Mitterrand* (Paris, Grasset, 1986), pp. 90-101.

the purchasing power of the currency . . . [the authorities] have been unwavering in their adherence to this policy, despite the short-term costs involved'.³⁶ This has required that the domestic interest rate be set so as to maintain the franc's covered value vis-a-vis the deutschmark. The 'short-term costs' of this policy of competitive disinflation were incurred because a restrictive monetary policy and a general environment of austerity have contributed to slow growth and persistently high unemployment.

By the late 1980s, France had achieved the goals of nominal convergence with Germany, especially on inflation. However, this success was mitigated for French policymakers by continuing German dominance of the EMS. Under the EMS, the burden of adjustment falls on countries with high inflation and balance of payments difficulties, while the Bundesbank gears its monetary policy to domestic economic goals. This imbalance was an important reason for the French proposal in early 1988 to create an Economic and Monetary Union. Sandholtz describes the motivation of French policymakers in the following terms: 'From the French point of view, the proposal for monetary union represented a bid to gain a seat at the monetary table, a table that under the EMS was located in Frankfurt'.³⁷

But if the French were so concerned about regaining control over monetary policy, why did they not simply devalue and leave the EMS? The answer may be found in changes in the international economy and domestic politics. The increase in international capital mobility, combined with heavy reliance on international trade, would limit the expansionary impact of a floating exchange rate. Depreciation, as the French discovered in the 1970s, likely would lead to significantly higher inflation but give only a nominal boost to economic growth. The crucial factor, however, was the domestic political strategies of French policymakers. Having realized in the early 1980s that the effects of changes in macroeconomic aggregates under government control, such as fiscal and monetary policies, are limited when financial capital is highly mobile across borders, policymakers chose a strategy of long-term adjustment to changes in the international economy. This strategy involved, first of all, the macroeconomic austerity described above. But it also included significant changes in the operation of the domestic economy in the areas of industry, finance, and labour markets. While many of these policy changes attracted significant political opposition, policymakers were able to design and partially implement a strategy of domestic adjustment aimed at increasing both international competitiveness and French influence in the EMS.

Fiscal policy was marked by consolidation of public spending in the 1980s. Firms' tax and social security obligations were reduced, and 'controls over the nationalized industries were loosened so that they could lay off workers, become more profitable, invest abroad, and even sell off some subsidiaries to raise funds', while government subsidies were channelled increasingly to research and development.³⁸ The government also emphasized limiting the growth of labour

³⁶ OECD, *Economic Surveys: France* (1991/1992), p. 31.

³⁷ W. Sandholtz, 'Choosing union: monetary politics and Maastricht', *International Organization*, 47 (1993), 29–30.

³⁸ P. A. Hall, 'The state and the market', in Hall *et al.*, *Developments in French Politics*, pp. 178–83.

costs,³⁹ which have risen more slowly than in Italy.⁴⁰ Government allocation of credit to individual firms through the state-directed banking system gradually was curtailed and new sources of finance were created, including a greater role for the stock markets, the establishment of a financial futures market, and other policies. These measures, begun by Socialist Prime Minister Laurent Fabius, were continued and deepened in 1986–8 under conservative Prime Minister Jacques Chirac, who largely dismantled government credit controls and privatized a number of state-owned firms.⁴¹

French policymakers' desire to exert greater control over monetary policy through the creation of an Economic and Monetary Union was undermined by divergent economic policies between Germany, the anchor of the system, and the other member states. These tensions led to the withdrawal of sterling and the lira in September 1992, devaluations of the Irish, Spanish, and Portuguese currencies, and the widening of fluctuation margins to 15 percent in early August 1993. An expansionary German fiscal policy to finance unification led the Bundesbank to raise interest rates to fight inflation. While the Bundesbank accepted its obligations to support other currencies in the system by intervening in the foreign exchange markets in 1992 and 1993, it was unwilling to sacrifice its domestic objective of price stability by lowering interest rates to reduce pressures for the appreciation of the deutschmark. Other EMS countries were beginning to experience slower growth, but were forced to keep their interest rates in line with those in Germany to maintain the EMS. With these underlying causes, market speculation against EMS parities was triggered by the initial failure of Danish voters to ratify the Maastricht treaty, as well as the narrow approval of the treaty in the French referendum of September 1992, and earlier turbulence in the markets for Nordic countries' currencies.⁴²

In this context, the decision of the French government to accept the widening of the fluctuation bands is consistent with earlier French strategy within the EMS. Speculation against the franc in July and August 1993, triggered by the Bundesbank's failure to lower interest rates quickly enough, led the Banque de France to exhaust its foreign currency reserves, and increased German pressures for reform of the system, since exceptionally large purchases of francs by the Bundesbank increased the German money supply. In negotiations in early August, the French government pressured the Bundesbank to lower interest rates. When the Bundesbank refused, the French suggested that the deutschmark temporarily leave the EMS. In response, the Netherlands, Luxembourg, Belgium, and Denmark insisted on leaving the EMS to maintain their exchange rates with Germany. The French viewed this proposal as an implicit and unacceptable devaluation of the franc, and thus agreed to widen all fluctuation bands (except for that between the guilder and deutschmark) to reduce pressures for intervention.⁴³

Since the latest EMS crisis, the French government has lowered interest rates only gradually, in contrast with British and Italian policy after their withdrawal

³⁹ Sachs and Wyplosz, 'The economic consequences of President Mitterrand', p. 300.

