

THE NEGOTIATION OF AN ASYMMETRICAL EUROPEAN MONETARY SYSTEM AND THE DECISION OF HIGH INFLATION COUNTRIES TO JOIN THE SYSTEM

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Abstract

The EMS negotiations were centred on the debate on symmetry. High inflation countries struggled to introduce elements to force a more symmetrical functioning of the system than the Snake. However, these attempts found the strong opposition of the German government, which was able to impose its stance in all aspects determining the symmetry of the system. The main reason for this was that Germany benefitted from a bigger bargaining power during the discussions, mainly explained by the particular institutional design of monetary policy in Germany, in which the Bundesbank enjoyed a strong reputation and an exceptional degree of autonomy. For countries like Italy or Ireland, the EMS design did not meet their minimum requirements to join. However, both countries decided to join the system anyway. In these countries, domestic debates on EMS membership were highly influenced by other economic and political national discussions, which would determine their eventual decision to join the EMS

Resumen

Las negociaciones sobre el SME se centraron en el debate de la simetría. Los países de inflación elevada intentaron introducir elementos que impusiesen un funcionamiento del sistema más simétrico que el de la Serpiente. Sin embargo, estos intentos se encontraron con la oposición alemana. El gobierno alemán consiguió imponer su postura en los aspectos que determinaban la simetría del sistema. La principal razón por la que Alemania consiguió imponerse fue su mayor poder de negociación durante las discusiones, que se explica principalmente por el diseño institucional de la política monetaria en Alemania, donde el Bundesbank gozaba de gran reputación y un nivel excepcional de autonomía. Para países como Italia e Irlanda, el SME no satisfacía sus principales requisitos. No obstante, ambos países decidieron entrar. En estos países, los debates domésticos sobre el SME estuvieron fuertemente influenciados por otras discusiones sobre cuestiones económicas y políticas.

Introduction

From a general perspective, the process of European economic integration, and in particular monetary integration, has been traditionally analysed as a unidirectional route, progressively turning less integrated economies into more integrated economies. In the case of monetary integration, it is interpreted as a path leading from floating to fixed exchange rates and, eventually, to a monetary union. This process of economic and monetary integration, according to neo-functional approaches, is the result of a learning process and an improvement of the efficiency of European institutions and mechanisms of decision making. European economic and monetary integration has been studied under the assumption that it was an irreversible process, in which every stage was a preparation for the next one.

However, it is important to take into account that this process has been characterized by recurrent crises and, in many occasions, these crises were precisely the reasons that accelerated integration. In several occasions, it was the response to short term problems during these crises what conditioned the design of the long-term integration strategy, instead of a long-term project devised to reach the final stage of the process. In that sense, the current design of the European institutions is the result of the concrete conditions experienced by European countries at the moment in which they were created. The political and economic crisis that is affecting the European Union nowadays imposes the need of reassessing all the process of integration, in particular what refers to monetary

integration. A re-evaluation of the process of negotiation leading to the launching of the European Monetary Union and its eventual functioning is relevant to understand the present crisis of the Eurozone.

Frequently, the European Monetary System (EMS) is considered the predecessor of the European Monetary Union and the ECU (European Currency Unit), the currency basket created with this new monetary arrangement, the predecessor of the Euro. Conversely, at the moment of the launching of the EMS, it was by no means seen as a step leading necessarily to a monetary union. The design of the European Monetary System was the outcome of the particular circumstances of the second half of the 1970s, and was an attempt to address the causes of the extremely high inflation rates, the volatility of exchange rates and, in general, the awful results in terms of monetary stability. It is true that the EMS had an impact on the future European developments in the field of monetary integration and, in this regard, it had long-term consequences. Still, the design was addressing the short-term problems which characterized the last part of the 1970s, although it ultimately determined an institutional design that was intended to be permanent and irreversible.

The second half of the 1970s was characterized by very high inflation rates and volatility of the exchange rates. There were essentially two main causes of the inflation of the 1970s. The first factor of inflation was cost-push inflation, produced not only by the increases in oil prices, but also by a surge in labour costs resulting

both from declining productivity and the mechanisms of wage indexation that were in force in many European countries. The second factor of inflation was the monetization of budget deficits. In the majority of countries, the first reaction to the crisis was the adoption of expansionary economic policies. Also, in most countries, by that time, there was a prevalence of fiscal policy over monetary policy, leading to, in different degrees depending on countries, monetization of deficits.

In fact, with respect to economic policies, the 1970s were a transition period. Most countries were still in a Keynesian paradigm but, as a result of the dreadful consequences of expansionary monetary policies in terms of inflation, there were several experiments to find alternative approaches to the management of money supply. A new economic consensus grounded on Monetarist ideas started being built during that period, although it did not consolidate until the 1980s. During the last part of the 1970s, different countries investigated alternative mechanisms to impose monetary rigour. There were several debates on aspects such as wage determination, independence of monetary policy, and use of the exchange rate to impose monetary stability, among others. The negotiations leading to the launching of the EMS were conditioned by these inflationary tensions that characterized the period, and took place in the framework of this general debate on the role of monetary policy and its institutional design, in which the Keynesian paradigm started being abandoned, but the new Monetarist consensus was still not consolidated.

The discussions about the EMS design concentrated on the issue of asymmetry. Asymmetry is defined as the capacity of one of the members of the agreement (in the case of the EMS, Germany) to choose independently its monetary policy, forcing the others to adjust to that standard. Since some of the elements of the system were not clearly defined in the agreement, or ended functioning differently to what was established, it is important to distinguish between asymmetry in the design and asymmetry in the functioning. The concept of asymmetry applied to the design of the system refers to the explicit election of the German mark as the *numéraire* of the system and the definition of rules regarding intervention obligations and credit facilities accordingly. Asymmetry in the functioning refers to the adoption of different patterns of intervention by Germany on the one side and other countries on the other, leading the German mark to become eventually the standard of the system, although the design was intended to be symmetrical.

