

A revised version appears as Chapter 2 in *Institutional Designs for A Complex World: Bargaining, Linkages, and Nesting*, Vinod K. Aggarwal, ed. (Ithaca: Cornell University Press, 1998).

CHAPTER 2:

NESTED INSTITUTIONS AND THE EUROPEAN MONETARY SYSTEM

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I. Nested Institutions, Regimes, and Regions

One way to think about social-political systems is to envision each as a set of nested institutions. For Aggarwal's purposes in this volume², this opens up two important questions: how does the nesting of institutions take place, and how or when does this resolve conflict.

Concerning issue areas, the rationale for thinking about nested institutions is clear. Even “pure” markets are wound up tightly in many tiers of institutional infrastructure. Property rights systems nest within information exchange systems which nest within systems that store and exchange value and so on. For regions the rationale is less obvious. Part of the problem is to agree first off on what it is that constitutes a “region”. Geography is plastic, or at least it is plastic in the way that human minds construct maps. It might be possible to develop objective and easily measured delineators to mark off regions, but this has not yet been successfully done (despite repeated attempts).³ What if we were instead to

conceive of regions as clusters of nested institutions? This might very well be compatible with “transaction density” measures, since most people agree that institutions surround transactions even when they differ over the direction that arrows of causality run between them. Two things are then worth knowing:

- Density and Boundaries: how densely institutionalized is the region, and what are its boundaries (ie where density of a “nest” falls off). It is easy to talk casually about these things and exquisitely difficult to measure them.
- Principles and Logic of Organization:: A set of nested institutions will share at a minimum principles and norms, which Aggarwal sees first as cognitive factors. Beyond these (sometimes hard to isolate) principles are rules and procedures or systemic factors, all of which I prefer to think of as logics of organization, standard ways of doing things, and patterns of authority and obligation. Harry Eckstein’s classic work on Norway argues that “congruence” between these patterns of authority, at different levels of social and political structure, is the major explanation for the surprising stability of a conflict - ridden society.⁴ Focusing on the principles and organizational logic of a nested system might clarify how the system itself came to be, and it might not. But it will almost certainly help to illuminate what kinds of conflict can be resolved, under what conditions, with what means, and -- perhaps -- with what outcome.

This paper examines the 1992-3 crisis in the European Monetary System. I argue, contrary to standard opinion, that the EMS did not collapse in this crisis. Instead, it was sustained in its essentials and was restructured so that it could be reconciled with changes in market conditions. It remains as a central part of the nested institutional structure that makes up the European Union (EU). It survived because the EU as an institutional cluster supports principles and logics of organization that can provide for the provision of certain kinds of goods -- in this case, common property resources or CPRs -- in "unconventional" ways.⁵

II. EMU

In March 1979, the European Economic Community launched a bold experiment in monetary cooperation aimed at creating a "zone of monetary stability" among its member states.⁶ Two major economic issues drove this project. The first was increasing concern over exchange rate instability among EEC currencies, that had developed with the collapse of Bretton Woods, oil shocks, and other developments of the 1970s. The second was a perceived opportunity, to use exchange rate stability as a mechanism for driving forward convergence of economic policies and trends among member states. The central (but by no means only) objective of that convergence would be price stability: to narrow and to lower the range of inflation rates in community economies. In the minds of some European leaders, the European Monetary System (EMS) was aimed also at promoting longer range

goals of monetary union and perhaps political union as well.

Fifteen years later, the EMS seemed in disarray. A series of crises (or perhaps one long crisis) rocked the system from the summer of 1992 through the autumn of 1993. The pound and the lira left the exchange rate mechanism (ERM). Many remaining currencies devalued against the German mark. In the summer of 1993, the EC decided to widen the bands within which currencies fluctuate from 2.25% to 15%. To many observers this signaled the effective demise of the system, papered over by a thin veneer of constraints more cosmetic than real.

When the EMS "collapsed", economists argued that this outcome was ultimately pre-ordained given the logic of money and markets arrayed against the system. It is a basic axiom of international economics that states cannot sustain at once capital mobility, fixed exchange rates, and autonomous monetary policies. The standard story was that EMS had evolved into a system quite close to that triad and something had to give. What gave out, according to most observers, was the system itself. The question became, what would come next? Mainstream prescriptions from the economics community and from many political scientists as well were to replace what they saw as an inherently unstable EMS, either with monetary union (abolishing autonomous policies) or a de facto float (abolishing fixed exchange rates).⁷

What does it really mean for an institution to fall apart? The answer depends substantially on what we think the institution is or ought to be. I argue in

this chapter that the EMS can be understood as something like a voluntary organization for the management of a common property resource. The CPR is credible exchange rate stability and the economic "goods" that come along with it. Seen in this light, the EMS did not fall apart during the crises of 1992-3. Rather, the system was sustained in its essentials according to two basic criteria.⁸ The first is that adaptations made to accommodate the impact of exogenous shocks and endogenous developments which together may destabilize the day to day workings of an institution, are carried out in accord with the nested system's higher order collective choice rules. In other words, the inevitable re-negotiation of imperfect contracts in an imperfect world happens in ways that adhere to (and reinforce) the "meta-regime".⁹ The second criteria is that the institution continues to provide the essential "goods" that members expected of it before the shock.¹⁰

I will argue in this chapter that the EMS meets both these criteria for survival. The system came to a crisis because of exogenous shocks (principally German reunification) and endogenous developments (principally political pressures, accentuated by Maastricht, to avoid re-alignments). Although the stage was set nicely, the bleak predictions of standard collective action arguments don't apply here. With two notable exceptions that I consider later, EC member states made adaptations to the system's specific operational rules in conformity with higher order rules about collective choice processes. In Aggarwal's terms, member states chose to change the institutional context by modifying an existing

institution. Months after the rash of devaluations and the move to wider bands, the system was delivering the goods -- relative monetary stability -- nearly as effectively as before the crisis began. States demonstrated in rhetoric and in costly behaviors a continued commitment to the EMS.¹¹ These commitments are being taken seriously by governments and by the markets, which is a substantial change from preponderant expectations in the immediate wake of the "final" crisis phase of August 93. Europe has not deteriorated into a continent of competitive devaluators, and the negative political spillover from the crises has generally been contained. The outcome of the crisis does not look like the probable product of an n-person prisoner's dilemma game where the most powerful and most important player chose to defect. Instead, it looks more like a successful adaptation of a valued institution. Alternative interpretations -- most importantly, variants of the argument that Germany simply did what it wanted to do and others followed along without any real choice -- don't stand up to scrutiny as of 1997 and I don't think that future developments will change that assessment.

III. What is the EMS? A Short Selective History

This section highlights some important elements in the history and evolution of the EMS prior to the crises of 1992. Monetary coordination within the EEC goes back at least in principle to the Treaty of Rome, which called for consultation among member states on short term macro policies and raised the possibility of

mutual assistance for balance of payments disequilibria. It also established a Community Monetary Committee, "an advisory body of national Treasury and Central Bank Officials", to serve as a permanent institutional locus for discussions. Exchange rates were to be considered "a matter of common concern" but national monetary policies would not be subject to any binding constraints.¹² There was at the time no convincing reason to do more than this, since the single market was still a long way off and the Bretton Woods system was working reasonably well. Indeed, Germany was wary of any European monetary arrangements that could have been interpreted as discriminating against or competing with the dollar. The French were the most vocal but certainly spoke for others when they expressed opposition to sacrificing any substantial degree of national control over monetary policy to some supra-national EEC authority.

These conditions changed gradually over the course of the 1960s as the Bretton Woods system showed increasing strain. Once DeGaulle left office, monetary coordination came back on the agenda. At their 1969 Hague Summit, and in the wake of a franc devaluation and mark revaluation, EEC leaders agreed in principle that monetary union would be a goal for the Community. This was a diffuse agreement that did not extend to a consensus even on a general strategic approach. The French argued for what was then called a "monetarist view", that states should force themselves toward policy convergence by fixing exchange rates up front. The "economist view", favored by Germany, was that states should

first coordinate policies and only then fix exchange rates, after greater convergence had been achieved.¹³ These attitudes followed (at least in part) from obvious calculations of who would bear the costs of adjustment in each case. Under the monetarist plan, the Bundesbank (Bbank) as guardian of the strongest currency in the system would have been impelled to support weaker currencies and thus pay some of the costs of convergence that it would avoid if states fought their way toward convergence on their own.

By 1971 the weakening dollar was putting more pressure on Europe. The Smithsonian Agreement (Dec. 71) not only devalued the dollar and the pound but also widened to 2.25% the bands within which currencies could fluctuate against the dollar. In Europe, this meant an effective tripling of the possible divergence between any two EEC currencies since the range within which they could move against each other was now about 9%. That was a problem for trade flows but even more a problem for the Common Agricultural Policy (CAP) whose costs were already taking a substantial portion of the community's budget. If EEC currencies could fluctuate this widely it would be impossible to forecast the real cost of the CAP and thus to budget effectively. This led to the idea of a European "snake" in a BW "tunnel", and thus "the snake".

The snake, a German-led initiative introduced in April 1972, lined up European currencies in a bilateral parity grid of 2.25% bands. This effectively cut in half the fluctuation range of "member currencies", but it was a very weak

arrangement. Participation was not limited to EEC members (Britain, Ireland, Sweden, and Norway joined) and there were no formal mechanisms for joint interventions or negotiated realignments. The snake was a statement about targets or a declaration of intentions, and it didn't work. States held firmly to their divergent monetary policies. In particular, the Bbank ran a much more restrictive policy than did France and Italy, leading to recurrent pressures for revaluation. In March 1973, the "tunnel" itself disappeared when the EEC countries suspended defense of their currencies against the dollar. By the end of 1978 the snake looked more like a de facto D-mark zone than any real EEC currency stabilization scheme.

In its second phase European monetary coordination began to take on more substantive institutional elements. German Chancellor Helmut Schmidt was still reluctant to "sideline" the Americans, but he saw continued weakness in the dollar at the end of the 1970s and upward pressure on the D-mark as a real threat to the export-dependent German economy.¹⁴ He found a willing partner in French President Valery Giscard d'Estaing, who was pushing a "franc fort" policy to beat inflation and knew that he could increase the credibility of that policy with an effective D-mark peg. French-German bilateral talks on the subject began in February 1978. Notably, Paris was represented at the talks by the governor of the Banque de France (BDF) (Bernard Clappier) while the Germans sent Horst Schulmann -- an economic advisor to Schmidt and not a Bbank official.¹⁵ In April

the talks expanded to include other EEC states. By the end of the year, a detailed plan for the EMS was agreed.

The EMS differed from the snake in several important respects (I discuss more detail later.) While it retained the snake fluctuation range for most currencies, the system's exchange rate mechanism was now limited to EEC members.¹⁶ The ERM created a community fund for joint intervention and a specific set of rules under which central banks would be obligated to intervene. Monitoring of the system and negotiation of any realignments was delegated to the EEC monetary committee. These changes were substantial moves toward creating an EMS with substantial institutions for provision, monitoring, and enforcement mechanisms.

One clear signal of this is that the Bbank took a much more serious attitude toward the EMS negotiations than it had toward the snake. The Bbank "dragged its heels" on the EMS when it was first endorsed by Schmidt.¹⁷ Held at arms length by the German government early in the negotiations, the Bbank later demanded assurances from Bonn that obligations to the EMS effectively came second, after its obligation to defend the Dmark. Before Germany signed the December 1978 act establishing the EMS, an exchange of letters between Otmar Emminger (Bbank governor) and the German government said that if intervention obligations should threaten the value of the Dmark, the Bbank "is starting from the premise that, if need be, the German government will safeguard the Bbank from

such a situation of constraint, either by a correction of the exchange rate in the EMS or, if necessary, by discharging the Bbank from its intervention obligations."¹⁸ Economics Minister Otto von Lambsdorff confirmed this understanding before the Bundestag in December 1978, saying that the government would be responsible for managing appropriately any necessary realignments and that "the Bbank has the responsibility to intervene, and the option not to intervene if it is its opinion that it is not able to do so."¹⁹

This would prove prophetic in later crises, but it does not diminish the importance of the normative change taking place here. The EMS was not a formal arrangement for fixed exchange rates, but it was also not just a low-cost wish list or a set of voluntary targets. It was a substantial (if still contingent) commitment by member states to take concrete steps toward creating a "zone of monetary stability" within the EEC.²⁰

The EMS came into existence on 13 March 1979. The system needed two realignments that year, despite substantial currency interventions that central banks carried out in accord with the obligations to defend values set out in the agreement.²¹ Both realignments were negotiated and agreed by Finance Ministers and Central Bank Governors of member states meeting under Community auspices. There were no realignments in 1980, but the European Council that year did note growing instability within the international monetary environment which suggested a need for further refinement of the mechanisms of the EMS. That

turned out to be prescient.

In March 1981, after a prolonged period of pressure on the lira, Italy devalued its currency by 6%. This was a unilateral move decided without prior consultation, and it caused considerable consternation among other EMS states whose export competitiveness would suffer from the Italian action. The fallout from this episode led to an agreement that future realignments should be collective decisions taken at, or at least through the forum of the Monetary Committee. The next seven realignments were carried out, for the most part relatively smoothly, in accordance with this rule. And as the doctrine of monetary neo-orthodoxy spread among European capitals during the 1980s, a more elaborate set of standard practices connected with realignment developed and became an expected part of the consultation procedure within the Committee.²²

I summarize these in the language of norms, because that is really what they were. A country seeking realignment should present a domestic economic reform package that demonstrates to other EMS members its commitment to greater policy convergence. The Monetary Committee should discount requests for realignment, placing relatively more of the burden of readjustment on the EMS laggard. Lastly, realignments should be kept small so that market rates fall within the new bilateral central rates not above them.

Diffuse as these norms seem, and at the same time often consistent with what countries wanted generally to do on their own, their steady practice

nonetheless represented a progressive institutionalization of the EMS that member countries took as meaningful. Qualitative evidence that the EMS did figure into state calculations about monetary policy during these years is clear, as is evidence that EMS commitments were instrumentally useful to governments that themselves wanted to make difficult and painful economic choices in a politically credible way. EEC member states by the mid 1980s considered the EMS to have made a contribution to the reduction of exchange rate fluctuations within the system and to the convergence of national economic policies, which was one of the reasons why serious discussions of moving on to some kind of EMU were revived in the lead-up to the SEA in 1985. And at least in some EEC member states, the EMS increasingly took on the mantle of being a central part of the general process of European integration.²³

That connection would become more evident during an exchange rate "crisis" in 1987. Some of the events of 1987 are strikingly similar to the crisis of 92-93, but the most important common feature is that in both cases the immediate preferences of certain states came sharply into conflict with each other, and with EMS rules and norms. 1987 took place against the backdrop of major changes in the sophistication of capital markets and foreign exchange trading along with a dollar sliding rapidly from its height of 1985. Under pressure from an appreciating Dmark, the franc dropped through its floor despite concerted central bank intervention on the order of \$8 to \$10 billion in about a week.²⁴ The

realignment that followed did not happen smoothly, in part because the French accused the Germans of intransigence while the Germans accused the French of running irresponsible policies that permitted the franc to drop too far and too fast. It was only after thirteen hours of "acrimonious talks" in the Monetary Committee that officials reached an agreement on realignment. Despite the official German position that "on the basis of economic fundamentals there was no reason for realignment"²⁵ the Bbank stood hard for that option (as it would again in 93-94). The alternative was to reduce German domestic interest rates but the Bbank ruled that out firmly until after the elections on 25 January. If there had been any doubts about Bbank priorities this should have put them to rest: German monetary policy first, everything else comes second.