⁴⁰ See R. Anderton, R. Barrell and J. W. in't Veld, 'Macroeconomic convergence in Europe: achievements and prospects', in R. Barrell (ed.), *Economic Convergence and Monetary Union in Europe* (London, Sage, 1992), p. 9.

⁴¹ For a discussion of the role of international forces in prompting changes in government control of the financial system, see Loriaux, *France After Hegemony*.

⁴² See G. Garrett, 'The politics of Maastricht', *Economics and Politics*, 5 (1993), 118–21.

⁴³ L. Barber, 'ERM bands produce sort of harmony', *Financial Times*, 4 August 1993, p. 2.

from the system, and has insisted that the franc has not been devalued. By maintaining relatively high interest rates, the French have tried to rebuild the Banque de France's foreign currency reserves, maintain the franc's value against the deutschmark, and thereby hold out the possibility that progress toward greater European monetary policy cooperation may resume.⁴⁴

Italy

The Italian government's decision to participate in the EMS in 1979 did not represent a move from an autonomous policy stance to one dictated solely by exchange rate stability. Instead, during the negotiations over the EMS, the government repeatedly sought to structure the rules of the EMS so as to allow member states greater flexibility. The government was largely unsuccessful in this effort, but it did win a concession that the lira be allowed a fluctuation band of 6 percent plus or minus its central parity (all other members adhered to a 2.25 percent fluctuation band). While the government wished to participate in what was a major European political initiative, it did not want to see emerge a system under which economic policy would have to be geared primarily towards maintaining the exchange rate.⁴⁵

Having said this, it is important to note that by 1979 it had become clear to the Italian authorities, particularly the Banca d'Italia, that a truly autonomous economic policy was much less viable than in the past. Indeed, in 1980 the OECD remarked that, 'in the face of the acceleration of inflation in the course of the year, the defence of the exchange rate now seems to have become the priority objective of the Banca d'Italia, in order to prevent the triggering of an inflation-depreciation spiral'.⁴⁶ This commitment to greater exchange rate stability by the Banca d'Italia was undermined throughout the 1980s by governments' inability to control inflation and fiscal deficits.

Italy did not experience as sharp and dramatic a break in exchange rate policy as occurred in France in the early 1980s. Instead, any convergence that has occurred has been gradual, and brought about primarily through a tightening of monetary policy. There has been little effective coordination of macroeconomic policy tools aimed at stabilizing the exchange rate. While the wage indexing system (the *scala mobile*) has been reformed since 1985 with the intention of reducing its inflationary effects, no real effort has been made to implement a coherent policy aimed at restructuring Italian industry.⁴⁷

One reason monetary policy has borne the brunt of responsibility for convergence is the different political processes through which fiscal and monetary policy are made. Fiscal policymaking is not a straightforward process in any country, but it is particularly difficult for Italian governments to manage effectively. Instead of setting the level of spending to meet macroeconomic goals, the process is characterized by intense negotiations between the legislature and prime minister, as well as within the legislature, over specific budget items.⁴⁸

⁴⁴ J. Ridding, 'Paris wary on interest rate cuts', *Financial Times*, 13 August 1993, p. 1, and J. Ridding, 'France signals acceptance of wider ERM bands', *Financial Times*, 26 August 1993, p. 1.

⁴⁵ For a detailed discussion of the Italian negotiating position, see L. Spaventa, 'Italy joins the EMS: a political history', Johns Hopkins University Bologna Center *Occasional Paper*, 32 (1980), pp. 67-93.

⁴⁶ OECD, *Economic Surveys: Italy* (March 1980), p. 39.

⁴⁷ See R. Prodi, 'Una crisi non solo politica: l'industria Italiana a rischio', *Il Mulino*, 337 (1991), 885-91.

⁴⁸ Della Scala, 'The Italian budgetary process', p. 123.