There is an intense debate in literature about the symmetrical or asymmetrical character of the EMS and the reasons for this asymmetry. Although a few authors claim that both the design and functioning of the EMS were symmetrical, the majority of scholars assert that the EMS was asymmetrical, due either to an asymmetrical design from the beginning or to an asymmetrical functioning. The debate about symmetry is connected to the debate about the motivations and factors behind the new monetary arrangement. Authors who interpret the European Monetary System as an anti-inflationary device, the aim of which was to impose monetary rigour and import the Bundesbank's reputation, assert that

the EMS was necessarily asymmetrical, owing to this disciplinary nature. Other authors explain asymmetry as the result of the different bargaining power of the actors involved in the discussions about the design of the new system. Asymmetry would be, in this case, the result of a bigger bargaining power of the German leaders, who were not willing to give up their monetary autonomy and managed to impose an asymmetrical system to the other participants. Generally, this German capacity to impose its preferred option during the negotiations is attributed to the long-term success of Germany in the control of inflation and the surplus position in its balance of payments. Since other countries required the German reputation and the German credit lines to finance interventions for the functioning of the new system, they were forced to accept the German conditions. These two explanations of asymmetry, the disciplinary nature of the system and the German bargaining power, are not mutually exclusive and are both relevant to understand the negotiations.

This dissertation is organized in four chapters. The first chapter studies the asymmetry of the EMS. I will review the main arguments presented in literature about EMS symmetry, both in the design and the functioning, and I will confront them with archival evidence (resolutions of the European Council and the proposals of the different delegations). I will conclude that the final design of the EMS was not asymmetrical from a strict point of view, although its functioning ended up being asymmetrical. During the negotiations, there were proposals to introduce features in order to force a more symmetrical operation of the system. However, these elements were

never endorsed. The main explanation of this design that was not asymmetrical but allowed an asymmetrical functioning was the German bargaining power, which allowed the German negotiators to block every feature that would have imposed a more symmetrical functioning, together with the lack of concretization of other aspects, which allowed Germany to maintain a high degree of discretion, thanks to its hegemonic position in the operation of the EMS.

Two research questions emerge from this conclusion. The first question is why was Germany able to impose its preferences in all the features that were essential to determine the degree of symmetry. The second question is why did countries which could not influence the final design, and for which the EMS did not meet the requirements they considered indispensable, decide to join anyway. In academic literature, the study of the negotiations leading to the EMS has concentrated on the interaction between the different countries, their stances, and their participation in the negotiations. However, less attention has been paid to the interactions between the different national agents and the distribution of the decision-making power on exchange rate decisions at the domestic level. In order to approach my research questions, I will emphasize the importance of these two levels of negotiations: the European discussions and the domestic debates.

The second chapter addresses the first question, this is, the reasons that explain the German bigger bargaining power. Although, as several scholars have highlighted, the German success in monetary

stability and the situation of the German balance of payments are important to understand the supremacy of this country during the negotiations, I will argue that a fundamental aspect that explains the German bargaining power is precisely the specific institutional organization of the German economic policy making, in particular, the independence and status of the Bundesbank and its relationship with the German Federal government, very exceptional in the European context. The German institutional architecture was the result of the Allied occupation after World War II. Consequently, it was the outcome of a very particular historical framework, and was an exception compared to other European countries. In order to address this matter, I will use the European Council resolutions and working papers, the different countries' proposals and other European documentation. Additionally, I will also use German sources, in particular, Bundesbank's minutes and the correspondence between the Bundesbank and the German Chancellor. The main reason for using German sources, but not other countries' sources, is the importance of the relationship between the Bundesbank and the German Federal government, which was very different from any other country in Europe. In other countries, central banks were not independent and during the EMS negotiations worked under the government's authority and, consequently, were unable to shape the framework of the negotiations as the Bundesbank effectively did. The Bundesbank, thanks to its status in the German institutional structure, was able to impose the Federal government a certain bargaining strategy, and established what the government could and could not accept during

the negotiations. I will conclude that this Bundesbank's capacity to impose negotiation conditions to the German Federal government had a decisive influence on the German bargaining power.

The third and fourth chapters tackle the second research question using the cases of Italy and Ireland, respectively. These two countries, together with the United Kingdom, had the highest inflation rates of the EEC, which complicated their participation in the EMS. During the negotiations, neither Italy nor Ireland had a relevant role in defining the basic characteristics of the system, and the final design did not satisfy their basic requests to join the EMS. Since they hardly influenced the characteristics of the system, the decision they had to make was either to join the system designed by other countries or to stay out. When the final agreement was endorsed in the Brussels European Council of the 5 December 1978, both countries requested some additional time to take the final decision on their participation in the system. In both countries there were debates in the Parliament on this matter. Eventually both countries joined. I will argue that their decisions to join the EMS were not strictly related to the macroeconomic objective of price stability or exchange rate management. In both cases, domestic discussions about the EMS were crucially influenced by other debates on national economic policies, institutional reforms or political agenda.