Or so it might have seemed. Unfortunately, the 12 January realignment didn't end the crisis. Instead, the French bond market soared on expectations that interest rate reductions were imminent. This along with continued dollar weakness brought new strains on the franc. The Bbank gave way, albeit in a manner that others interpreted as belated and half-hearted. Overriding its earlier commitment, the Bbank on 22 January cut its discount rate 50 basis points.²⁶

The EMS survived its 87 crisis, but with substantial criticism particularly from Paris. French Finance Minister Edouard Balladur reproached the Bundesbank specifically for its reluctance to intervene adequately not only at the obligatory level but earlier, on a voluntary basis, when it became clear that a crisis

was imminent.²⁷ Balladur had a point, but his criticisms slighted the other side of what the Bbank had decided to do. Fact was, the Bbank did choose to make a "political interest rate cut" for the sake of the EMS in January of 1987. It did so ten days after a broad realignment and in the face of a firm commitment not to act, because of domestic political factors. When the Bbank cut rates, it did so primarily in support of the EMS not in response to German domestic conditions. Bbank support came grudgingly and reluctantly, but it came nevertheless.

In any case, European leaders recognized that EMS mechanisms needed some work. Capital mobility within international financial markets was changing the parameters. The Basle-Nyborg agreement of Sept. 1987 responded in a modest way by changing some EMS rules, in particular extending credit facilities for longer term loans in support of intervention and making it possible for states to draw credit for intramarginal intervention as well. The agreement also suggested the practical value of making small and frequent realignments rather than allowing pressure to build behind differential inflation rates in Community economies.

This last recommendation made a great deal of economic sense but it was submerged in the political momentum behind the single market project and later, Maastricht. For reasons that I discuss in detail later, the political stigma as well as the real costs attached to realignment increased dramatically over the next few years. There were no realignments after the 1987 crisis until January of 1990, when the lira was devalued at the same time as it was "graduated" to a regular

fluctuation band of 2.25%. Britain joined the ERM in October of that year.

Overall, the system seemed to be working rather well even in the face of capital liberalization (capital controls in most EC countries were essentially eliminated by the beginning of 1990), massive growth of forex trading, and external shocks the most dramatic of which was the Gulf War.

Eichengreen and Wyplosz argue that the apparent success of the EMS created "self-validating expectations of continued stability".²⁸ But it is also true that the ERM found itself in a world of nearly free capital movements, with what had become de facto "fixed" exchange rates; but with member states still running "autonomous" monetary policies. Inflation differentials were building up behind currency values like water behind a dike.²⁹ The monetary fallout from German unification, the strict convergence criteria written into Maastricht, and the Europe-wide recession that would boost unemployment in Europe to historic levels in 92 and 93 (each of which I consider later) made the system more brittle by creating spectacular conditions for speculative attacks that could be just as self-fulfilling as earlier expectations of stability.³⁰

When the crash came in 1992, political officials in the Community and member states bemoaned their bad luck, bad circumstances, and bad timing of Maastricht referenda and other such shocks. But in retrospect there is a greater sense of inevitability to what happened, since the system had come to rest on expectations that could be easily shattered. The question was what member states

would sacrifice, and why, to sustain it.

IV. EMS Logic

I will construct an answer to that question in four steps. The first step is to assess the goods: what it is that the EMS provides to states, that they would wish to sustain it. The second step is to look at the logical structure of provision and appropriation for those goods. I argue here that the EMS has characteristics of a CPR. Third, I consider standard solution concepts -- Leviathan, and Privatize -- and how they apply to the EMS. Lastly, I examine the EMS "rulebook" and standard operating procedures to see what kind of an institution the EMS actually is.

The bottom line is that there are CPR elements within the EMS, but the institution follows a logic different from the standard solution concepts. Instead, the EMS has characteristics that make it more like a voluntary organization, "a binding contract [among the players] to commit themselves to a cooperative strategy that they themselves will work out."³¹ Analyzing how the EMS works and how it survived the crisis of 92-93 (in Section 4 of this chapter) illustrates what that statement means in practice and what role the nesting of European institutions plays in the explanation.

The generic good that the EMS provides to states is exchange rate stability. Four arguments capture this good. The transactions argument says that a single market works better with one currency that enhances the usefulness of money as a

medium of exchange, as a unit of account, and as a store of value mainly by reducing transaction costs. The inflation argument says that countries with a history of relatively high inflation can enhance the credibility of a promise to lower inflation rates in the future, by linking currencies to a country with a long history of price stability. A tangential part of the inflation argument is that the EMS should help countries avoid any moves toward competitive devaluation of currencies.³² The political argument says that movement toward a single currency is more than just an economic act -- it is a prominent symbol of constructing a polity since control over money is still generally understood to be a central sovereign right.³³ The budgetary argument focuses on the value of placing boundaries around exchange rate risk that the EU has to hedge against in its own internal budgets, particularly with CAP expenditures.

The credibility that attaches to states' promises to defend relative exchange rates and the benefits that financial markets extend to that promise have many characteristics of a CPR. CPRs are non-excludable but subtractable goods. They are generally joint in provision as well. Individual actors then have incentives to over-appropriate, and lack sufficient incentives to contribute to provision of the good. The "tragedy of the commons" is the standard result.

A priori, the dilemmas connected to exchange rate (ER) stability look familiar in this context. ER stability within the EU is practically non-excludable, in the sense that it would be very difficult for EMS member states to ex-

communicate one of their own. There are in fact no formal mechanisms for doing so. On a more general level, involuntary expulsion from the EMS during the 1980s would have been nearly tantamount to expulsion from the community as a whole. This was outside the range of acceptable options and almost inconceivable given the implications for the community's broader agenda and plans.

At the same time, ER stability is a rival good. If appropriators take too much too quickly, credibility can easily be depleted. The amount of stability in the system is neither fixed nor inexhaustible. Credibility needs to be supplied, repaired, defended, and replenished by the behavior of the members of the EMS. But unless there exist providers whose interest it is to supply and replenish the good regardless of what others do or don't supply or how much they appropriate, provision is going to be a joint activity subject to the standard problems of making commitments, monitoring performance, and sanctioning putative providers who don't do their share.³⁴ In other words, provision is either a story about hegemonic stability, or it is a collective action story.

As for appropriation, countries that draw on ER stability within the system to bolster the credibility of their own currency commitments diminish the supply that is available for others to draw on³⁵. Put differently, the confidence that financial markets place in the EMS is a subtractable good that easily can be over-appropriated. This problem is tricky for both analysts and actors. It is hard to know just how much of the credibility resource appropriators can "use" in a

sustainable way, because so much depends upon aggregate expectations. Italy, for example, draws from the CPR when it runs a substantial budget deficit over time yet is able in the long term to borrow money at lower cost than it would have if it were outside the EMS. Other appropriators are tempted to and can do the same, drawing on the credibility of the system to their individual benefit. This sets up a classic commons dilemma, because the costs are diffused over the entire community. Unless provision keeps up with appropriation, the CPR is going to be depleted and the credibility of the EMS run down.

Rendering this in different language clarifies the specific problem that developed within the EMS. As the system evolved toward semi-fixed ER at the end of the 1980s, it became more difficult for individual countries to run de facto independent monetary and fiscal policies without placing great strains on the ERM. Several other options were closed off. Central bank intervention was becoming increasingly feeble compared to forex trading. And the EC lacked adequate alternative mechanisms for adjustment, particularly the large transfer payments that states use to cope with regional differences in economic performance. This meant that the burdens of adjustment would on first rendering fall heavily on weaker economies, and the question was whether governments would bear the strains of those costs.

The obvious temptation was not to do so. Instead, the stark individual incentives favored a choice to appropriate credibility from the EMS "commons",

by running looser monetary policies and more expansive fiscal policies while shifting at least some of the costs of adjustment to "the system" -- that is, to the other member states. For most of EMS history, those incentives tempted mainly the weak currency countries. Realignments within the EMS did shift and diffuse the costs of adjustment -- but in a compromise balance according to a set of norms that I discussed earlier in the context of the Monetary Committee. In general, the costs did not fall as heavily on stronger economies (in particular Germany) as the weaker currency countries might have wished, but they did fall there somewhat more than the Germans wanted.

There are two standard solutions to CPR dilemmas. Centralized control, the equivalent of Leviathan, is what happens within a state. There is a central bank and/or a central government that sets the rules (in this case, the value of the currency). It manages adjustment by various measures including transfer payments. In the EC the equivalent solution would have been monetary union, the move to a single currency for all member states.³⁶ A new institution would conduct monetary policy for the community and (presumably) moderate the adjustment burden for poorly performing regions via the usual mechanisms. There are always substantial costs -- monitoring, administering rules, sanctioning, etc. -- associated with the Leviathan solution. And the political barriers to reaching it in this case would have been immense. Nonetheless it was one of the options raised as a possible answer to the EMS dilemma and in a sense, it would

have "worked". That is, monetary union would indeed have "solved" the CPR problem in the EMS.

The other standard solution concept is to "privatize" the good. Putting resources into "private" hands means aligning incentives and responsibilities with firm property rights. The analogy here is to floating exchange rates. Each state runs its own monetary policy and adjustment of exchange rates takes place through the market. Governments might still intervene to moderate exchange rate movements that worked against their preferred economic growth and adjustment strategies. But intervention would be unilateral in the sense that no government would be obligated to intervene on behalf of another's currency. And intervention would matter only so far as it represented a part of supply/demand curves, or expectations about those curves held by other players in the market.

"Privatization" would also "solve" the CPR problem in the EMS, in effect by abolishing the system and leaving the market (in place of the ERM) as the main interlocutor for individual countries trying to run an economic policy. There are obviously costs here as well, although the purely economic costs are hard to measure. Given the historical context, the political argument matters greatly here, because a decision to abolish the EMS in 92-93 would have struck an enormous blow to the evolution of the Community. Member states were anxious not to have that happen.

Elinor Ostrom's argument about "voluntary organizations" suggests another

kind of possibility for managing CPRs. The basic feature of a voluntary organization is "a binding contract [among the players] to commit themselves to a cooperative strategy that they themselves will work out."³⁷ Of course the small-scale environmental concerns that Ostrom looked at are different to a currency exchange rate mechanism between nations. But if the generic logic of the problem, as well as the nature of the constraints and incentives facing the actors are similar, then the basic functional requirements for voluntary organization to succeed should be similar as well. A set of institutions that will support this kind of solution would have to deal with three generic challenges: supply, commitment, and monitoring. I consider them separately here, although in modified order because the first and third seem less problematic for the EMS than does the second.

Supply in this context means the supply of new institutions. It may be that a particular set of institutions, once they are in place, can solve or at least help to solve collective action problems. But how do those institutions come to be in place? Someone or something must "supply" them. If that is itself a collective action problem (as it frequently seems to be) then the dilemma has merely been pushed back one frame in the picture.³⁸ But the EMS "supply game" did not take place in an institutional vacuum, where stark cost-benefit calculations by autonomous actors might be the strongest determinants of the shape (or non-existence) of new institutions. Instead, the game was itself nested within a well-

developed and established institutional network called the EC.³⁹ This institutional environment sets forms and standards of legitimacy which new organizations strive to meet. There is a rough organizational template available. These conditions change the incentives facing would-be self-organizers who try to construct new institutions for collective action. The point is simply that EC member states, living in an already densely institutionalized environment, face incentives that are different to those they would face in a less densely populated environment -- where "technical" criteria of efficiency and input-output rationality play a larger role. To supply a new institution within the EC means creating a rationale for its existence. The rationale may include technical elements but can draw heavily as well on institutional legitimacy, which is not subject to the same kinds of efficiency calculations that lie at the heart of collective action arguments writ in rational choice terms.⁴⁰ While "supply" may not be easy, within a densely nested institutional system it is certainly possible and is (at a minimum) one of many potential equilibria for the system as a whole.

Monitoring by comparison is relatively straightforward. EC member states have access to enormous information about each other's economic policies and performance. The challenge facing these states lies not in gathering data, but in understanding what the data precisely means in the context of a CPR-type situation. What is a sustainable level of appropriation? The answer is not always clear. It may also matter what the motivations are of an appropriator who seems to

be testing the limits. Not all defections are the same and EC members know this. An institution that can support the kind of monitoring necessary to achieve that level of information and understanding (or can link itself to other institutions that do it) should be less brittle, particularly if graduated sanctions can then be matched to the circumstances.

The most difficult challenge is commitment, but this too may be different in a densely nested institutional environment than in an isolated game. If the EMS stood on its own, it is hard to see how it would happen. The problem is simply that once the EMS is set up and working, appropriators will be tempted by high immediate returns and diffused and delayed costs to break the rules and over-appropriate. Reasoning backward logically unravels the institution. If players in the game know that they will later be faced with these temptations and that others will as well, they would not agree to join it in the first place. What is needed is a way to align incentives so that a contingent commitment, something like "I will stick to the rules if others do as well", can be sustained.

This is not a problem solved easily through abstraction. It is certainly possible to envision models that would claim to solve it.⁴¹ But the question still remains how the critical problems actually do or do not get solved in real world interactions. The institutional structure of the EMS suggests some answers.

V. Institutional Structure of the EMS

Institutions can be seen as sets of agreements nested one within another. In Governing the Commons Ostrom lays out a three - tier framework for analytically disentangling this kind of layering.⁴² Operational rules govern the day to day workings of the institution -- what are the bands, what are the intervention rules, etc.. Collective choice rules delineate who can change the operational rules and how they can do that. Together they make up what Aggarwal calls rules and procedures. Both nest within a set of constitutional rules, which talk about the identity of the actors and the basic nature of relationships among them -- like Aggarwal's principles and norms.

I have already made the point that a change in operational rules does not always signal a failure or collapse of an institution, so long as change comes about for purposes and via processes that fit within the higher-order rules. At the same time, it is important to remember that states do not respect analytic categories and are free to choose in which arena(s) they pursue their interests. When the EMS came under pressure in 1992, there was room for action at all three levels.