In contrast, monetary policy tends to be more centralized in the hands of the Banca d'Italia and the Treasury, with the former increasingly taking the lead since 1981. Since fiscal policy is largely unable to be used in any coordinated fashion as a policy instrument to pursue macroeconomic goals, the burden of adjustment has fallen on the monetary policy authorities. This policy combination significantly limits the degree of convergence with other European economies:

In the absence of fiscal measures designed to promote structural change, the achievement of monetary policy [in controlling inflation and bringing the balance of payments into equilibrium] has tended to be temporary . . . Monetary policy has tended to be relaxed and the problems of current account deficits and inflationary pressures have re-emerged.⁴⁹

As the pressures for convergence have increased due to the liberalization of international capital movements, monetary policymaking institutions have been able to increase their autonomy from the government and legislature. Two important institutional changes occurred in the monetary policy area, both of which increased the ability of the Banca d'Italia to implement a tight monetary policy. The first occurred in 1981, when the Banca d'Italia's obligation to purchase unsold public debt at primary auctions was reduced. Under the earlier system, any unforeseen increase in the public sector borrowing requirement forced the Banca d'Italia to exceed its targets for money creation. The rationale for this 'divorce' of the central bank from the Treasury, as it was called in the media at the time, was to increase the Banca d'Italia's power to conduct monetary and exchange rate policy by reducing the influence of public deficits on the growth of the money supply. However, greater independence for the central bank also had important implications for political management of the economy: 'For the first time, the central bank could resist government pressures to finance the deficit and reject loud protests from labour and government ministers.'⁵⁰

The second institutional change occurred in 1983 with the abandonment of administrative credit controls over bank lending and the central bank's targeting of Total Domestic Credit (TDC). Monetary policy henceforth relied almost exclusively on global and indirect policy tools of interest rates and monetary aggregates. Since 1982, real interest rates have been kept quite high in an effort to maintain the exchange rate and stamp out inflation (compared to average negative real interest rates between 1970 and 1982), while the rate of growth of the monetary base has been gradually cut. There appear to have been two major reasons for this shift. First, administrative controls began to impose significant efficiency costs on the banking system and the economy, since they could not always keep pace with financial innovation, and in practice were often evaded by private investors. Second, the shift away from targeting Total Domestic Credit toward monetary base targets was a response to continual fiscal deficits. Since TDC included the public sector borrowing requirement, any unexpected

⁴⁹ K. G. Saini, 'Economic policy management in Italy', *Review of Economic Conditions in Italy*, 3 (1984), 345.

⁵⁰ Goodman, *Monetary Sovereignty*, p. 181. See also G. A. Epstein and J. B. Schor, 'The divorce of the Banca d'Italia and the Italian Treasury: a case study of central bank independence', in P. Lange and M. Regini (eds), *State, Market, and Social Regulation: New Perspectives on Italy*, (New York, Cambridge University Press, 1989).

increase in the budget deficit required that more of the annual TDC target be reserved for government deficits, while a corresponding amount would no longer be available for private borrowing to finance investment.⁵¹ Rather than attempt to ration credit to particular sectors of the economy in order to increase their competitiveness, the Banca d'Italia favoured moving to global policy tools which would further increase its ability to undertake a tight monetary policy independent of political pressures. One reason that the central bank moved in this direction was that neither the Banca d'Italia nor the government could use bank credit ceilings to direct investment to potentially competitive sectors. Mario Sarcinelli, then the Deputy Director of the central bank, wrote at the time that unlike in France, 'in Italy, the fragmentary nature of the banking system makes it more difficult to apply a ceiling based on moral suasion. It is therefore enforced through an automatic penalty mechanism that treats all banks alike'.⁵²

Officials at the Banca d'Italia also have used their prominent position in economic policymaking to impress upon government ministers, legislators, and interest groups the importance of promoting economic convergence through a stable exchange rate and tight monetary and fiscal policies. Like their French counterparts, Italian authorities saw in the proposal for an Economic and Monetary Union the chance to exert greater control over German monetary policy. But the scale of domestic economic policy problems has limited their ability to first achieve macroeconomic stability. In this context the EMS, and the threat of being excluded from a future monetary union, have been used as political weapons to change the behaviour of domestic groups. Carlo Azeglio Ciampi, then Governor of the Banca d'Italia, in early 1992 declared that while adhering to the EMS played an important role in the convergence process, low inflation and higher economic growth would only be restored in the long term if wage rises were brought into line with productivity increases and budget deficits were brought under control.⁵³ After the lira was withdrawn from the EMS in the fall of 1992, Ciampi and Prime Minister Amato declared that re-entering the system and stabilizing the exchange rate at its new level remained priorities in order to allow Italy to participate in future EC developments and to restore international confidence in the Italian economy, factors which they hoped would persuade Parliament to implement deficit reduction and labour market reforms.⁵⁴ In a statement before the Senate Budget Committee, Ciampi emphasized that even if Italy were to remain outside the EMS for an extended period (a decision which he opposed in principle), it was necessary to gear economic policy toward stabilizing the exchange rate and restoring the country's economic policy credibility.⁵⁵

While the Banca d'Italia was able to increase its control over the money supply, stringent monetary policy was accompanied by little fiscal consolidation. Since the early 1980s, the fiscal deficit has equalled roughly 10 percent of gross domestic product (see Figure 2). Continually high government deficits had important repercussions for Italy's economic convergence with its EC partners.