Chapter three analyses the Italian debate about joining the EMS or not. The sources used in this chapter are Parliamentary records, government's documentation, the Conclusions of the General

Assembly of the Banca d'Italia, correspondence between the Minister of the Treasury and the governor of the central bank, and a generalist newspaper, *Il Corriere della Sera*. I will analyse the stances of the different political parties and social and economic agents on Italian EMS membership. I will argue that EMS membership was the mechanism that some Italian economists and policymakers used to impose institutional reforms that lacked the necessary political support to be implemented. These reforms did not necessarily require EMS membership to be implemented, but EMS membership was used as a powerful argument to enforce them. The two biggest institutional reforms of this period, which addressed the two main sources of inflation of the 1970s, were the reform of the system of wage indexation and the reform of the relationship between the Treasury and the Central Bank to stop the monetization of deficit. Debates on both issues were closely connected to the EMS debates. In fact, a new academic and political elite linked EMS membership to these reforms, which they considered essential. The reform of the system of wage indexation has been widely studied. In many occasions, it has been analysed in the framework of the interaction between social groups and the relative strength of each group in a historical context of decline of trade union affiliation. I will argue that, although these factors were important, EMS membership was used in a crucial manner as a mechanism to impose the reform. Due to its noteworthy distributive effects, any proposal of reform of the system of wage indexation generated huge social unrest. EMS membership increased the cost of not reforming the system, since, under a fixed exchange rate

regime, the only way to preserve the system of wage indexation, was breaking up the peg, which had an important political cost. In contrast, the change in the relationship between the Italian Treasury and the Central Bank generated less discussion and there was almost no public debate before the measure was endorsed. In fact, the agreement to stop the monetization of the deficit was carried out in a very particular way, through a private agreement between the Minister of the Treasury and the governor of the Banca d'Italia, without any legislative change or Parliamentary debate. The reason for this peculiar procedure was the lack of support to this measure both in the Cabinet and in the Parliament, which led the protagonists of this agreement, known as the "Divorce of the Treasury and the Banca d'Italia", to undertake it "privately". Once the consequences of the "Divorce" started becoming noticeable, in the form of rising costs of financing public debt, public discussion started. For the supporters of the measure, EMS membership was a strong argument to force the maintenance of the "Divorce", when, as a result of the end of monetization and the consequent need for a reduction in government spending, many political and social actors had started demanding its repeal. Therefore, in the case of Italy, EMS membership was a determinant driving force of the change in the relationship between fiscal and monetary policy, to eliminate the prevalence of the first over the second, and the reform of the status of the Central Bank.

The Irish case is examined in chapter four. For Ireland, the decision of joining the EMS was more transcendental than for other countries, since it entailed a high probability of breaking the one-to-

one peg of the Irish punt with the sterling pound, which had been in force for 150 years, at a moment in which trade with the United Kingdom accounted for almost half of the total Irish international trade. The stance of the Irish government was favourable to participate in the EMS, provided that the country was offered financial transfers from the EEC partners in order to facilitate the modernization of the Irish economy and the increase in productivity, essential to make sustainable the maintenance of the peg with other EEC countries' currencies. This request of transfers became the main condition that the Irish government imposed to join the EMS. However, although the final agreement fell very short of the Irish initial requests, the decision was to enter the system anyway. With respect to the break of the peg with the sterling, the position of the government is a puzzle. In every official declaration, the Irish government stated that they wanted the United Kingdom to be in the EMS, and claimed that, if eventually the British stayed out of the EMS, one of the objectives of the government was to maintain the peg with the sterling. However, during the EMS negotiations, the stance adopted by the Irish government regarding the design of the system, the support to the parity grid option, was the one that made British incorporation more improbable. Also, by adopting the narrow fluctuation band, Ireland chose the option that made it more likely an early break with the sterling. The decisions of the Irish government can be considered contradictory with its official stance. Additionally, the justifications to support such decisions were very weak from both economic and political perspectives. In this chapter, I will argue that the majority of the

Irish society and most economic agents preferred to preserve the link with the sterling, which provided many advantages, as at that time almost half of the Irish trade was with the United Kingdom, and the Irish financial system benefited from free movements of capital with Britain. However, although the government publicly stated that its objective was to maintain the peg, it endorsed decisions that made the breakup unavoidable. These decisions were apparently motivated by the nationalistic desire of separating Ireland from the United Kingdom also in monetary matters, against the preferences of most interest groups. One of the priorities of the government agenda was to gain more economic independence from the United Kingdom and promote the reunification of the island. The Irish government was quite confident of the idea that joining the EMS and getting the promised transfers in parallel with British self-marginalization from the system, would contribute to an increase in the Irish living standards beyond British levels, this turning into a powerful factor to promote reunification. The sources used in this chapter are Parliamentary debates, Irish government documentation, British government minutes on the discussions at European Councils, and a generalist newspaper, *The Irish Times*.

The negotiations leading to the creation of the European Monetary System were naturally carried out at the European level. However, domestic circumstances and debates are crucial to understand the outcomes of the bargaining process and the national governments' decisions on EMS membership. Germany's negotiation power was determined by its domestic institutional design. The stance of the German Federal government and its bargaining capacity cannot be

understood without considering the role of the Bundesbank. The decision of the Italian government to join the EMS, despite the fact that the system did not fulfil the minimum requisites demanded, was more related to the particular domestic circumstances of the country than to external policy. The Irish debate was totally conditioned by the relationship of this country with the United Kingdom and the government's will of breaking up the monetary relationship with the sterling pound. In all, the internal circumstances of the participants in the EMS agreement are relevant to understand the stances of their governments and the outcome of the negotiations.