Member states could have gone so far as to break out of the constitutional rules that make up the EU's institutional environment -- for example, by unilateral imposition of capital controls or unrestrained currency devaluation. Or they could have broken out of the collective choice rules -- for example, if France and Germany had agreed in private bilateral negotiations to a fast-track franc-dmark union. Member states chose neither of these kinds of options, but instead confined

themselves for the most part to changing operational rules in a manner consistent with maintenance of the institution's higher order elements.

If this suggests that the EMS survives in essential equilibrium, then it also suggests that the bleak predictions of standard collective action theory don't fit comfortably here. I will construct a different explanation in two steps: first, by examining elements of the EMS rulebook that could contribute to the explanation; and second, in the next section of this chapter, through a focused narrative account of how those mechanisms (and others) "managed" the crisis of 92-93.

EMS Rules

Concrete Obligations, and Burden Sharing

The snake was more a statement of intentions and a rudimentary information-sharing mechanism than a substantive institution. The EMS went considerably further than this even in its early years, although it remained optional -- Britain chose not to join in 1978, and Greece chose not to participate when it joined the Community in 1981. When the ERM was established, each currency was assigned a "central rate" denominated in ECU.⁴³ The ratio between two ECU central rates is the bilateral central rate for the two currencies; linking these all together gives the parity grid for the system as a whole.⁴⁴ Member states agreed to maintain exchange rates within fixed bands around the central rate; those bands started at 2.25% on each side (with an exceptional 6% band for the lira).⁴⁵

The EMS rulebook prescribes two separate stages of intervention to support these rates. The first stage is set off by the divergence indicator: when a currency moves outside 75% of the bandwidth of its ECU central rate. This carries a "presumption" to intervene and adjust domestic economic policy, but no obligation to do so. In practice the divergence indicator has had little direct impact on behavior. Intervention at this level has been rare. And while states often adjust domestic policies as currencies fall toward the 75% level, it would be hard to develop evidence that those adjustments were driven in any meaningful sense by the divergence indicator per se.⁴⁶

Intervention becomes mandatory when a currency hits the boundary of a bilateral parity. The issuing bank of the stronger currency purchases the weak one, while the issuing bank of the weak currency sells the strong currency (if necessary, after borrowing it from the other's central bank).

This can sometimes be expensive. But the use of ECU central rates (directly in the case of the divergence indicator and indirectly in the bilateral grid) and the central role of the ECU (not national currencies) in the settlement of borrowings made to support intervention, amount in effect to a Community burden sharing scheme that spreads out the costs. Because the value in a national currency of debts and claims will be affected by the behavior of all the currencies that make up the ECU "basket", settlement in ECU spreads out the exchange rate risk for both debtor and creditor countries in interventions. It also allows a de

facto larger divergence spread for smaller countries (whose currencies make up a smaller part of the ECU).⁴⁷

Three separate financing facilities that member states can use in support of intervention make up another kind of burden sharing scheme. The Very Short Term Financing Facility (VSTF) is essentially a network of mutual credit lines among central banks that are run according to a set of community-wide rules.⁴⁸ Short Term Monetary Support (STMS), also administered by the central banks, is aimed at temporary balance of payments problems and acts as a kind of "mini-IMF" for the EU. It includes a set of debtor and creditor quotas that can be waived under special circumstances by mutual agreement. The third facility, Medium Term Financial Assistance (MTFA), is something like a very mini World Bank. MTFA is administered by the Council of Ministers and provides longer term financing that is part of the more general set of EU allocation schemes favoring the less prosperous member states.⁴⁹ This burden-sharing is still an order of magnitude less than the intricate redistribution regimes characteristic of single states. But it is considerably more than a privatized market for currencies in which stabilization and its costs are the sole responsibility of the individual states.

Monitoring, Collective Choice, and Conflict Resolution

In practice the EMS is a central part of political life within the Union. The natural consequence is that many EU institutions are involved in monitoring and

discussion of its operations although one specific institution, the Monetary Committee, is the primary arena where operational rules and some changes in collective choice rules are played out. Each member state appoints two representatives to the Monetary Committee. These are usually a top official from the Economics or Finance Ministry, and a first or second deputy Governor of the Central Bank. The Commission also appoints two members.⁵⁰ Since the 1981 flap over the unilateral Italian devaluation, consultations within the Monetary Committee have been the standard procedure for negotiating realignment. And as I discussed earlier, a set of norms about procedures and outcomes of realignments have generally been sustained through this process.

The Monetary Committee is also the central focus for the Union's multilateral monetary surveillance exercises, biannual since 1990. The mandate for these surveys is quite broad, extending over national statistics on everything from employment, regional development, interest rates, and the like; to a review of budgetary policies including the size and proposed funding of deficits. The Monetary Committee does the work and drafts a report which serves as the basis for discussions at the Council. The Council, in turn, is entitled to make economic policy suggestions and issue country-specific recommendations with the concurrence of the Commission.⁵¹ None of this is binding, of course. But member states are obliged to "bring the results of the multilateral surveillance to the attention of their national parliaments so that it can be taken into account in

national policy making". The European Parliament is also involved: it can call before several committees the President of the Council to report on recommendations, and it is supposed to receive from the Council periodic reports on the progress made through the multilateral surveillance procedure. Again, there is nothing approaching Leviathan here, but there is much that goes beyond a private market.

EMS Collective Action

These institutions make it easier for states to monitor each other's policies and activities, that affect the common resource pool of exchange rate stability in the EMS. Label this "information provision", and it fits comfortably within the familiar conceptual framework of an "international regime." More interesting for my argument here is the contribution these institutions make toward contingent commitments with behavioral consequences that go beyond what the standard notion of regimes will support.⁵²

How does this work? Ostrom found through close examination of many cases that successful voluntary organizations seemed to share a number of "design principles", which failures were less likely to have.⁵³ Several of these design principles have analogies in the EMS. The system has clearly defined boundaries, which distinguishes common property from open access. It has collective choice arrangements which allow all of the states affected by operational rules to

participate in modifying those rules, at a reasonable cost, along with realistic dispensations for the more powerful states and particularly Germany. The high degree of interdependence in the EU boosts the private benefits of monitoring, as knowing what other states are doing is an important input to each member state's strategic decisions about its own monetary and fiscal policies. States have easy access to a dense network of conflict resolution mechanisms and there are a set of norms about legitimate procedure that point to particular institutions as the appropriate_(not necessarily efficient) place for conflicts to be worked out.

The two most important features of the EMS in this context are “graduated sanctions” and “nested enterprises”. What is important about graduated sanctions is the range of means by which member states can respond to non-compliance by one of their own. Contrast this with the different story about decentralized cooperation that Robert Axelrod tells in Evolution of Cooperation. Tit for Tat is an exemplar "trigger strategy" model but it is extremely "brittle" to defection or non-compliance. In Axelrod's stark model all defections are de facto the same -- no matter who defects or when or why the defection occurs. And all defections call up exactly the same response. It's obvious that the EMS (like most real world institutions) doesn't work that way, but it is much less obvious precisely how contingent cooperation does work once we introduce differentiated measures of behavior for both the "defector" and the "responder".

The term "graduated sanctions" captures the (intuitive) idea that in

successful, real world organizations, all defections are not the same and there exist ranges of possible responses -- which together make cooperation less brittle than in Axelrod's world. The logic of compliance in this kind of system is less stark than in a trigger strategy model.⁵⁴ Two general beliefs support compliance. The first is that the system to which I am contributing will, on the whole, deliver the collective goods I am helping to pay for. The second is that most other members of the system will also contribute their share. The history of the 92-93 crisis shows a similar logic of "quasi-voluntary" compliance operating in the EMS. The details in the next section of this chapter show the central importance of two shared beliefs: that the system will continue to provide exchange rate stability, and that others will contribute a fair share to that end by titrating interest rates and adjusting economic policies over the longer term.

There is a "flip side" to these beliefs that is important. If someone seems not to be contributing, the relevant question in the EMS is "why not" -- since in a highly interdependent and densely institutionalized system with a comparatively small number of players it may be possible and cost-effective to try to differentiate among defections. A particular defection might very well be a baldly opportunistic grab for unilateral benefits, but it might also represent a genuine disagreement over management decisions (particularly given the level of uncertainty about sustainable yields from the CPR), or the quality of existing rules that are supposed to govern appropriation. Another possibility is that a state with

a strong reputation for compliance is plunged into unexpected circumstances by an external shock, and succumbs in an isolated instance to strong temptations.

These differences should matter greatly to participants in a voluntary organization, both in terms of making decisions about whether and how to sanction the violator -- or, more importantly for the EMS, whether to sustain their own contribution to the system or to withhold it, in which case the system itself would collapse. What is not possible to do in Axelrod's institution-free thought experiment world -- to appreciate the significance of a defection -- may very well be possible in the densely institutionalized environment of the EU. This can create "wiggle room" on compliance and sanctioning that would be central to the maintenance of the system in the face of external shocks, and that essentially is what happened in 92-93.

Nested institutions play an important role in making this work. The norms and criteria of legitimacy that frame the EU's institutional environment set boundaries on what is legitimate and appropriate to do in collective choice mechanisms and operational rules. As in other institutional environments, congruence among the several levels stabilizes the entire structure and reinforces the historical trajectory of development that characterizes EU institutions.

These are abstract statements that will take on more specific meaning when I tell the story of the crisis, in the next section. But it is worth pointing out now how nesting makes the EMS different to the snake. The snake was more an

ancillary arrangement than an integral part of European integration, and that was true both institutionally and cognitively.⁵⁵ The EMS is different on both scores. National leaders and community officials publicly and consistently tied the success of the EMS first to the SEA and later to the more elaborate integration plans within Maastricht. Whether or not a single currency was technically necessary or even beneficial to either scheme was not the central argument around which decisions were taken (although such arguments were of course part of the debate). As the 1980s moved forward, it became increasingly difficult for national leaders to oppose the EMS and at the same time paint themselves in favor of European integration, whatever the technical merits of such a position might have been.⁵⁶ The debate over "multi-speed" Europe in the run-up to Maastricht clearly demonstrated that a country unable or unwilling to be a part of the EMS risked sacrificing legitimacy as a full member of the EU or whatever other institutional arrangements might come out of the negotiations. Such a position might have made sense substantively in a technical environment, but it simply did not make sense within the EC.

VI. EMS Under Crisis: 92-93

The Build-up

The basic economics that brought about a crisis in the EMS are simple. Lurking in the background as an underlying impetus of change was the fact that the system

had become brittle. There had been no major realignment since 1987, but member states continued to run economic policies that led to differential inflation rates among them.⁵⁷ At the same time, capital mobility was increasing rapidly both because of the formal lifting of most controls, and the astounding growth of the forex market generally in the later 80's and 90's. De facto, the EMS seemed to be much like a fixed exchange rate system in a world of capital mobility among countries with supposedly "independent" monetary policies . While Eichengreen and Wyplosz argue that only Italy was suffering definite competitiveness problems as a result of currency "misalignment" (the data are less clear for Spain and UK), pressures on currencies were certainly starting to build up much like water behind a dike. And although "real" economic forces from "fundamentals" might not have on their own caused a crisis in 92-93, the situation was certainly ripe for an external shock of sufficient magnitude to come along and do that.

German economic and monetary union (GEMU) was an enormous shock. As the de facto anchor currency of the EMS, Dmark interest rates set an effective floor for rates throughout the system and had done so for much of the 1980s. In late 1987 with domestic inflation rising moderately in Germany, Dmark interest rates had already begun a gradual upward climb that carried rates throughout Europe somewhat higher. But the real shock came in 1990, when the Kohl government at the outset of GEMU (German economic and monetary union) decided (largely for political reasons) to exchange ostmarks to Dmarks at a 1:1

ratio up to a very generous limit and to make enormous transfer payments to the Eastern lander which were financed largely through deficit spending.

The effect of "ostmark diplomacy" was to expand the German money supply at a rapid rate and to create an enormous surge in public and private spending, particularly in the East -- but without an immediate corresponding supply-side response. German inflation was a predictable result. In fact, the Bbank anticipated this dynamic as early as 1989 and tried to head it off by arguing for a dmark realignment at that time. Standard economic reasoning clearly favored an appreciation of the Dmark.⁵⁸ This would make goods from other EC countries more competitive in Germany, so that the surge in German demand could be met by supply from all EC countries. "Diffusing" the demand spurt around the community would have insured that output (and by implication, inflationary pressures) would rise in like manner throughout the community rather than in Germany alone.

The problem, of course, was that saying "upward realignment" of the Dmark was simply another way of saying "downward realignment" or "devaluation" of other currencies within the system. By the end of the 1980s, devaluation had become a difficult and nearly unacceptable option for EC countries. This was in part because of the symbolic nesting of the EMS within other EC institutions and the commitment to "Europe" that exchange rate stability had come to represent. But it was also in part a result of important links to

domestic political concerns and strategies. The Italian government, for example, argued that exchange rate stability was critical to its ongoing efforts to restructure public finances in Rome and to push through budget reforms aimed at reducing the country's enormous deficit. Rome saw devaluation of the lira as signaling a loss of credibility that it could not afford at such a crucial time.⁵⁹ The British government argued similarly that a devaluation of the pound so soon after it had entered the EMS would undermine the credibility of its monetary strategy. In France, the long standing domestic political significance of the "franc fort" policy had been, if anything, magnified by German reunification and the changes in Franco-German relations this was certain to bring. So when the Bbank suggested realignment in 1989 as a prophylactic measure against a crisis that had not yet materialized, it is not surprising that the idea was turned back firmly.⁶⁰