⁵¹ Tabellini, 'Monetary and fiscal coordination with high public debt', p. 98.

⁵² M. Sarcinelli, 'The role of the central bank in the domestic economy', *Review of Economic Conditions in Italy*, 3 (1981), 444.

⁵³ C. A. Ciampi, 'Scienza e arte del banchiere centrale', *Il Mulino*, 339 (1992), 13-17.

⁵⁴ G. Fabrizio and A. Carboni, 'Passato e futuro del sistema monetario visti dal governatore della Banca d'Italia', *Il Sole 24 Ore*, 15 October 1992, p. 1.

⁵⁵ Ciampi's remarks are reprinted in *Il Sole 24 Ore*, 25 September 1992, p. 7.

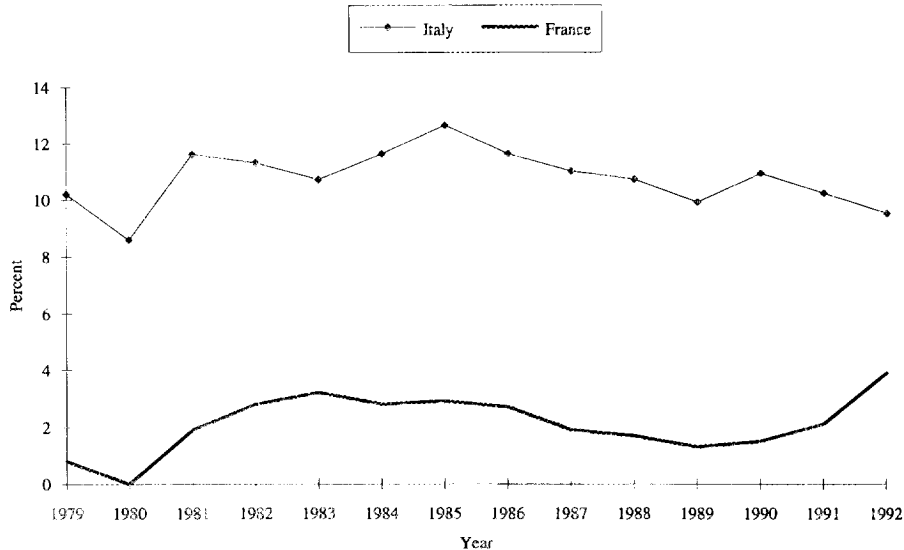


Figure 2. French and Italian Government Budget Deficits as a Percentage of GDP, 1979-92

Source: OECD, *OECD Economic Outlook*, 53 (1993), p. 214.

The deficits fuelled inflation and put downward pressure on the exchange rate, reducing the willingness of investors to place their money in Italy in the expectation that the lira would be devalued. In order to counter these inflationary pressures, the monetary authorities pursued a tight monetary policy by maintaining high domestic interest rates to bolster the lira.

Conclusion: State Structures and Policy Change

The explanation of differing levels of economic convergence and exchange rate stability which I offer here focuses on variations in state structures and policymakers' access to policy instruments. Differences in the organization of political institutions have affected the ability of policymakers to implement macroeconomic convergence policies. French political leaders, in part by virtue of their domination of economic policy formulation, succeeded in implementing macroeconomic austerity while taking steps in the areas of microeconomic policy to improve competitiveness. Italian leaders, in contrast, have been unable to integrate their policy goals even in the macroeconomic area, which has been characterized by a tight monetary policy and loose fiscal policy. The outcome has been a less rigid adherence to the EMS.

French and Italian governments both emphasized the importance of achieving economic convergence and stable exchange rates, but with varying amounts of success. It is important to remember, however, that the original forces for policy change have been the constraints on economic policy imposed by greater international capital mobility and the need to respond to changes in monetary and exchange rate policies adapted by other states. State structure clearly has served as an intervening variable in the adjustment process. Thus a full explana-

tion cannot look only to either international pressures or the organization of political institutions, but must be prepared to integrate both.

But even this type of integration may be incomplete. Structures are not entirely static. Instead, they change in response to their environment, just like all other social institutions. The cases considered above, for example, discussed significant changes in the organization of the French and Italian policymaking processes. In France, by the late 1980s policymakers had largely abandoned tools such as government credit controls which they had relied on in earlier periods to promote economic adjustment. And Italy experienced the 'divorce' of the Banca d'Italia from the Treasury, considerably changing the dynamics of monetary and exchange rate policymaking. Accounting for changes in state structures is thus an important area for further research.

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