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1. THE NEGOTIATION OF THE EUROPEAN MONETARY SYSTEM: THE DEBATE ABOUT SYMMETRY

1.1 Introduction

Historically, the objective of stabilization of exchange rates has led to the creation of several fixed exchange rate agreements. These monetary arrangements have been very different in what regards to their design and functioning. The elements that define a fixed exchange rate system are the definition of the parities (the election of the *numéraire* of the system) and the fluctuation bands (how much currencies are allowed to fluctuate with respect to the central parity).

When countries face tensions in their balances of payments, and this threatens the parity, there are three mechanisms to correct this situation. The first is a realignment of the parity. A country can opt for a devaluation or a revaluation in order to correct the unbalances. The second option is the use of capital controls in order to isolate the domestic financial market from international pressures. Through the use of capital controls, a country can maintain the currency systematically over or undervalued, since capital controls reduce speculative pressures. The third option is central bank intervention. The country's central bank can intervene selling or purchasing the currency in order to rectify the situation.

Since interventions are usually an important part of monetary agreements, the approval of such kind of arrangements normally

include some provisions referring to the credit facilities that countries have access to in order to finance interventions. There are two important aspects related to credit facilities. The first is the amount and conditions of the credits available. The second is who controls and approves the use of these facilities. In particular, it is important to establish if credit facilities are under the control of national central banks or if there is some form of multilateralization or creation of a pool of reserves.

The three mechanisms to correct unbalances (realignments, capital controls and interventions) are connected to Mundell's trilemma: When taking decisions on exchange rate policy, a country has to choose two out of these three options: fixed exchange rate, free mobility of capital and autonomous economic policies. Therefore, in order to defend the exchange rate, a country needs to choose one of the three mechanisms mentioned before, which entails giving up one of the elements of the trilemma: If the country changes the parity, the exchange rate is not fixed; if uses capital controls, there is no free mobility of capital any longer; and if the central bank intervenes, monetary policy is not autonomous, but subjected to the need of maintaining the exchange rate.

To sum up, the definition of the parities and the fluctuation bands, the mechanisms to defend these parities, and the availability and management of credits to finance interventions are crucial to understand the functioning of any fixed exchange rate system. However, the definition of the design of the system does not necessarily entail a certain functioning. In some occasions, in spite of the particular features established in the design of the system, it

ends up functioning differently from what was expected. In other occasions, there are aspects which are not clearly defined or not defined at all in the design. Accordingly, when analysing a fixed exchange rate agreement, it is necessary to distinguish between design and functioning.

The definition of the design of a monetary system, this is, the definition of parities and the rules about the use of the mechanisms to correct unbalances, and its eventual functioning, determine its degree of symmetry. In a monetary agreement, symmetry is defined as the relative capacity that countries have to maintain their monetary independence and choose their inflation rate. An asymmetrical system is that where there is a currency that is selected as the standard of the system, and all other members' currencies peg to it. Therefore, all parities are defined in relation to this currency, which acts as the anchor of the system. The anchor country can define independently its monetary policy and inflation rate, which will become the standard for the system, while the rest delegate their monetary policies to this country. An example of an asymmetrical system is the Bretton Woods system, where all participants pegged to the dollar. In a symmetrical system no country carries out this role of anchor. All currencies parities are defined in relation to a *numéraire*, which can be a precious metal or a basket of currencies, or otherwise parities can be defined in relation to all the other currencies of the system through bilateral exchange rates. Therefore, there is no country with the capacity of choosing independently its preferred inflation rate. An example of a

symmetrical system would be a pure gold standard system, where every currency is pegged to gold.

To determine the degree of symmetry, not only the definition of the parities is relevant, but also the rules of the use of the mechanisms to correct unbalances. The definition of the intervention rules, this is, what circumstances generate the obligation to intervene, the distribution of the cost of intervention, and how are interventions financed have an impact on the symmetry of the system. The possibility of using capital controls also affects symmetry, since the use of capital controls allows countries to isolate their domestic financial system and maintain an autonomous monetary policy. Finally, the possibility of changing parities (or lack of) determines to what extent countries can maintain certain flexibility instead of having to subordinate their economic policies to the maintenance of the peg. In the negotiations leading to the launching of the EMS, symmetry was the main battle.

The main objective of this chapter is to analyse the symmetry of the EMS in order to establish whether it was a symmetrical or an asymmetrical system. In order to address this question, I will explain the design of the system according to what was approved in the Brussels European Council in 1978 and, since there were several aspects which were not clearly defined in the agreement, I will distinguish between the design and the eventual functioning of the system. I will review the literature on EMS symmetry and the different approaches to that issue, highlighting not only the different positions about the symmetry of the EMS, but also the reasons authors have suggested for the asymmetry and the different

methodologies to measure it. The approach I will follow is that symmetry and asymmetry are not binary categories and that it is possible to establish different degrees of symmetry. Therefore, I am not addressing here the question whether the EMS was symmetrical or asymmetrical. I will examine whether the design of the system and its eventual functioning could have made of it a more or less symmetrical system, and I will connect this question to the demands of the countries taking part in the negotiations. The EMS discussions did not start from zero. The starting point was the Snake, the system which was in force during the 1970s. The main part of the negotiation on the EMS consisted in the discussion of the proposals made by non-Snake countries, which intended to create a system substantially different from the Snake, in particular regarding the aspects which determined symmetry. Therefore, in order to evaluate the degree of symmetry of the EMS compared to the Snake, it is necessary to examine to what extent these proposals to make the EMS more symmetrical were successful or not. The sources used to this aim are the proposals presented by the different countries during the negotiations, the minutes of the meetings of the governments, statements of European leaders in national Parliaments and in the press, and the resolutions of the European Council.