FIGURE 1A: RESPONDING TO GERMAN UNIFICATION AND GEMU

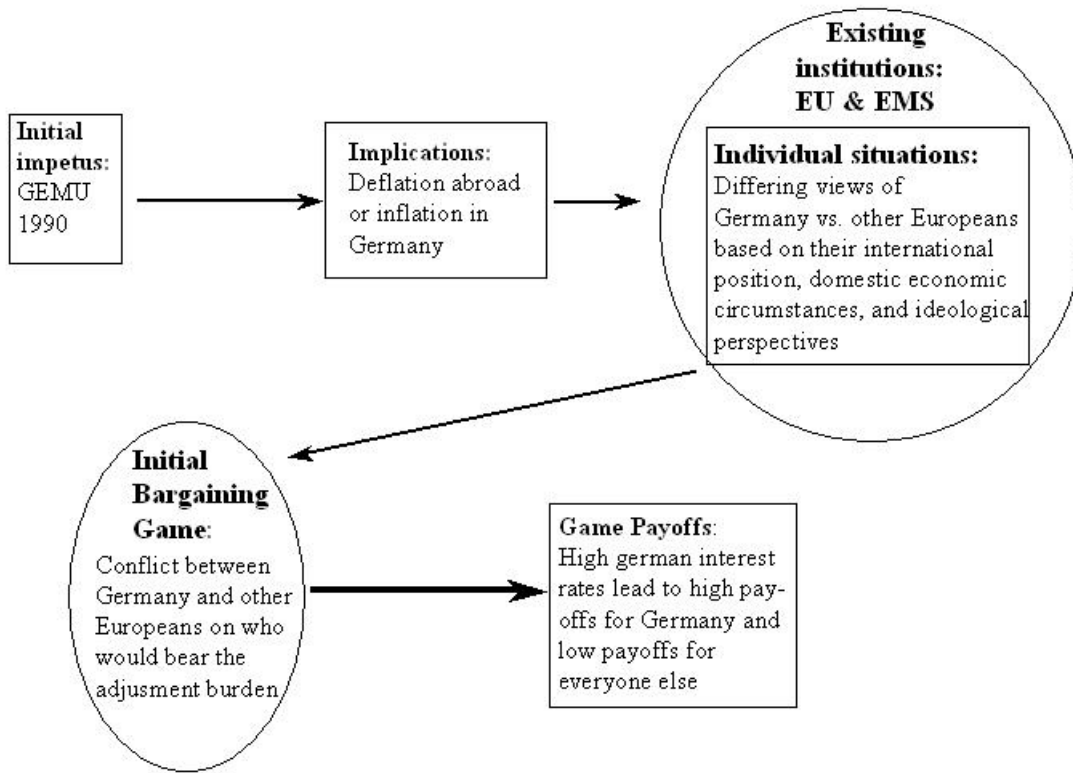


Figure 1A captures the logic of the game at this point. Member states shared much common knowledge about the economics of GEMU and its ramifications for the EMS, but did not agree on what to do about it. As Eichengreen and Wyplosz explain, the necessary adjustments might have been made without a formal decision to revalue immediately, through several possible recipes combining differential inflation rates. Three general possibilities include:

- 1) substantial German inflation, stable prices elsewhere
- 2) stable German prices, substantial deflation elsewhere
- 3) moderate German inflation, moderate deflation elsewhere

Presumably, neither the French, the British, nor other EC states with relatively high unemployment would support option #2. And hardly anyone could have believed that the Bbank would stand for option #1. This left option #3, perhaps the best of the bad choices; but it still depended on the Bbank accepting a certain amount of German inflation. What seems likely, is that other states believed that if realignment were indeed ruled out, the Bbank would take a "responsible" "European" perspective on the situation and compromise on a more expansionary German monetary policy than it unilaterally would have preferred.

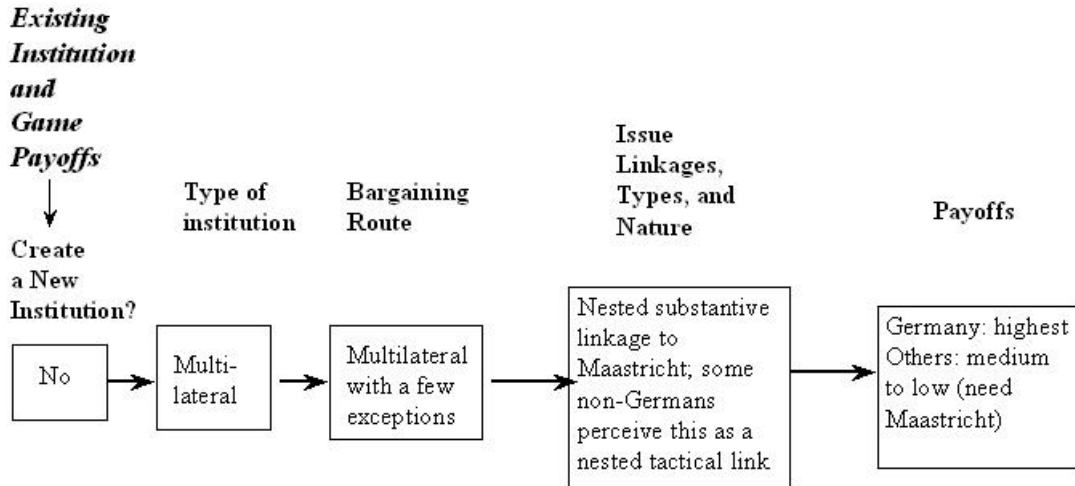
They were wrong, at least at the beginning of the crisis. The Bbank stood by its domestic policy commitment to low inflation in Germany and boosted interest rates 10 times for a total of 600 basis points between December 1987 and September 1992. Central banks in other EMS countries found themselves with no real option but to raise their own rates to stem a flow of currency into dmarks. In effect, the Bbank was choosing something close to option #2: to export deflation, which contributed to recession and a rise in unemployment (from a GDP-weighted average of under 10% in EMS countries other than Germany in 1990, to over 11% by the same measure in 1993) around the community.

This would have made for the necessary economic adjustments -- but it was vulnerable politically. Anyone living in Paris or particularly in London during 1992 would have witnessed the bizarre spectacle of a country in deep recession with high and rising unemployment, raising its interest rates more or less in

lockstep with a central bank in another country.

What made the system even more brittle were some ironic follow-on effects from the "convergence criteria" agreed under the Maastricht Treaty in December 1991. In addition to strict guidelines for budget deficits and inflation, Maastricht made exchange rate stability within the narrow band of the ERM for two years a necessary prerequisite for a state to enter stage three of European monetary union. Despite some wiggle room for discretion in applying the convergence criteria, this made realignment an even more noxious idea to most member states.⁶¹ To be cut out of monetary union would not only deprive that state of a position in a European Central Bank; it would be tantamount to accepting second class citizenship in the EU generally. Figure 1 B illustrates the logic of what was generally seen as a nested substantive linkage by most member states.

FIGURE 1B: THE LINK TO MAASTRICHT



Ironically it was that linkage that partly set the stage for crisis: "unable" (de facto) to realign, unable to control capital flows across borders, and unable to convince the Bbank to moderate its anti-inflationary bias, member states in effect were locking themselves into deflationary monetary policies in the midst of recession.

To cast the story against the theoretical framework of a CPR problem, in a sense Germany did exploit the system here. Germany expanded its money supply in a flash and in effect tried to transfer some of the costs of that decision to others. German behavior can be viewed as a kind of opportunism that is available to monetary pseudo-hegemons and is certainly not unique to Germany.⁶² But in this case the special presence of the Bundesbank changed the logic of the situation.

Instead of accepting inflation at home, the iron discipline of the Bbank turned the game around, to one of deflation abroad. This brought the EMS to a vulnerable point where the system for organizing provision and appropriation of the CPR -- exchange rate stability in Europe -- was on the brink of collapse.

The crisis of 92-93, as I see it, is essentially a story about how change was "organized" to avoid collapse. The next section argues, in recounting that story, that the EMS survived in its essentials as I proposed at the beginning of this chapter. Its reorganization followed to a considerable degree the logic of a voluntary organization, which leads to several interesting questions. Which "design principles" turned out to be important causes? What other factors were important in holding the EMS together, and what does this suggest about the future of EMU?

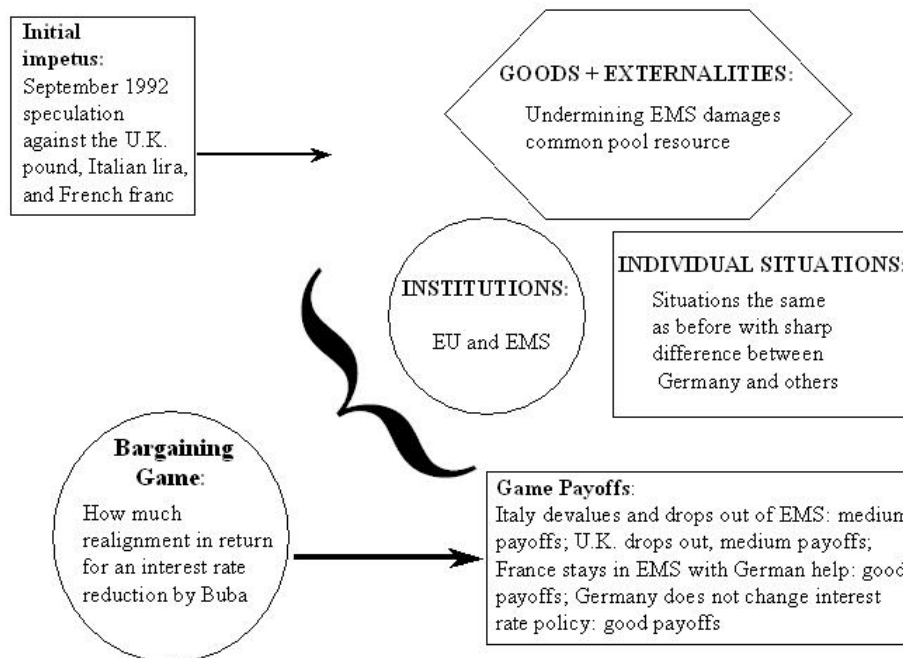
The Crisis: Phase 1

In mid-summer 1992 historically low interest rates in the US and much higher rates in Germany were driving money out of dollars in particular (as well as out of pounds and lira) into Dmarks. The inflow of money into Germany further increased the growth of its money supply and inflation, and put additional upward pressure on German rates. At the same time, the pound and the lira fell near to their respective floors within the ERM, forcing the Bank of Italy to raise its discount rate to 13% in mid-July. At the end of August, the Bank of England

intervened massively in currency markets to support the pound. The Bbank raised the realignment issue again in early September, but was turned back firmly by Italy and Britain with the support of France.⁶³ Additional intervention in support of the pound and lira (financed largely through borrowing from the VSTF and additional sources) along with another jump in the Italian discount rate to 15% barely managed to keep the pound and the lira above their floors.

When Finance Ministers and Central Bank governors met in Bath, England during the first week of September, they knew the ERM was being sorely tested. The Italian Treasury Minister said that Italy would consider devaluing the lira if it were done in the context of a broader realignment, but that idea was still opposed strongly by both France and Britain. Both countries argued that the EMS problem was not about mis-aligned currencies, but about German interest rates. Bundesbank President Helmut Schlesinger disagreed, but did offer up the possibility that the Bbank might lower its rates if the ministers could agree a general realignment. His compatriots demurred and the meeting ended with only a continued commitment to support existing exchange rates and intervene as necessary to do so. Figure 2A describes the logic of the game at this point.

FIGURE 2A: ENTER THE SPECULATORS



Economists and other observers have since criticized harshly the Bath meeting for not acting more aggressively, but many of these criticisms don't take sufficient note of the stakes and the nature of the disagreements that were on the table. The Bbank position was not shared by other central banks, in large part because no one wanted to be "the only" or one of only a few countries to devalue, for reasons I discussed earlier. The French in particular felt that a broad realignment had also to be ruled out, at the very least until after the French referendum on Maastricht scheduled for Sept. 20. With August opinion polls showing French public support for the treaty dropping below 50%, the French government argued that a realignment just before the referendum would embarrass the government's Europe policy and turn the vote into an almost sure defeat. From

this perspective, the pressure was on Germany to make a sacrifice for the sake of Europe rather than the other way around. But the Germans still didn't see it that way.⁶⁴

During the following week the pound hovered barely above its floor and the lira slipped beneath its floor, despite intervention of around \$16 billion to support it.⁶⁵ On September 11, Schlesinger and Bbank VP Hans Tietmeyer met with the Chancellor and his top finance aides to press the case within the German government for ERM realignment . Despite pressure from France, Kohl was won over by Schlesinger's arguments about the costs of continued intervention and its probable effect on the German money supply and inflation dilemma.⁶⁶ They agreed that the government would support a broad realignment, for which Schlesinger offered in return an interest rate cut linked to the size and extent of the realignment.

Tietmeyer and Horst Kohler (State Secretary of the Finance Ministry) arrived in Paris the next morning, to brief French government officials on the realignment/interest rate cut message they were about to carry to Rome. The Germans met with Finance Minister Michel Sapin and Jean-Claude Trichet, the Director of the Tresor -- who was also at the time chair of the EC Monetary Committee. According to the Financial Times, Tietmeyer and Kohler told Sapin and Trichet that Germany wanted a broad realignment within the ERM but did not specifically request a meeting of the Monetary Committee to negotiate such a

move. And Trichet, perhaps because he thought the British would block realignment and/or because his own government wanted desperately to make it past the Maastricht referendum (just one week away) with the franc intact, did not call for a meeting. The Germans went on to Italy, where they agreed in bilateral negotiations with the Italians a 7% lira devaluation to be answered with small reductions in the Bbank discount rate (0.5%, to 8.25%) and Lombard rate (0.25%, to 9.5%). In a mostly pro forma move, ERM member states the next day gave their approval to the German-Italian deal.⁶⁷

This small and single devaluation was in some ways the worst of all possible worlds for the ERM. Not enough to shield the lira from pressure, it did act as a reminder and a signal that realignments could and did happen. This only whet the appetites of currency speculators reading the "fundamentals" at least for the lira and the pound.

On Monday 14 September Schlesinger and Tietmeyer said publicly that the Bbank had indeed asked Kohl to push for a broad realignment. The next day, the pound predictably fell to just above its floor against the Dmark. That evening, the Wall Street Journal and Handelsblatt released summaries of an interview with Schlesinger in which the Bbank President indicated clearly his own strong preference for a broad realignment. Regardless of whether Schlesinger had approved the precise language, this public revelation acted as another signal to currency traders.⁶⁸

"Black Wednesday" (16 September) brought disaster to the pound. Britain, however, did not surrender the pound without an unprecedented fight. Over the course of the day, the Bank of England spent approximately 15 billion pounds (about half of total available reserves) to support the pound. The Bank, the BDF, and other ERM members spent an additional 5 billion pounds. All told, this was probably the largest one-day central bank intervention in currency markets ever.⁶⁹ That was not all the British did to fight. In the midst of a painful recession, Prime Minister John Major authorized two interest rate hikes, first from 10 to 12% at 10:30 in the morning of Black Wednesday, and finally from 12 to 15% at 2:15 PM. This represented will to sustain a savage shock to the British economy and an enormous blow to John Major's already faltering popularity.

None of this would save the pound from its fate at the end of the day, but that "fact" was not known to the actors who made the decisions at the time that they made them. What seems clear is that the British government was willing to pay substantial, even unprecedented costs both financial and political to keep the pound in the ERM. The alternative argument of some observers, that these were only theatrical moves designed to show that Britain was "trying" prior to pulling out, has little evidence to support it and is not logically compelling. To what audience would this play? Certainly the government did not help its domestic position much by raising rates for a few hours, raising them yet again, and then dropping out of the ERM and reducing rates at the end of the day. The British

press and public reacted sourly to the whole affair, which (in part because of the interest rate moves) looked much more like a massive defeat for the government than a reasoned policy choice. The general sentiment among the elite in the City was that changing interest rates thrice in a day was no way for a serious government to run a monetary policy.⁷⁰ But if the maneuver had worked to support the pound, the domestic picture for the government might not have been much better -- as Major would have been stuck more or less with blistering interest rates and no politically acceptable way to lower them at least in the short run.