This chapter is organized in three sections. Section 1.2 describes the characteristics of the European Monetary System according to the elements that defined the system (parities and fluctuation bands), the mechanisms to defend these parities (realignments, capital controls and interventions) and the instruments to finance

interventions. A clear distinction is made between design and functioning since, as previously explained, some aspects were not set in the agreement or, having been set, ended up operating differently to what was expected. Section 1.3 analyses the literature about the symmetrical or asymmetrical design and functioning of the EMS, the main reasons of asymmetry, and the different approaches to measure symmetry. Finally, section 1.4 explores the bargaining process leading to the launching of the EMS in order to examine the preferences and stances of the participant countries regarding the issue on symmetry. The countries' different proposals to introduce more symmetry in the new system in comparison to the Snake are confronted to the final agreement, to determine to what extent these proposals were successful or not.

I will conclude that although the design of the EMS was not asymmetrical, its functioning ended up being asymmetrical, and that it would have been possible to introduce features in the design to force a more symmetrical functioning of the system. Non-Snake countries' attempts to introduce symmetry into the functioning of the EMS failed, whereas Germany's hegemony during the operation of the system crucially contributed to its asymmetrical operation.

1.2 Design and functioning of the EMS

The 5 December 1978 the Brussels European Council approved the creation of the European Monetary System and in March 1979 the new system was set in motion. The "Resolution of the European Council of 5th December 1978 on the establishment of the

European Monetary System (EMS) and related matters” established the creation of the European Currency Unit (ECU), a currency basket that would be at the centre of the EMS. The main characteristics of the European Monetary System, namely the definition of the system (parities and fluctuation bands), the mechanisms to defend the parities, and the credit facilities to finance interventions are summarized in Table 1.1. Since some of the elements were not clearly defined or ended functioning differently from the initial arrangement, the table distinguishes between the design, this is, what was agreed in the moment of launching the system, and the real functioning.

Table 1.1. Design and functioning of the European Monetary System (EMS)

		DESIGN– FORMAL AGREEMENT	REAL FUNCTIONING
DEFINITION OF THE SYSTEM	Parities	Defined in ECUs	
	Definition of margins of fluctuation	Defined with respect to the bilateral exchange rates	
	Fluctuation bands	$\pm 2.25\%$ (possibility of a wider band of $\pm 6\%$ for non-Snake countries and new incorporations).	
	Divergence indicator	75% of the maximum spread of divergence for each currency (defined in	Problems in the construction. Ended having no role.

		<p>relation to the ECU central rate)</p> <p>Possibilities for correction (not compulsory):</p> <ul style="list-style-type: none"> - intervention - measures of economic policy - changes in the central parity 	
MECHANISMS TO DEFEND THE PARITIES	Realignments	<p>No formal rule. By mutual agreement.</p>	<p>1979-1983: very frequent.</p> <p>1983-1983: reduction in the frequency and size.</p> <p>1987-1992: <i>de facto</i> fixed exchange rates</p>
	Capital controls	Not defined.	<p>Generalized used before 1986.</p> <p>Elimination of capital controls in 1986</p>
	Intervention rules	Unlimited and compulsory in the margin.	<p>Importance of intra-marginal intervention.</p> <p>Germany maintained different intervention patterns than the rest of the countries.</p>
INSTRUMENTS TO FINANCE INTERVENTIONS	Credit facilities	<p>Credit lines between central banks.</p> <p>Only for marginal interventions.</p> <ul style="list-style-type: none"> - Very Short-Term Financing Facilities (VSTF): unlimited, 	<p>Basle-Nyborg Agreement (1987): VSTF also for intra-marginal interventions (but not automatic access). Extension</p>

		automatic access for marginal intervention, 45 days. - Short-Term Financial Support Facilities (STSF): limited, required previous approval, 3 months. - Mid-Term Financial Assistance Facilities (MTFA): limited, required previous approval 2-5 years.	of the repayment period up to 75 days. Extension of STMS and MFTA (but still limited in amount and required previous approval).
	Reserve pooling	Creation of a European Monetary Fund not later than two years.	European Monetary Fund disappeared from the agenda.

The rest of the section describes the functioning of the EMS and is organized in three subsections. The first subsection explains the definition of the system: parities and fluctuation bands (definition of the bands and width), and the divergence indicator, which was introduced as a mechanism of symmetry. The second subsection explains the mechanisms available to defend the parities: realignments, capital controls and intervention rules. Finally, the third subsection describes the credit facilities available to finance interventions and the management of these resources.

a) Definition of the parities and fluctuation bands

Central parities of EMS currencies were set in terms of ECUs. The ECU was a basket of currencies that had its origins in the European Unit of Account (EUA). Since its creation, the EEC used a unit of account in some areas of the Community activities (the budget, agricultural policy, the Coal and Steel Community and the European Investment Bank among others). This unit of account was defined as equal to 0.88867088 grams of 0.9 fine gold, the official par value of the U.S. dollar. In 1975, with the devaluation of the dollar, the generalization of floating exchange rates and the creation of the Special Drawing Rights, the EEC decided to introduce a basket unit of account, which was known as the European Unit of Account. The EUA was defined as the addition of 3.66 Belgian Francs + 0.14 Luxembourg Francs + 0.286 Dutch Guilders + 0.217 Danish Krona + 0.828 German Marks + 109 Italian Lire + 1.15 French Francs + 0.0885 Sterling Pounds + 0.00759 Irish Pounds. For the calculation, the Commission took the reference of the SDR basket composition, and gave the EUA the same value of the SDR on the 28 June 1974: that day the unit of account valued at 0.88867088 grams of fine gold had a dollar value of 1.20635 U.S. dollars. To facilitate the changeover from the old to the new unit of account, the Commission chose a day on which the value of the currency basket was the same than that of the old unit of account in terms of SDR. The SDR were based on a basket from 1 July 1974 onwards, and the unit of account ceased having the same value as

the SDR that day (1.20635 U.S. dollars).¹ The EUA was introduced first in 1975 in relation to the Lomé Convention on development aid and in the European Investment Bank Sheet. Later was also used in the operational budget of the European Coal and Steel Community, the general budget of the European Communities and in customs matters. The ECU was created in 1979 with identical value and composition of the EUA, although the ECU, unlike the EUA, allowed the revision of its composition (Walmsley, 2000).

According to the European Council Resolution, the ECU would be used as: (1) the denominator (*numéraire*) of the exchange rate mechanism; (2) the basis for the divergence indicator; (3) the denominator for operations in both the intervention and the credit mechanisms; (4) and a means of settlement between the monetary authorities of the European Community. The weights of the currencies in the ECU could be re-examined and, if necessary, revised in six months after the system entered into force and every five years thereafter, or on request if the weight of any currency had changed by 25%. The initial composition of the ECU in the moment of the launching of the EMS and the different modifications are shown in table 1.2.

¹ Commission of the European Communities, Information, Economy and finances, “The Units of Account as a factor of integration”, No. 87/75.

Table 1.2. ECU composition

	13 March 1979		17 Sept 1984		21 Sept 1989	
	Value	Weight (%)	Value	Weight (%)	Value	Weight (%)
Belgian francs	3,66	9,31	3,85	8,24	3,301	8,183
German marks	0,828	32,98	0,719	32,08	0,6242	31,915
Danish kroner	0,217	3,06	0,219	2,69	0,1976	2,653
French francs	1,15	19,83	1,31	19,06	1,332	20,356
British pounds	0,0885	13,34	0,0878	14,98	0,08784	12,452
Irish punts	0,00759	1,15	0,00871	1,2	0,008552	1,089
Italian lire	109	9,49	140	9,98	151,8	7,84
Luxembourg francs	0,14	0,33	0,14	0,33	0,13	0,322
Dutch guilders	0,286	10,51	0,256	10,13	0,2198	9,87
Greek drachmas	-	-	1,15	1,31	1,44	0,487
Spanish pesetas	-	-	-	-	6,885	4,138
Portuguese escudos	-	-	-	-	1,393	0,695

Source: The ECU, European documentation, Luxembourg: Office for Official Publications of the European Communities, 1984 and European Commission, Press Release Database (<http://europa.eu/rapid/search.htm>)

The ECU was chosen as the *numéraire* of the system and each currency had a central parity set in terms of ECUs (see table 1.3). However, fluctuation bands were not defined on the basis of these ECU central rates, but on the basis of a grid of bilateral exchange rates (see table 1.4)., Fluctuation margins of $\pm 2.25\%$ were established around these bilateral exchange rates. Currencies that floated at the moment of the creation of the EMS and new members could opt for wider margins of fluctuation, of $\pm 6\%$.

Table 1.3. ECU central rates (March, 1979)

	Units of national currency per ECU
Belgian/Luxembourg franc	39,4582
Danish krone	7,08592
Deutsche mark	2,51064
French franc	5,79831
Italian lira	1.145,15
Irish pound	0,669141
Netherlands Guilder	2,747480

Source: Nyberg, P., Ungerer, H. and Evens, O: "The European Monetary System: The Experience, 1979-1982", International Monetary Fund.

Table 1.4. EMS bilateral rates (March, 1979)

	Belgian/Luxembourg	Danish krona	Deutsche mark	French franc	Italian lira	Irish pound	Netherlands Guilder
Belgian/Luxembourg francs	1	5,568535913	15,71639104	6,805120802	0,034456796	59,54714339	14,36159681
Danish kroner	0,179580417	1	2,822356053	1,222066643	0,006187766	10,69350083	2,57906154
Deutsche mark	0,063627839	0,354313907	1	0,432995131	0,002192411	3,788856057	0,913797371
French francs	0,14695	0,81829	2,30949	1	0,00506	8,75034	2,11041
Italian lire	29,02	161,61	456,12	197,50	1	1.728,17	416,80
Irish pounds	0,016793417	0,093514745	0,263931906	0,11428123	0,000578647	1	0,241180282
Netherlands Guilders	0,06963014	0,387737937	1,094334512	0,473841516	0,002399232	4,146275946	1

Source: Nyberg, P., Ungerer, H. and Evens, O: "The European Monetary System: The Experience, 1979-1982", International Monetary Fund.

The main difference between defining the fluctuation bands in relation to the ECU central parity or in relation to bilateral exchange rates has to do with the kind of fluctuations that generate intervention obligations. If fluctuation bands are defined in relation to the ECU central rate, the currency will reach the fluctuation limit and, consequently, the incumbent country will be forced to

intervene, when the value of this currency diverges beyond a limit with respect to the value of the ECU, which is fixed. Therefore, the currency is allowed to fluctuate within a fixed and absolute range with respect to the ECU central rate. Conversely, if fluctuation bands are defined using bilateral exchange rates, then two currencies will reach their fluctuation margins if they diverge in relation to each other. Therefore, the maximum fluctuation allowed to a currency is defined in relation to the fluctuation of the rest. In that case, if all currencies diverge in relation to their central parities in ECUs but in the same direction, they will not be forced to intervene, as they would in the first case. Another important difference is that, in the first case, it is possible to have only one currency reaching the margin and being forced to intervene, while in the second case, since the maximum fluctuation allowed is relative to the fluctuation of other currencies, there are always two currencies reaching the limits and having to intervene.