David Cameron characterizes what Britain did as "exit"; but this is in my view incorrect. It simply ignores the price that Britain was willing to pay to sustain something closer to "loyalty". Another way to put it, is to ask if this series of events represents the abject "failure" of the EMS as an institution, and I think the answer to that question has to be a measured "no".

The system certainly failed to deliver the goods. Why? The story does not seem to be one of abject defection or free-riding -- certainly not by the British, and arguably not by the Germans either. A better characterization is that faulty management decisions made earlier left a nearly unsalvageable situation in September. Seen in that context, what looks really striking about this story is how much states were willing to sacrifice to salvage what they could. The failure of the EMS to deliver the goods under these peculiar and unforeseen circumstances

demanded a change in operational rules. How those changes would be made -- and the subsequent implications for the EC -- are the important questions.

Major's government could not and did not accept defeat lightly, particularly seeing as how it had staked so much of its domestic prestige on an economic policy that put ERM at the center. But in the mid-afternoon when the interest rate hike failed to push the pound up above its floor, the Bank of England had exhausted all its realistic options. Major called both Kohl and French Prime Minister Pierre Berezgouvoy to inform them that his government would withdraw from the ERM. The British Cabinet met after the close of the London markets, and at 7:30 that evening Chancellor Lamont announced the suspension of the pound from the ERM.

This decision was not taken within the context of the EC Monetary Committee, but the Committee did meet in emergency session that night in Brussels to acknowledge ("take notice") of what Britain had done. Following an all-night meeting, the Monetary Committee announced also that the lira would be de facto suspended as well, and that the Spanish peseta would be devalued 5%.

This was, without question, a first-order crisis for the ERM -- two currencies effectively dropped out and a third was devalued. But did the institution fall apart? In the days immediately following the crisis, the vitriol flowing between London, Bonn, and Frankfurt made it easy for journalists to conclude that it had -- and to suspect that the damage might easily spill over to

other aspects of the community. Back and forth criticisms over the events of Black Wednesday got so nasty that the British Foreign Office at one point summoned the German ambassador for consultations -- an unprecedented move between two EC member states.⁷¹ These exchanges were motivated in part by real anger between the two states; in part by real misunderstanding; and in part by the need to posture before domestic political factions that smelled blood in Major's climbdown. But they had the effect of making the ERM appear even more brittle to currency traders, who saw in the upcoming French referendum on Maastricht a golden opportunity to exploit what seemed to be the imminent fracturing of the EMS.

The Crisis: Phase 2

On Friday 18 September traders drove the franc to within one centime above its dmark floor. Tietmeyer that day made several public statements in support of the franc, but without obvious effect. BdF currency market interventions (reported later to be on the order of \$10 billion, some of which was borrowed from the Bbank) didn't help much either.⁷² That weekend all eyes were on the upcoming French referendum. The positive outcome -- razor-close as it was -- seemed to barely change currency traders' calculus. On Monday 21 September the franc fell to 1/2 centime above its dmark floor despite continuing heavy intervention by central banks. That afternoon and the next morning,

Schlesinger, Tietmeyer, and Waigel (all in Washington for a previously scheduled G-7 conference) each made vehement public statements in support of the franc.

According to Buchan and Dawkins of the Financial Times, these were part of a coordinated strategy worked out in Washington among Sapin, Trichet, Jacques de Larosiere (then governor of BdF) and the Germans -- Schlesinger and Tietmeyer from the Bbank, and Kohler and Waigel from the government.⁷³ While Sapin and Kohler flew back from Washington to implement their joint defense, Kohl and Mitterand met on Tuesday 22 September in Europe to reinforce the French-German link and perceptions of their shared commitment to Maastricht. Despite these political signals and continued heavy central bank intervention, currency markets kept up the pressure on the franc and brought new pressure on other currencies as well -- the peseta, escudo, krone, and punt in particular. By late Tuesday the entire ERM seemed on the brink of disaster.

A turning point came on Wednesday 23 September, one week after Black Wednesday. In conjunction with the strategy agreed in Washington, the BdF announced early that morning a moderate increase in a short term interest rate and then released a joint French-German statement that the franc and mark were fairly valued and would be supported by joint intervention.⁷⁴ The Bbank that day did two unusual things. It intervened intramarginally; that is, it bought currencies on a voluntary basis before they hit their floors; and it announced publicly that it was doing so at the time.⁷⁵ The BdF spent perhaps \$17 billion on intervention in the

week after Black Wednesday, a substantial portion of which it probably borrowed from the Bbank. The Bbank itself probably spent somewhere between \$7 and \$20 billion to support the franc that week, and (according to Schlesinger) around \$60 billion total during the month of September to support weak ERM currencies overall.⁷⁶ By the end of the trading day on Wednesday, the franc was up several centimes and other currencies as well were trading safely within their ranges. It appeared, at least for the moment, that the ERM had been saved.

What happened here can be captured in a few simple observations. The pound and the lira were each in an untenable position. Italy was uncompetitive; Britain was stuck with stifling interest rates in the midst of a recession, probably an overvalued currency, and a somewhat ambivalent commitment to EMU as the ultimate objective for the EMS. In that context, what is striking about phase 1 is how hard states actually tried to hold to operational rules. Recriminations after the fact did not extend to breaking down the collective choice rules of the institution. These were followed, for the most part, in managing the crisis. The Bbank spent nearly as much money trying to defend the pound as it did the franc, but the franc was in a better position in terms of fundamentals and was thus probably easier to defend. It seems also that the Germans learned from the first phase of the crisis, at least about what didn't work. And it is certain that the level of cooperation between France and Germany was higher than that between Britain and Germany.

This probably reflects long standing characteristics of both relationships,

but it also follows in part from the nature and the sequencing of events. After Black Wednesday, political expectations about the future of the ERM changed tenor. The loss of the pound and the lira were unfortunate events that were damaging to the ERM. The possible loss of the franc in the next crisis phase was seen widely as a different kind of event, threatening certainly the existence of the EMS and possibly the future of Maastricht -- and by implication the next stage of European integration -- as well. Once the crisis took on this broader set of implications for nested institutions, the behavior of the central states in the drama changed. Germany and France, governments and central banks, spoke more or less with one voice in a way that had not happened in the first phase of the crisis. This was sufficient to calm the markets for a time. But the crisis was not yet over.

The Crisis: Phase 3

The next attack on the ERM came in mid-November, when currency traders began to pressure the Swedish krona -- a currency which, although not a formal member of the ERM, had been pegged to the ECU since 1991.⁷⁷ The Swedish government, which had raised overnight interest rates to 500% during the September phase of the crisis, now appealed to the EC Monetary Committee for access to EC currency support funds. The Monetary Committee rejected Stockholm's request, de facto reinforcing the boundaries between formal members of the ERM and aspirants like Sweden (who as yet, presumably, had no legitimate

claim on the resources of the system).⁷⁸ On 19 November the Swedish government raised interest rates again and tried -- but failed -- to pass an emergency package of spending cuts aimed at cutting public sector borrowing. Capital continued to flow out of krona and into dmark, leaving the central bank with no real option other than to abandon the peg, which it did later that day.

Sweden's surrender was a significant signal to currency markets. Stockholm was seen as having great political will and substantial incentives (as an EC applicant) to maintain the peg. If it could be forced to devalue, what then of the weaker currencies that were within the system? Trading on Friday 20 November pushed downward the punt, escudo, and peseta near to their ERM floors. Spain that night requested a meeting of the Monetary Committee.

After a long Sunday parley in Brussels, the Committee announced a 6% devaluation of both the peseta and the escudo.⁷⁹ This was essentially a pro-active move taken before currency markets forced the hands of the Spanish and Portuguese governments. Realistic options were now more clear than they had been. The threat to the ERM would probably have been greater if either country had held out for its overvalued currency, now that devaluation was nearly sure to happen, by force or by choice. As it was, the decision to devalue was taken by consensus, within the Monetary Committee, according to the collective choice rules of the ERM. In effect, the ERM was being re-configured gradually in a way that would lead to the necessary change in operational rules, that would allow the

institution to survive.

The obvious remaining target at end-November was the punt, which hung on only through the Bank of Ireland's massive interest rate hikes.⁸⁰ The Danish krone also dropped close to its floor against the dmark despite similar rate increases in Denmark. Early December brought new pressure against the franc, which three small interest rate hikes and large interventions did little to ease. Another round of coordinated French-German defense followed: Kohl and Mitterand held a summit, Sapin and Waigel issued common commitments to the ERM, and the central banks of the two countries engaged in joint interventions.⁸¹ On 10 December, Norway (another EC aspirant) abandoned its ECU peg. More importantly, the Bbank Council maintained its determined stance not to lower German interest rates unless and until monetary conditions within Germany changed. This pushed the franc perilously close to its dmark floor, prompting another round of publicly announced, intra-marginal intervention by the Bbank. But even this dramatic action, along with a public statement by Schlesinger that the franc-dmark exchange rate was justified by "fundamentals", could not keep the franc out of the danger zone and by the end of the week it was down to less than one centime above the dmark floor.⁸²

Christmas and New Year's provided some breathing space, but in the first few days of 1993 the franc fell right back to where it was before the holidays. This set off another round of intervention along with a joint statement by the

central banks and finance ministries of Germany and France that they would work together in "close cooperation...to ensure the proper functioning of the ERM."⁸³

On 5 January 1993 the two governments staked their defense on the declaration that "the actual central rate of the two currencies is fully justified on the basis of their economic fundamentals."

The punt, however, could not stand similarly on fundamentals -- and neither massive intervention nor blistering interest rate hikes could save it.⁸⁴ Even so, the Irish government (which had made the "hard punt" policy a center of its economic program) fought hard, raising overnight rates at the end of January to 100%. When this failed to boost the currency, Ireland too had run out of options. On Saturday 30 January the Monetary Committee announced a punt devaluation of 10%.⁸⁵

At the end of January 1993, one way to read the situation was to say that the ERM had collapsed. Indeed, with the exception of hard "core" currencies essentially linked to the dmark, all other currencies (save the franc and the Danish krone) had been devalued.⁸⁶ But there was another way to read the situation, which was to say that the broad realignment needed to compensate for shocks to the system had been de facto completed.

It hadn't happened smoothly or in planned fashion. There was bitterness and even a sense of betrayal, at least publicly, on the part of leaders of some states who intimated that the Germans had taken advantage of their dominant power

position within the system. But polemics aside, the Bbank had been remarkably consistent and had stuck to its declared orthodoxy all along. Months earlier, and before the crisis had begun, the Bbank made plain its economic arguments for an ERM revaluation and had offered to cut German interest rates in return -- an unappreciated bid for compromise. And on 4 February, following 3 phases of crisis which had essentially produced the realignment, the Bbank council moved to reduce German rates (the Lombard rate went down half a percent, to 9%; and the discount rate went down a quarter of a percent to 8%).

The striking fact of February 1993 was that the revaluation of currencies, a necessary adaptation to the shock of German reunification, had been carried out and for the most part in accordance with the collective choice rules of the ERM. It had happened under pressure and at the cost of some tough rhetoric. But it could hardly have been otherwise given the political incentives (made worse by Maastricht) that had come to surround realignment. Arguably, the EMS entered 1993 bruised and battered but with its essential institutional elements still very much intact. The tough test of that would come in the next phase of the crisis several months later.

Crisis : Phase 4

Phase 4 of the crisis began brewing in the Spring of 1993. The successful defense of the franc along with some very good indicators of French economic

performance had raised monetary self-confidence in Paris. When new Prime Minister Eduard Balladur took office at the end of March, French inflation was running at about 2% which was about half that in Germany at the time; and the French budget deficit (about Ffr 410 billion, or \$70 bn) was (despite its record size for France) still considerably smaller than that held by Bonn. But this was just part of the story. Some French numbers certainly looked good compared to German numbers at the moment, but France did not have the sustained low inflation "track record" that would make for market confidence in the long term value of the franc. The BdF was not yet fully independent of political control, which had to add an additional discount factor to its credibility. Finally, France was living with record high unemployment, touching 11.5% in May, and expected to rise by perhaps another full point by the end of the year. Germany may not have looked quite the economic stalwart that it had in past years, but France was still far from a credible bid to take over that role.

Nonetheless, the new government in Paris capitalized on the perception of strength, and reduced interest rates in hope of prodding the economy gently out of recession. Between February and June 1993, three-month money market rates in France fell from 12.3% to 7%, which was at that time slightly less than comparable rates in Germany. Late in June, the BdF moved to reduce its key intervention rate, which brought that rate below the Bbank discount rate for the first time in 26 years. This was a politically salient and risky move. It caught the

attention of the currency markets, bringing a round of mild downward pressure on the franc. The BdF in early July gently reversed its course -- after the Bbank cut its discount rate by 1/2 percent, the BdF allowed itself only a 1/4 percent cut. Meanwhile, three-month money rates in France edged up while Germany's were falling, so that they were within 10 basis points of each other by the second week in July. Despite this, the franc continued to slip.⁸⁷

France by the summer of 1993 had locked itself into a very tough political bind surrounding ERM that made the franc appear vulnerable. What mattered to currency markets were not just fundamentals, but also expectations about the ability and willingness of the French government to raise interest rates to defend the franc. France's enviably low inflation rate had not come cheaply: the recession in the country had been deep and long, and GNP was expected to shrink by a further 0.7% in 1993. French unemployment, already the highest among the G-7, looked set to reach 12.5% by the end of the year.⁸⁸ To raise interest rates under these conditions would seem, from a purely domestic politics point of view, nearly an act of suicide.

What was happening across the English channel tightened the political bind for France. In the short term, Britain's exit from the ERM looked like a viable strategy. British exports were booming -- industrial production and retail sales were up nearly 4% on the year; and unemployment fell to 10.4%. The devaluation had not brought any noticeable inflationary pressures in Britain (at least not yet).