The two systems to define fluctuation bands also had important differences regarding the relation of the EMS with third currencies. At the moment of the launching of the system, the relationship of European currencies with the dollar was still very tight, and the two options to define fluctuation bands had important consequences on the fluctuation that currencies were allowed to have with respect to the dollar. In the case of bands defined on the basis of the ECU central rates, since the ECU fluctuated against the dollar according to the fluctuation of each of the currencies of the basket, the fluctuation band of each of the EMS currencies against the dollar also fluctuated. For example, if all EMS currencies depreciated

against the dollar with the only exception of one of them, let's say the mark, then the ECU would depreciate against the dollar and Germany (the diverging currency with respect to the ECU) would be forced to intervene and correct the appreciation of the mark against the dollar (and against the rest of the EMS currencies). In the other case, in the system based on the parity grid, taking the same example, since every EMS currency would be forced to maintain the bilateral exchange rate with the mark, they would also be forced to intervene to maintain their parity with the mark, and not only Germany would have the intervention obligation, unlike what happened in the first case. In this second case, since the allowed fluctuation was defined in relation to the other currencies, they were forced to move together against the dollar. In the first case, it was the evolution of the exchange rate of the ECU against the dollar what determined the evolution of each of the EMS currencies against the dollar.

Besides fluctuation bands defined with respect to the bilateral exchange rates, the EMS agreement also included an ECU-based formula which was used as an indicator of divergence. This indicator defined a maximum "threshold of divergence", which was fixed at 75% of the maximum spread of divergence for each currency. When a currency reached this threshold of divergence, authorities should correct this situation with adequate measures: diversified intervention, measures of domestic monetary policy, changes in central rates and other measures. According to what was established in the EMS resolution, none of these actions was compulsory.

Eventually, the divergence indicator ended up being totally irrelevant. First, because it did not entail any obligation of intervention or other actions: it was just a warning signal. Second, because it had some technical problems in its construction that reduced its usefulness. Since the Deutsche mark and the Dutch guilder had together a very high weight in the average and tended to move jointly, they were hardly identified as divergent. Besides, the indicator was constructed to identify a currency that diverged in relation to the rest. So, if two major currencies diverged in opposite directions, the indicator might not detect it (Apel 1998, Giavazzi and Giovannini 1989).

b) Mechanisms to correct unbalances and maintain the fixed exchange rate

In order to correct imbalances in the balances of payments and deviations from the margins of fluctuation, EMS members had three mechanisms: realignments, capital controls and interventions. The EMS agreement was not very clear with respect to these mechanisms, in particular the first two; so, at the moment when the system was launched, there was a high degree of uncertainty about its eventual functioning. Besides, the system changed in a fundamental way during its operation as a consequence of a shift in the use of these two instruments.

With respect to realignments, the EMS agreement did not set any specific rule, and only established that they were a shared responsibility. The use of realignments as a mechanism to correct

imbalances changed during the time of operation of the EMS. According to Gros and Thygesen (1998), the operation of the EMS can be divided into three stages: 1979-83, 1983-87 and 1987-92. During the first stage, there was an important divergence in macroeconomic policies and realignments were used to accommodate differentials of inflation (although not entirely). During the second stage, realignments became less frequent and smaller, and it was not allowed to use devaluations to compensate differentials of inflation. This led to a reduction in inflation and deviation from the average. In the last stage, realignments became exceptional and there was an unprecedented degree of exchange rate stability. Therefore, with these changes in the pattern of realignments, the EMS transformed from a fixed but adjustable exchange rate system into a *de facto* fixed exchange rate system.

The change in the pattern of realignments is connected to the second instrument, capital controls. Although in the agreement there was nothing set about the use of capital controls or whether countries were allowed to employ them or not, this was a crucial element of the EMS and, in fact, their removal constituted a major break in the operation of the system. There is a general agreement in literature on the idea that capital controls allowed high inflation countries to isolate their financial systems during realignments to avoid speculative attacks. Giavazzi and Giovannini (1989) attribute two important functions to capital controls: they avoided realignments during crisis and allowed central banks to delay these realignments, contributing to encourage the disinflation process. Giavazzi and Micossi (1990) state that capital controls reduced the

cost of disinflation in terms of output, diminished pressures on international exchange markets and on interest rates when a realignment was expected, and facilitated the management of exchange rates in periods between realignments. For Gros and Thygesen (1998), capital controls were necessary to protect the system during realignments. Even if they were not effective in the long term, they were effective in the short term. These authors highlight that after the removal of capital controls movements of capitals tended to stabilize, but when tensions (differentials of inflation) accumulated, capital movements accelerated the crisis in 1992. Aldcroft and Oliver (1998) claim that the removal of capital controls reduced the viability of the EMS. A system of fixed but adjustable exchange rates was not possible anymore.

To analyse the degree of isolation of domestic financial markets, Giavazzi and Giovannini (1989) examine the differentials between onshore and offshore interest rates. Their results show that capital controls were not used to keep systematic differentials between onshore and offshore interest rates. Deviations were more frequent before realignments, showing that capital controls allowed central banks to protect themselves from the fluctuations originated by exchange rate movements. Artis and Taylor (1990) attribute to capital controls the fact that the reduction in exchange rate volatility did not generate an increase in interest rate volatility. According to these authors, capital controls avoided movements of interest rates that differentials of inflation and expectations of realignments could have generated. They find empirical evidence of fast increase in

differentials between onshore and offshore interest rates in France and Italy.