Professional economists argued over whether the British "recovery" had been underway before Black Wednesday and they disagreed even about the short-term stimulative effects of devaluation; many also predicted that there would be an inflationary price to pay not long in the future.⁸⁹ But the French electorate was less interested in what had to seem like esoterica. What was happening in Britain made it terribly easy for opposition politicians in Paris to argue that making a low interest rate "dash for growth" was the best medicine for France's ills. As an Economist leader put it in July, "each cheery new economic statistic from Britain provokes another beleaguered French politician to suggest the obvious: France should copy Britain and quit the ERM."⁹⁰

Balladur, an unusually popular Prime Minister, was certainly less vulnerable to facile assault on the franc fort policy than a less popular leader might have been. But he was not immune. Attacks by prominent political figures, including his nominal ally Philippe Seguin (the leading anti-Maastricht figure in France), pushed Balladur into a political corner.⁹¹ In a widely publicized interview of 12 July, Balladur defiantly raised the stakes by declaring that if France wanted a change in the franc fort policy, it would have to change its prime minister to get it. This was more or less an invitation to currency traders to test Balladur's mettle, and that is precisely what they did.⁹²

On 14 July the franc brushed aside new increases in French money market rates and fell back to one centime above its Dmark floor. The Bbank council

convened the next day for its regularly biweekly meeting, but the domestic indicators did not support a cut in interest rates. German inflation measured 4.2% in the 12 months to June and the money supply was still growing much faster than Bbank targets. The council did not reduce rates, which left only one more scheduled meeting (on 29 July) at which it would be possible to do so before the summer recess. On 21 July, the German government announced that its closely monitored M3 grew at a rate of 8.3% in the six months to June, considerably above the declared Bbank target of 4.5 to 6.5%. Just as hopes of an interest rate cut the next week were being dashed by these numbers, the Bbank raised some eyebrows by moving to reduce its 14 day repurchase rate slightly (from 7.28% to 7.15%). This confounded some expectations, but didn't prevent the franc from falling further that day to less than 1 centime above its floor.

French and German delegations met secretly the next day in Munich and agreed several additional measures for a coordinated defense of the franc.⁹³ On 23 July, the BdF raised overnight borrowing rates to 10%, and the two governments issued another joint statement in support of currency parities. Five days later, and just one day before the critical 29 July meeting of its governing council, the Bbank cut again its 14 day repurchase rate -- and this time by 20 basis points, to 6.95%. Bbank officials would later claim that this was not a conscious policy choice but simply a result of sparse bank bidding for the available money -- as a way of responding to criticisms that the Bbank had raised expectations unfairly and set

itself up for disaster. Intentions aside, that was pretty close to the effect. The repurchase rate reduction along with the consistent statements supporting the franc did raise widespread expectations that the next day's meeting would bring a significant cut in the much more important discount rate.

It didn't happen. On 29 July the Bbank chose not to cut its key discount rate (then at 6.75%). It did cut the less important Lombard rate (which acts a ceiling for German money market rates) by more than 50 basis points, but the markets read this as *sui generis*. On the whole, the Bbank stuck to its guns to give priority to German monetary conditions (which hardly justified any interest rate cut at all) and its primary commitment to control the money supply at home. The Financial Times later reported that Tietmeyer had suggested a modest cut in the discount rate principally for the sake of the ERM, but that Schlesinger had overruled him. Schlesinger instead offered the Lombard rate cut, along with a promise that the Bbank would allow money market rates to fall gradually. The latter move Schlesinger announced in an off-the-record briefing with a small group of German journalists, and it was not made public until the next day. This was a classic kind of understated policy move, coming just when the markets were looking for something much bigger as a "costly" signal of Bbank commitment to the ERM.

Surely, Schlesinger was in a bind of his own. To generate that kind of signal, he would have had to compromise what he was trying first and foremost to protect -- the Bbank's anti-inflationary credentials. But the halting moves of 29

July might have been worse politically than no move at all. On Friday 30 July the franc collapsed in early European currency trading. Meanwhile, top French and German monetary officials convened a secret meeting at Bercy.⁹⁴ While they talked, the BdF exhausted its swap credit with the Bbank; by the end of the day the BdF had spent around 300 bn francs, leaving a net deficit on currency reserves over 180 bn francs.

This was the final phase of the crisis and the most pivotal for the ERM. De la Loisiere immediately asked the Germans to offer a further cut on repurchase rates and, more importantly, to commit to unlimited intramarginal intervention to support the franc. The Germans denied both requests. By 11 A.M. the franc had hit its dmark floor, setting off obligatory intervention by both central banks.

With the New York market set to open in just a few hours, the Germans proposed a formal "lifting" of the obligation to intervene, and to close official lunchtime fixing of currency values. This would essentially mean the de facto suspension of the ERM, at least until the monetary committee could meet and develop a broader strategy over the weekend. The Germans certainly hoped that this would force a revaluation decision at the Monetary Committee, and they were almost certainly trying to rescue both themselves and the BdF from spending enormous sums of money on interventions that could prove futile. But the French rejected this plan, arguing that it would be interpreted widely as a defeat specifically for Paris and its crucial franc fort policy. So intervention continued

and actually accelerated after markets opened in the US. The Financial Times estimated later that the scale of this intervention may have been as much as twice what the Bank of England spent in September, on the order of 32 billion pounds.

What is noteworthy here is that the Bbank did not, in fact, need French approval to suspend intervention, nor did it need any "help" from the monetary committee to force revaluation. The Bbank could have simply and unilaterally suspended its obligation to intervene, as it had explicitly reserved the right to do when Germany joined the ERM in 1979. In fact, the circumstances of 1993 matched nearly precisely the contingencies for which the Bbank had specifically left itself an "out" in 1979. To invoke that escape clause would certainly have been an unprecedented move, but so were all the other possible options.

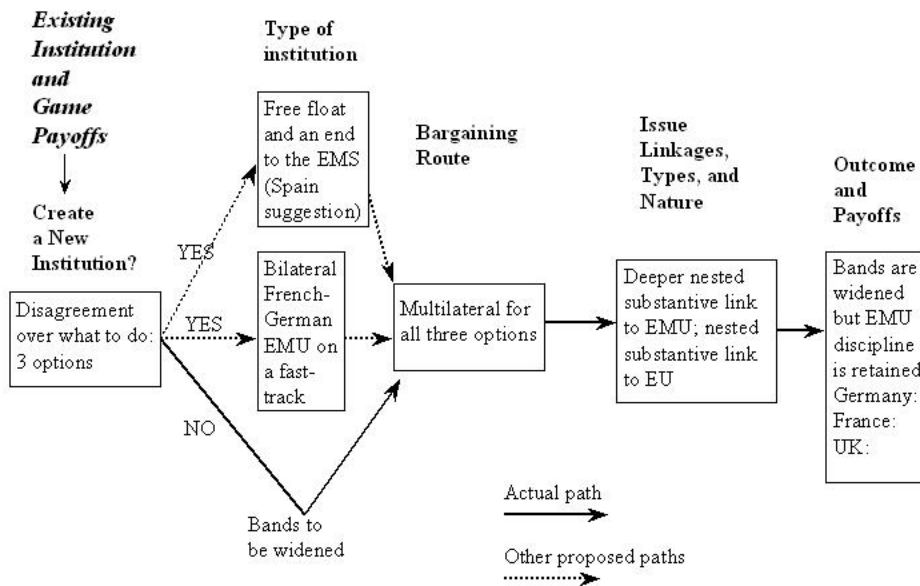
The ERM was not going to survive with its operational rules intact. That much was certain, and was given by the nature of the external shock that had started the crisis and the faulty management decisions that had been made early on. What really was at issue now, was the survival of collective choice and constitutional rules, the higher level and more essential elements of the institution.

Had Germany gone its own way at this point and unilaterally "broke" the ERM, this would have been a clear violation of collective choice. Given the timing of events -- particularly the proximity of the crisis to German reunification, the Maastricht Treaty, and other tensely contested EU policy issues (notably the recognition issue over Yugoslavia) -- Germany's partners might very well have

interpreted it also as a flagrant breaking of constitutional rules -- by which I mean the broader set of EU institutions and norms surrounding the ERM. Given the stakes at hand I think it plausible to suggest that this would have meant a grave political crisis for the EU as a whole that could have readily had substantial upward ripple effects through the entire structure of nested institutions.

As it was, the "destiny" of the ERM was to be determined that weekend in a multilateral framework, within the Monetary Committee in Brussels. The bargaining was hard of course, and it took all weekend to come to a decision. In the early morning of 2 August, the result was clear: all currencies except the guilder and the dmark would move to 15% bands. Figure 2 B depicts this final phase of the crisis.

FIGURE 2B: INSTITUTIONAL CHANGES IN THE EMS



What did this mean for the ERM? The general assessment at the time was that 15% bands were de facto equivalent to a free-float, and that the so-called "agreement" was a cosmetic cover to a collapse of the system. The Economist, for example, wrote that although "better than nothing" 15% bands "mock the intent of the ERM."⁹⁵ Expectations were widespread that each country would now go its own way, in a possible race for competitive devaluation. Quoting The Economist again, "RPR doubters and struggling French businessmen will lobby hard for a British-style dash for growth led by interest rate cuts."⁹⁶ Financial markets certainly shared that expectation: stocks and bonds all over Europe surged after 2 August, reflecting widespread beliefs that interest rate cuts were on the way. In mid-August stock markets in London, Paris, Zurich, Britain and Amsterdam hit all-time highs, and even the German market had a boom.⁹⁷ But the reality would turn out to be different.

The behavior of states in the wake of 2 August makes better sense when placed in the context of what we know about the positions of some states and the issues on the table at the fateful Monetary Committee meeting of the previous weekend. The French at this meeting called for Germany to leave the ERM, and let the dmark float freely against all other currencies (which themselves would remain linked). This would shift the political onus of "exit" to the Germans, and lead to de facto devaluation of other currencies (since the dmark would

presumably float upwards). Jacques Delors also supported this plan. But it was confounded immediately when Holland announced that in a secret deal with Germany 3 days before, the two states had agreed that the guilder would remain tied tightly to the dmark. When Belgium and Denmark said that they too wanted the same arrangement, the French plan was doomed --- since it would have effectively left France at the head of an emasculated ERM with no other strong currencies.

The ERM realistically could have collapsed at this meeting in at least three additional ways. The first way would have been for the Monetary Committee to accept formally a "solution" that must have been in everyone's mind, but that Spain actually placed on the table: to dissolve the ERM entirely and move to a free float. According to The Economist, this "drastic step" was one that the "ministers only narrowly averted."⁹⁸ The system could have collapsed also through a failure to agree on any measures (either to save it or to "bury" it by mutual agreement). This too was possible; "the negotiations almost broke down entirely three times."⁹⁹ Finally, the system could have collapsed with a cosmetic agreement to disagree. Moving in unison to wide bands, if it had been followed by unilateral behavior such as low-interest rate dashes to growth and "competitive" devaluations, would have signaled this kind of outcome.

The third breakdown scenario is precisely how the actual outcome was interpreted at the time. And it naturally followed in this interpretation that there

would be severe implications for the network of norms and institutions surrounding ERM. For example:

"Franco-German relations are embittered, Europe's currencies are in actual or potential disarray; the notion of European economic, monetary, and political union looks, if not nonsensical, certainly illusory... [this] has dealt a severe blow to three pillars ...European Union, the Franco-German alliance, and the strong franc..."¹⁰⁰

but as I have already suggested that interpretation would prove to be off the mark. The ERM did move to 15% bands, a considerable change in operational rules for the system. But this was not simply a cosmetic overlay for unilateral action. Nor did the series of crises seem to have more than a short term impact on the larger network of EU institutions or the French-German relationship at its core.

Consider what member states did in the immediate aftermath of the crisis resolution. Confounding currency, bond, and equity markets across Europe, the French government proclaimed that it would not submit to short term enticements and reduce interest rates rashly. This was not a low cost move -- given France's low inflation (which seemed to make interest rate cuts possible); and the continuing evidence of British "success" in reducing unemployment by rate cuts (which seemed to make it almost necessary, at least politically.) Nevertheless, French Minister for European Affairs Alain Lamassoure announced in the wake of

2 August that it was now more important than ever for Paris to resist temptation. In his words, "with wider margins we have more liberty to make mistakes but that is not a reason to make them."¹⁰¹

Other governments also maintained commitment to the system. For example, Denmark (arguably now the weakest currency on fundamentals) on 3 August actually raised one month rates to 25% and overnight rates to 250% in defense of the krone. Market outcomes say something about the way state actions were judged externally. On 4 August, despite the new 15% bands, most currencies were not very far outside the old narrow bands -- the franc sat only a little more than 1% below the old floor; the Belgian franc, Spanish peseta, and Portuguese escudo had risen against the dmark. No currency in the system was more than 4% below its central rate. The signals were hardly those of a system that had just collapsed.

The Bbank's behavior also confounded expectations. Just as the French and others did not make full use of their new found freedom to cut rates, the Germans did not make use of their similarly new license not to cut. On 3 August the Bbank cut its 14 day repurchase rate (to 6.8%) and the next day cut its 28 day repurchase rate to just below the 6.7 % discount rate. Meanwhile, the BdF left its discount rate unchanged. Although the Bbank did not in August cut its discount rate from 6.75%, it soon renewed its gradual but consistent interest rate reductions. The German discount rate dropped 50 basis points in September, and another 50 basis

points in October.¹⁰² In February 1994 the Bbank cut again, to bring the discount rate to 5.25% -- which was 3.5 percent lower than it had been a year earlier.

No one can peer into the collective mind of the Bbank and say for certain to what extent these moves represent "political" interest rate cuts made for the sake of the EMS. But the data on Germany's domestic economy makes it look as if EMS considerations had to be playing a significant role. Germany was coming out of its recession: excluding the eastern lander, GDP in the 4th quarter of 93 had increased 2.6% (the best performance in the EU, save Britain). German inflation, meanwhile, was still third highest in the EU -- consumer prices rose 3.4% on the year, with only Italy and Spain doing worse. M3 money supply was up 8.9% in 1993, more than double the Bbank target. If the Bbank was focused solely on its domestic objectives, interest rate cuts under these circumstances would have been at the very least surprising.

By the middle of 1994 Germany's discount rate was at 4.5%, a five year low. And ERM currencies were almost all sitting within or close to their previous narrow band boundaries. It was not a long step from there to the revival of discussions about returning to narrow bands, or moving forward to EMU perhaps on a schedule only minimally modified from Maastricht. By the autumn of 1994 EU finance ministers were again talking explicitly about a single currency and were considering ways to loosen (at least in a de facto sense) the Maastricht convergence criteria.¹⁰³

The conversation at the end of 1994 was about how, not whether, to move forward within the framework of the EMS. And while there still may be some wishful thinking taking place on specifics, the overall picture becomes progressively harder to dismiss as cosmetic overlay, particularly as Europe continues to move rapidly toward EMU. In 1996 there is still much debate and disagreement among member states as to precisely how they ought to proceed, but the fact of the discussion -- and its tone -- look much more like evidence of a resilient institution, than of one that has either collapsed or been abandoned.

VII. Understanding the Outcome

Four general reasons might account for why states acted as they did in the wake of the crisis. The most prosaic is simply that central banks held rates up as part of their efforts to rebuild reserves. A second reason is that governments may have been trying to "punish" currency speculators who had made spectacular profits at their expense. Certainly many government officials would have enjoyed that, but it's unlikely that vengeance by itself would have been as strong a motive as the broader political incentives to cut rates. A third reason is that governments acted to save the "essential goods" the ERM provides to them. This makes greater sense, particularly as the passage of time has shown that states' behavior was not just a matter of "parrots [who] stay sitting in their cages long after the door has been opened."¹⁰⁴ A final reason concerns the nesting of this "good" and the

institutions connected with it, within the broader institutional framework of the EU. This next section elaborates in particular on how the last two reasons played themselves out.

First a small step backward, to emphasize several central features of the drama. The EMS provided to its members a set of valuable goods, at least some of which had characteristic features of a CPR. The combined actions of the German government and the Bbank after reunification led basically to an exploitation of the CPR. Opportunism (with or more probably without guile) seems to be the driving force behind German behavior here. There is nothing terribly surprising about that, since it seemed possible for the German government to get away with this defection. Kohl and those around him probably believed that they could do what they did in this case without damaging too badly the EMS; and they seem to have believed as well that Germany was on legitimate ground asking others in Europe to assist in paying some of the costs of reunification, if indirectly. The Bbank (though ironically an organ of the same "international actor") responded to the government's moves with interest rate policies designed to control inflation in Germany. Another way to put this, is to say that the Bbank stuck to its long standing commitments and sanctioned the German government for its defection. The costs for sanctioning? Quite low in this case, since the Bbank was insulated politically and had at least some ambivalent sentiments about full EMU.

Yet the Bbank's most fundamental goals -- to sustain Germany's hard-core

monetary reputation and its anchor role in the EMS -- were generally consistent with the goals of the other state actors in the system. There was a strongly shared interest to sustain the CPR in the face of the exogenous shock. The problem came in parceling out among member states the costs and burdens of what was happening in Germany. Here there were substantial differences among states. But the system did not break down with Germany's defection -- although Germany was the largest and most important actor. As "defections" go, this one seems to have had a very modest long term impact on core elements of cooperation.

Why is that? It becomes easier to answer the question if we explicitly drop the implicit notion that all defections are -- in behavioral terms -- the same. This is not true in Europe. Adding more texture to trigger strategy thinking opens up the issue of compliance in stories about decentralized cooperation. "Graduated sanctions" require lots of information at low cost about what other actors have done and why, as well as mechanisms for "testing" out over time the quality and reliability of that information and its interpretation. These are useful elaborations on the classic collective action argument about privileged groups, which depend on the "visibility" of actions taken (or not taken) by important actors.¹⁰⁵ Seeing what those actions are, and understanding why they were taken, makes possible the "contingent self-commitment" that underlies voluntary organizations.¹⁰⁶

I believe that this mattered greatly for the maintenance of the EMS under challenge. Two critical beliefs underlie quasi-voluntary compliance: that the

system will continue to deliver the goods, and that others will contribute a fair share to that end. If someone seems not to be doing so, the relevant question in the EMS becomes why not.. It is worth asking that question in an environment like the EU. A small number of actors who live together in a densely institutionalized space where monitoring is cheap and easy, communication equally so, and low-cost mechanisms for negotiation are available, may find it cost-effective to differentiate among defections according to intention. Some violations are the result of "opportunism with guile"; others may represent disagreement over management decisions or the quality of existing rules. This seems particularly likely when external shocks plunge the system into uncharted territory offering unforeseen temptations to states with strong reputations for "following the rules."

Differentiating between these kinds of defections should matter greatly to member states in a voluntary organization. In this specific case, other states' interpretations of Germany's behavior were critical. The essential difference between my argument and the alternative argument which portrays Germany as a hegemon and everyone else simply a responder to that, is how member states interpret the intentions behind Germany's defection and how that modifies their expectations for the future. If other states expect Germany to be an exploitative hegemon, a system based on quasi-voluntary compliance should break down.¹⁰⁷ It breaks down because beliefs change: members no longer expect that the system to

which they are contributing will deliver the collective goods they want, and they no longer presume that they can rely on others -- first of all Germany, and then each other -- to contribute their fair share.

This didn't happen. Surely, the popular media (particularly in Britain) and some political elites raised the spectacular spectre of German exploitive hegemony, but this faded rapidly. In retrospect this looks more like tabloid pandering and domestic political posturing, than mainstream or widely accepted views of events particularly among elites. If underlying beliefs had really changed, member states might have (indeed, they logically should have) withheld contributions to the system, as they easily could have done under 15% bands. And it seems unlikely that there would have been a revival of serious discussions as early as 1994 about moving forward with some modified version of the Maastricht EMU scheme.

The question now needs to be pushed back one stage. It becomes, why is it that interpretations of German behavior and expectations about the future that could support a continued general compliance equilibrium were sustained? Several things -- some of which are captured in design principles for voluntary organizations -- made an important difference.

1. K Group Logic

K-group logic, which depends in part on two design principles (clearly

defined boundaries, and monitoring arrangements), is a piece of the explanation. EMS member states make up a relatively small group whose actions are highly visible one to another. A country like Sweden, linked de facto but not de jure to the EMS, was left to its own devices when its currency came under pressure; member states were not. The actions of both the German government and the Bbank were highly visible to their partners in the system, as were many of the motivating forces that lay behind those actions. Other governments knew and understood the unprecedented pressures Kohl faced with reunification. They later criticized him for faulty management decisions and for indulging in wishful thinking. But at the time Germany was making its choices, leaders of other states recognized (at least implicitly) Kohl's dilemmas.

And while Bonn's original econometric predictions about the costs of reunification were commonly thought to be too optimistic, the real width of the discrepancy would turn out to surprise almost everyone, not just the Germans. Other EMS members saw that the Bbank and the German government had "split" and that their actions had combined to produce the problem. While not exactly an inadvertent defection, neither did this look like the strategic opportunistic move of a calculatingly guileful actor. Reunification was a unique historical shock that confronted Germany with a dire emergency and a strong temptation to pawn off some costs, in the context of real value disagreements over the quality and appropriateness of operational rules in the ERM. These are exactly the conditions

of defection that voluntary organizations are supposed to be able to survive.

2. The History, Structure, and Legitimacy of Extant Institutions

Supporting this logic was a densely institutionalized environment in the EU carrying norms and "ways of doing things" that proved critical in the management of the crisis. Another design principle for voluntary organizations -- congruence with "local conditions" -- in this case meant that the EMS would have to be structured such that it could respond to the power/size realities and changing world market conditions that impact on the process of monetary cooperation. Plainly, the Bbank had to be able to get a lot of what it wanted. It did so, but by no means all of what it wanted. It did not get a "prophylactic realignment" at the outset of GEMU. It did not get an "early" realignment at the start of the crisis. It did not even get a realignment on Friday 30 July when it was hemorrhaging money to save the franc, only to buy time for the weekend meeting of the monetary committee.

The rules of the EMS would necessarily have to change in ways that would keep the Bbank on board. That is not the same as Germany writing the rules and everyone else following along. Collective choice arrangements in the EMS allowed all member states affected by the operational rules to participate in modifying the rules -- first through the Monetary Committee and ultimately in the

Council of Ministers. Effective power to make decisions is not shared equally of course, but if the system is not working correctly all participants have a voice in how to change it. Certainly France and Germany were the central figures in the debate that produced the “15% solution”. But other countries were able to speak their preferences. They were also able to form coalitions that blocked de facto, for example, the original French proposal to let the d-mark float.

This is important because operational rules need to be changed over time as markets evolve. This is expected. The congruence of any real world institution with “local conditions” is not a one-off resolution to "the" problem (in this case) of monetary cooperation. "The" problem changes. The EMS needs to learn, as it did from the experience of the snake and later from the perverse incentives in Maastricht, what kinds of operational rules might be workable and what kinds of rules wouldn't be. What seems important in this process is that the learning be mainly of a collective sort. For legitimacy to be sustained over time, key actors would need to learn similar lessons about the sources of operational failures -- in part to support assumptions about each other's intentions underlying the behavior they observe. Put aside the immediate rhetorical backlash against the Bbank and the “Anglo-Saxons” and the “speculators”. With passing time it became more clear that member states shared a substantial degree of consensus on what went wrong (as well as what went right) in 1992-93.

The Bbank acted in ways that were consistent both with its mandate and its

established historical track-record. It more or less successfully walked a very fine line between the domestic and international demands of its anti-inflationary, non-politicized credibility concerns, and the eminently political "European"-oriented demands of being the anchor currency in the ERM. Germany made progressive interest rate reductions -- albeit more slowly than some others wanted -- that did allow rates to fall, gradually, around Europe. The maintenance of momentum towards a low-inflation recovery throughout the EU in 1994 could be read as a piece of evidence vindicating the Bbank's approach.¹⁰⁸ The system as a whole got the broad realignment it needed. Stronger currencies on fundamentals (like the franc) moved back toward realistic valuations. And core countries within the system resisted the very substantial political incentives to use the freedom of 15% bands to lower interest rates and make a short term "dash" for growth and jobs.

All around the system, what seemed remarkable was the high level of continued compliance with norms. Partly in consequence, the broader goal of EMU in Europe returned to the forefront of the political agenda with surprising speed. And while there is still disagreement over the details of what comes next, there is much less disagreement that something will in fact come next -- that is, that EMU of some kind is imminent even if not precisely on the Maastricht timetable and/or terms.

The actions of Italy and Britain in the first phase of the crisis are the major exceptions to this point. Italy's September 92 devaluation was worked out in a

bilateral deal with the Germans; the British withdrawal later that month was unilateral. In neither case was the Monetary Committee or any other EC institution involved (although both moves were later "agreed to" or "taken notice of" by the Committee). There may have been extenuating circumstances and/or misunderstandings in the Italian case that would attenuate in the long run the impact of this breach.¹⁰⁹ That is less the case for Britain. Italy soon expressed its desire to rejoin the ERM as soon as conditions were appropriate, and did rejoin in December 1996. Britain has taken a very different tack, arguing that the ERM must change (in unspecified ways) before it could once again consider membership.

But if my interpretation in this chapter is valid, the shoe is at least partially on the other foot. It is Britain that must change more so than the ERM or the plans for EMU, in order for that country to re-enter the system. What would matter is other states' interpretation of Britain's motives and strategy that led to non-compliance. A future (Labor?) government might try to stress the effort and costs London incurred to try to bolster the pound within the ERM. But that is not now the case as I write this in January 1997.

VIII. Conclusion

I offered in this chapter an interpretation of events in the 92-93 ERM crisis that contrasts with traditional interpretations driven by collective action theory or

intergovernmental bargaining perspectives on European integration. I portray a cooperative outcome where an institution undergoes change successfully. I hope the interpretation is sufficiently compelling to demonstrate the potential of this kind of argument (and the broader agenda from which it is drawn) to open up modified lines of debate about international politics in Europe and particularly the importance of nesting.

Regime arguments in principle allow for a great deal of cooperative behavior on the basis of shared norms, principles, rules, and decision making procedures. For this reason, it is beside the point to observe that nothing in this story is inconsistent with regime theory. A better question is to ask to what extent the kind and level of cooperative behavior seen in this chapter exceeds or is more elaborate than the standard expectations that we typically associate with regimes. It is to some degree a matter of judgment about the descriptive and analytical utility of concepts, and thus I don't claim to settle the matter but only to justify my position.

Regimes that are intricately "nested" one within another should support higher levels of cooperation than those that are not. The EU is certainly a set of nested regimes, but that is a minimum interpretation. The "institutional environment" concept goes several steps further, to where technical/efficiency criteria and power considerations -- even traded off and logrolled between sets of regimes in different issue-areas -- are less important than are standards of

legitimacy and norm-based procedures.

The EU is made up of many potential decision-making fora where there is almost continual contact between states at many different levels. Looking at how issues get tracked into decision making channels would be one way to start differentiating nested regimes from institutional environments. How important are strategic games played out by state actors who try to channel crisis management decision making into that forum where their autonomous, parochial preferences are likely to be best served?

Nested regime dynamics show up most forcefully in the central importance of French-German bilateral negotiations and arrangements. Certainly these two states went extremely far with each other in making costly commitments and breaking precedents to retain monetary cooperation between them. That monetary link, nested deeply within the Franco-German political relationship, was in turn central to the future of Maastricht. Monetary union was the most carefully prepared and most completely laid out part of the treaty, in essence its heart and soul. And because the EC was at the same time looking impotent elsewhere (particularly in Yugoslavia) the burden of political symbolism falling on the ERM was great.

Destruction of ERM would have demolished the Maastricht plan for EMU. On technical criteria, not everyone thought that would be a bad thing. Many Britons, some Germans, and others were not enthusiastic for monetary union of

any sort. And even some who in principle supported monetary union believed that the current system and scheme for moving forward was not the best way to bring it about. On that view, destroying ERM would give a golden opportunity to start all over and do it right.

Technical criteria aside, that point neglects the political hurdles that stand in the way. Institutional environments set standards of legitimacy and ways of doing things that are connected to the normative foundations of existing institutions. The notion of reconstructing French-German monetary links on a different institutional base runs against the basic logic of that environment, even more than it neglects transaction costs and friction that exist in an environment of nested regimes. The possibility of a “mini-EMU” made up of a smaller core group of countries excluding others runs against that logic as well. The EU is, in reality, already practicing “variable geometry” through opt-outs, dispensations, and the like. But this can only go so far. The primary limiting factor remains the network of existing institutions and what they establish as legitimate.

What happened in the 92-93 crisis was institutional evolution of the kind envisioned by Douglass North -- marginal change to adapt to changing conditions. And while core relationships were maintained and even strengthened in the process, that did not happen at the expense of the norms and standards of legitimacy that apply to the Union as a whole. France and Germany could have gone ahead and dropped the broader scope of European integration to save their

bilateral ties. They still could do so. The range of discussions over forging a “hard-core” -- more precisely, over what that would mean -- show that this kind of option is not outside the scope of cognitive possibilities. But if my argument here is correct, it is outside the scope of political possibilities set by the logic of nested institutions.

ENDNOTES

¹ This paper was partially prepared while the author was a Fellow at the Center for Advanced Study in the Behavioral Sciences. I am grateful for financial support provided by the National Science Foundation Grant #SBR-9022192 and by the UC Berkeley Center for German and European Studies. Participants in the convenor group that led to this volume provided very helpful comments and suggestions.

² See Aggarwal (1997)

³ Transaction densities, phone call densities, (in the spirit of Deutsch), bundles of externalities (Lake).

⁴ See Eckstein (1966).

⁵ To be precise, in ways that standard social science arguments about collective action would judge unconventional.

⁶ Schmidt used this phrase, quoted by Cameron, p. 6.

⁷ Reintroducing some kind of exchange controls was a much less popular notion, because of presumed effects on the single market, plus the technological and legal difficulties of doing so effectively. A partial exception: the Eichengreen/Wyplosz idea of a tax on open foreign currency positions.

⁸ See Shepsle (1989). Shepsle recognizes that in the real world institutions will not meet the criteria for subgame perfect equilibria.

⁹ See Aggarwal (1985).

¹⁰ Another possibility is that the institution adapts so that it (intentionally or not) starts to provide a different set of goods. This may not seem a failure per se but neither does it signal the survival of an institution; it is probably better to think of the outcome as a new institution that is serving different purposes.

¹¹ The two former members now outside the system take different positions. Britain has no intention of rejoining the system any time soon. Italy, on the other hand, consistently declared its aim to re-enter the ERM as soon as practicable and did so in late 1996. I discuss the reasons behind these positions later.

¹² Article 108, Article 105.

¹³ See Tsoukalis (1977) pp. 91-7.

¹⁴ Schmidt's worries were reinforced by doubts about the quality of American leadership. See Story (1988).

¹⁵ See Ludlow (1982), pp. 84-5. Schmidt was anticipating reluctance at the Bundesbank, and he certainly got it later.

¹⁶ States that entered the EMS later were given wider fluctuation bands; Italy was later given a wider band as well. Central rates for Italy, Ireland, and France were derived from market prices. The UK did not participate but was given a notional central rate, for the purpose of calculating the divergence indicator (which I discuss later).

¹⁷ See Funabashi (1989), p. 122.

¹⁸ Emminger describes the letter in his memoirs: See Emminger (1986), pp. 361 -

¹⁹ Italics added. Quoted in Eichengreen and Wyplosz (1993), p. 109.

²⁰ Schmidt, quoted in Cameron, p. 6.

²¹ In September the Dmark was revalued by 2% and the Krone devalued 2.9%; in November the Krone was devalued an additional 4.8%.

²² See Goodman, p. 197-8

²³ For example, see Goodman p. 199-201. Discussing the French "turn" of 1983, Sachs and Wyplosz write "unlike the much looser commitment under the European Snake in the 1970s, which France abandoned on two occasions, membership of the EMS has been invested with enormous political importance at the very highest levels of government. That is why the debate over leaving the EMS was treated as synonymous with the debate over abandoning other spheres of cooperation in Europe, including participation in the Common Market." See Sachs and Wyplosz (1986), pp. 294-5.

²⁴ See Funabashi, p. 123. The Dutch guilder and the Belgian and Luxembourg franc were driven up along with the Dmark.

²⁵ Financial Times 13 Jan 1987.

²⁶ See Funabashi (1989), p. 124.

²⁷ See Balladur (1987).

²⁸ See Eichengreen and Wyplosz (1986), p. 59

²⁹ Eichengreen and Wyplosz argue that the data convincingly shows only Italy as suffering a substantial decline in competitiveness resulting from higher inflation; for Spain and Great Britain some indicators point to a competitiveness problem but the evidence is not as clear. So it appears that this effect was not significant or immediate enough to cause on its own a crisis of this magnitude (albeit left unresolved, it could eventually have done so).

³⁰ Eichengreen and Wyplosz (1993) explain the logic (p. 52). Briefly, one of the things countries wishing to qualify for EMU had to do, was to maintain their currencies within the EMS bands for at least two years without severe tension. The political and economic incentives for qualifying were high. Governments were willing to pay costs to achieve that goal, including high interest rates and resulting higher unemployment despite the Europe wide recession. But a speculative attack that forced devaluation would also take away the biggest incentive for a country to pursue high interest rate and other austerity policies aimed at achieving charter membership in EMU. That point was not lost on domestic political forces. Thus speculation could prove self-fulfilling.

³¹ See Ostrom (1990), p. 15

³² The idea here is that in a relatively low inflation but high unemployment world, a state might be tempted to devalue its currency and tolerate a bit more

inflation for the sake of increasing export competitiveness and creating jobs. Since other states are similarly tempted, the stage is set for a competitive race to devalue. Such a competition would tend to be even more unproductive on aggregate in Europe than elsewhere. The reason is that devaluation "works" (i.e. boosts competitiveness) in part by causing a real pay cut for workers, who following devaluation have to pay a higher price for imported goods. If workers demand and receive higher wages that fully compensate, then the competitiveness gain is lost and what is left is inflation. In Europe workers are likely to demand higher wages because a relatively high percentage (much higher, for example, than in the US) of what they buy is imported. Thus devaluation more visibly and quickly raises their costs of living. They are also more likely to receive some of their demands since real wages are far less flexible (at least in the downward direction) in Europe than in the US, in part due to more effective labor unions

³³ The EMS is not a single currency of course but the level of monetary cooperation within the system has represented an important part of political commitment to Europe. Britain's decision to join the ERM was interpreted broadly as a sign of significantly increased commitment to Europe. In Germany the official government stance turns this argument on its head, by claiming that political cooperation or "union" is the price reluctant EU partners must pay for greater monetary cooperation or "union". It may be hard to measure, but political

symbolism and commitment to the EU project overall (even if defined vaguely) is certainly an important part of what the EMS is about.

³⁴ As well as designing institutions, which often has elements of a second order collective action problem (but see Kreps et. al. 1982). The relationship between provision and appropriation also matters here. Hegemonic stability posits a provider whose interest it is to provide a collective good regardless of whether or not others provide as well. To the extent that this really happens in world politics, it is much less likely to happen if the collective good is subtractable and subject to depletion by over-appropriators.

³⁵ As well, of course, for themselves to draw on, in the future.

³⁶ In principle, a system of permanently fixed exchange rates managed by a central authority would do the same thing, although there is no purely economic reason to think that this would happen.

³⁷ See Ostrom (1990), p. 15.

³⁸ See Bates (1988), esp. p. 394-5. One way to deal with supply is to introduce uncertainty, which makes possible a number of equilibria (some of which would include the supply of new institutions). Uncertainty is part of the EMS story, as it undoubtedly is for all real world institutions. But it is not the whole story and may not be the most important part of it for the EMS.

³⁹ For arguments about the importance of nesting in other contexts, that do not

make use of organizational theory in this way, see Aggarwal (1985).

⁴⁰ See Weber (1994).

⁴¹ These models are generally deficient in that they rely on summary variables, things like “long term expected net benefits”, to drive their conclusions. The question then becomes, how do actors estimate, measure, or anticipate these benefits, and that is not a question that can be answered deductively.

⁴² See Ostrom (1990), p. 52-3.

⁴³ Rates for snake member countries were based on snake rates. Rates for Ireland, Italy, and France were taken from the market. Although the UK did not join, a notional central rate for sterling was established, based on the market rate at the time.

⁴⁴ See Goodman, p. 192.

⁴⁵ Spain and Britain were also given 6 % bands when they joined the system in 89 and 90, respectively.

⁴⁶ Goodman, p. 194.

⁴⁷ This was actually a compromise ("Belgian Compromise") between states that wanted an ECU based intervention obligation, and others that preferred intervention driven by bilateral parities. The technical arguments are reviewed in see van Ypersele and Koeune (1985), pp. 48-9.

⁴⁸ In principle, VSTF lines of credit are unlimited. Borrowing was originally for

45 days; this was extended in 1987 to 75 days from the end of the month during with intervention took place (with two three month renewals possible).

Repayment must be at least 50% in the borrowed currency with the remainder in ECUs.

⁴⁹ MTFAs are denominated in ECUs, and loan terms are generally 2-5 years. There are agreed limits for each country.

⁵⁰ Personal Communication with Michael Shackleton, European Parliament; Feb. 1994. Under special circumstances, other high officials from the Commission have joined the Committee meetings.

⁵¹ See Council Decision of 12 March 1990, on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union. 90/141/EEC Official Journal of the European Communities, No. L 78/23, 24 March 1990.

⁵² This is a subtle claim that I will expand upon in detail in the Conclusion. I do not say that the behavior of states in a voluntary organization is inconsistent with the notion of an international regime. I do say it stretches that notion to a higher level of organization and compliance than "regime" usually represents.

⁵³ To be clear: Ostrom does not claim (and neither do I) that these are necessary conditions for success, and it is obvious that they are not sufficient conditions either. They are simply generalizations induced from case studies, not definitive

arguments or "explanations". Since each condition is backed up with a logical argument as to why it should matter, I feel comfortable treating them as working hypotheses -- no more and no less.

⁵⁴ See Levi (1988), particularly chapter 3.

⁵⁵ As Jeff Frieden put it, "there was never any sense that the snake was an essential component of the EC; neither national politicians nor Community leaders had staked much political capital on the arrangement". See Frieden (1993), p. 18.

⁵⁶ See for example Garrett (1993).

⁵⁷ There was a small re-alignment in 1990.

⁵⁸ Indeed, the Dmark did appreciate about 8% in real terms against the dollar and the yen between late 1989 and mid-1990. During the same period, German long term rates rose more than 200 basis points to carry them above US long rates (which were on the decline) by early 1990.

⁵⁹ See, for example Balls (1993), p. 12.

⁶⁰ Wayne Sandholtz (Colloquium Presentation, UC Berkeley, April 1994) adds that Germany, not wanting at the time to appear domineering in any EC context, may not have pushed the issue quite so hard against the objections of its neighbors. See also Marsh and Marsh (1993), p. 3.

⁶¹ See on this point Alesina and Grilli (1993), p. 145 - 65.

⁶² . After all, the US did something mildly similar during the Vietnam War and undermined (through inflation) the Bretton Woods accords

⁶³ Cameron, p. 23 provides detail on this.

⁶⁴ A different perspective on this is that the Bbank, unhappy with EMU plans under Maastricht, preferred to see the treaty defeated in the French referendum and held to its position with this in mind. This story represents an alternative argument on the entire case, which I will deal with in the final section of this narrative.

⁶⁵ Financial Times, 15 September 1992, p. 1.

⁶⁶ Ibid; also Norman and Barber (1992), p. 2.

⁶⁷ Norman and Barber, "Monetary Tragedy of Errors," report also that the British considered joining the Italians in the devaluation but decided against it.

⁶⁸ Financial Times, 15 Sept. 1992, p. 1; and 16 Sept. 1992, p. 1. Norman and Barber describe the reaction in London.

⁶⁹ Estimates reported in Financial Times, 19-20 September 1992 p. 6

⁷⁰ Personal Observation and discussions.

⁷¹ Cameron, p. 30., describes the extraordinary exchanges of blame that took place between Lamont, Kohl, Schlesinger, and the British Treasury.

⁷² See Dawkins and Buchan (1992), p. 15.

⁷³ Ibid. See also Financial Times 22 September 1992 p. 1; 23 September 1992 p.

⁷⁴ Financial Times 24 September 1992, p. 2.

⁷⁵ Intramarginal intervention, as I discussed earlier, has rarely been practiced within the EMS. According to Cameron (p. 32) "it was the first time since the founding of the EMS that the Bank had revealed it was doing so at the time of the intervention."

⁷⁶ See Cameron, pp. 32-33; and the interesting article by Dawkins (1992) p. 2.

⁷⁷ This peg was an important part of the Swedish government's strategy for building support behind its application for EC membership. The speculative attack was fueled by poor results from a government bond issue that was needed for refinancing.

⁷⁸ "Krona Flotation Followed EMS Rebuff to Sweden," Financial Times 21-22 November, 1992, p. 3.

⁷⁹ Financial Times 23 November 1992, p. 1.

⁸⁰ Three month punt rates went from 14.5 to 20 percent and overnight rates were raised first to 30 and then to 100%.

⁸¹ Financial Times , 5-6 December 1992, p. 1.

⁸² Financial Times, 18 December 1992, p. 18.

⁸³ Financial Times, 6 January 1993, p. 1.

⁸⁴ Ireland had a low inflation rate and was running a current account surplus, but at the cost of high interest rates and unemployment touching 18%. The punt was

hurt by the deterioration in Ireland's terms of trade with Britain (Ireland's biggest trading partner) as the pound lost 15% of its value against the punt between September 1992 and January 1993.

⁸⁵ Ireland's Minister of Finance tried to limit political damage by lashing out, much as Norman Lamont had done in September, at France and Germany but also in this case at Great Britain. See Financial Times 1 February 1993, p. 1.

⁸⁶ The krone did come under speculative pressure in early February, but pressure eased after the Bbank cut rates on 4 February.

⁸⁷ Economist 10 July 1993, p. 76.

⁸⁸ Economist 17 July 1993, p. 41.

⁸⁹ Ten year bonds in Britain were at this point yielding 80 basis points more than French ten year bonds, pointing to higher expectations of inflation over the longer term -- although how much of this was a result of ERM exit, is difficult to say.

⁹⁰ Economist 24 July 1993, p. 13.

⁹¹ Seguin in July called the franc fort policy a "social Munich". Economist 17 July 1993, p. 41.

⁹² Currency traders reacted also to signs of Franco-German tension. In June, the French Finance Minister made an usual public call for coordinated interest rate cuts between the two countries. Waigel reacted negatively, by canceling a planned French-German meeting on economic policy.

⁹³ Specifically, to increase the ceiling on bilateral swap credits to a reported 30 bn dmarks, and to coordinate interest rate policy changes.

⁹⁴ Waigel, Schlesinger, Tietmeyer, and Gert Haller (State Secretary of the Finance Ministry) represented Germany; Finance Minister Edmond Alphandery, de Larosiere, Trichet, and Herve Hannoun (Deputy Governor of the BdF) represented France. de la Loisiere, not Alphandery, led the negotiations for the French side -- recognizing the German's pique at Alphandery's public gaffe in June.

⁹⁵ Economist 7 August 1993, p. 21.

⁹⁶ Ibid, p. 22.

⁹⁷ Pushing the German market up was the argument that other countries would cut rates, speeding economic recovery throughout Europe, that would in turn stimulate demand for German products, boost German exports, and rebound profits to German firms.

⁹⁸ Economist 7 August 1993, p. 24.

⁹⁹ Ibid.

¹⁰⁰ Ibid, p. 21-22.

¹⁰¹ The Economist 7 August 1993, p. 22. Alphandery followed up with a public promise on 17 August that France would not consider re-introducing capital controls in any form (including taxes on foreign exchange holdings).

¹⁰² Tietmeyer took over as President from Schlesinger on 1 October 1993.

¹⁰³ See for example Gardner (1994), p. 14.

¹⁰⁴ This quote (which captures much of the contemporary analysis) was from Alison Cottrell (1993), p. 72 *Economist for Midland Global Markets*.

¹⁰⁵ See Olson (1965).

¹⁰⁶ See Ostrom (1990), p. 99.

¹⁰⁷ I'm borrowing the phrase "exploitative hegemon" from David Spiro of University of Arizona.

¹⁰⁸ Of course, there were many other reasons for this recovery and I do not claim that Bbank behavior was either necessary or sufficient for that to happen; only that it was a contributing factor.

¹⁰⁹ Norman, Barber, et. al. in their 11 December 1992 Financial Times expose, focus on the difficult decisions facing Jean-Claude Trichet (Director of the Tresor and at the time also chair of the EC monetary committee) and his possible errors of judgment, although they point out that under the circumstances "Trichet's behavior accorded with the letter of the Community's arcane [sic] rulebook."

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