The removal of capital controls from 1986-87 represented a major break in the operation of the system. It led to a change in the pattern of realignments and in the strategies to support exchange rates. Interest rates became much more stable than during the first years of the system. As expected, financial liberalization reduced the gap between onshore and offshore interest rates in France and Italy. Giavazzi and Spaventa (1990) observe that the reduction in the gap was due to a reduction in the volatility of offshore interest rates, not to an increase in the volatility of onshore interest rates. They attribute this fact to the stabilization of expectations on exchange rates, which promoted the convergence of the French and Italian interest rates towards the German levels. Giavazzi and Micossi (1990) find out that the removal of capital controls led to a faster response of monetary policies in high inflation countries and a more intense use of interest rates to support exchange rates. In fact, one of the accords of the Basle-Nyborg Agreement of 1987 was a more intense use of monetary instruments to support exchange rates.

One of the principles of the EMS at the time of its creation was flexibility. Realignments were a crucial element to guarantee this flexibility (Fратиanni and von Hagen 1990). Besides, realignments were considered a legitimate mechanism of adjustment (Kaelberer 2001). However, the removal of capital controls ruled out the use of realignments to compensate differentials of inflation. Consequently, the system became more rigid and lost its flexibility. This had deep

consequences on the autonomy of monetary policies and imposed the use of monetary instruments instead of realignments and capital controls to support exchange rates.

Lastly, the third mechanism to maintain the fixed exchange rates was central bank interventions. According to what was endorsed in the Brussels European Council, unlimited intervention was compulsory when fluctuation margins were reached. These marginal interventions, this is, originated by the fact that a currency reached the fluctuation limit, could be financed through the credit mechanisms included in the agreement. It was also possible to intervene intra-marginally, this is, before reaching the limit of the fluctuation band, although these interventions were not compulsory and, until 1987, there was no access to credit facilities. During the operation of the EMS, the Bundesbank maintained a different pattern of intervention compared to other central banks. The Bundesbank intervened only marginally, while other central banks intervened intra-marginally before reaching the maximum fluctuation allowed, with the objective of avoiding reaching the limit of the band (Apel, 1998; Gros and Thygesen 1998). Besides, the Bundesbank was responsible for most of the sales of dollars, the result of its responsibility in the management of the exchange rate of the dollar (Mastropasqua, Micossi and Rinaldi, 1990).

According to Mastropasqua, Micossi and Rinaldi (1990), during the first years of operation of the system, interventions were substantial and sales largely exceeded purchases. They were mainly in dollars and distributed uniformly. Marginal interventions

represented only 11% of the total (corresponding to 20-25% of the EMS-related interventions), while the rest were intra-marginal. For intra-marginal interventions, the balance was also negative (net sales), but not as large as in the case of marginal interventions. Most of them took place in the period 1981-82, when the Bundesbank implemented a more restrictive monetary policy.

During the period 1983-85, there were fewer tensions due to the general realignment of March 1983 and the convergence in inflation rates. Interventions continued being mainly in dollars, but the percentage of dollar interventions with respect to the total decreased. Interventions in Communitarian currencies increased from 26% to 44%. Interventions in dollars had a negative balance, while interventions in Communitarian currencies had a positive balance, leading to an important accumulation of European currencies (especially German marks) in European central banks. The Bundesbank was responsible for the majority of the sales in dollars, and hardly intervened using Communitarian currencies. According to Mastropasqua, Micossi and Rinaldi (1990), this could be considered a proof of the special role of the Bundesbank in the determination of the exchange rate with the dollar and the role of the mark as the pivot of the EMS.

The removal of capital controls since 1986 increased the scale of interventions potentially needed to guarantee the stability of the system. This led to a shift in intervention patterns. There was a fast increase in the proportion of interventions carried out in European currencies, showing that interventions in dollars were not an

effective mechanism to support European currencies anymore. The Bundesbank continued intervening mainly at the margin, not intra-marginally. In order to face the increased need for interventions, the Basle-Nyborg agreement of 1987 approved access to credit mechanisms for intra-marginal interventions and removed the restriction on the use of ECUs to repay credits (Before 1987 only the 50% of the credits could be repaid in ECUs).

c) Instruments to finance interventions

In order to finance interventions, the EMS agreement included the creation of credit mechanisms and the extension of the existing ones. Very-Short Term Financial (VSTF) facilities were the main mechanism to finance interventions. They were unlimited credit lines between central banks. Settlements were to be made 45 days after the month of intervention, with the possibility of prolongation for another three months for amounts limited to the size of debtor quotas in the Short-Term Monetary Support (STMS). The other credit mechanisms were the Short-Term Monetary Support (STMS), which were three months credits with a quantitative maximum, and the Mid-Term Financial Assistance (MTFA), which were 2-5 years credits, also limited in amount. In the Basle-Nyorg agreement of 1987, these last two instruments were extended to an amount of 25.000 million ECU, distributed in Short-Term Monetary Support (14.000 million ECU) and Medium-Term Financial Assistance (11.000 million ECU).

The EMS agreement also established the creation of a European Monetary Fund as a mechanism to enhance monetary cooperation. The debate on this matter took place in the framework of the discussions about the role of the European Monetary Cooperation Fund (EMCF). The EMCF was created the 3 April 1973 “to contribute to the progressive establishment of an Economic and Monetary Union between the Member States of the European Economic Community”.² Initially, the responsibilities of the EMCF were the concerted action necessary for the proper functioning of the Community exchange system, the multilateralization of positions resulting from interventions by Central Banks in Community currencies and the multilateralization of intra-Community settlements, and the administration of the Very-Short Term Financing facilities made available by agreements between Central Banks. Nevertheless, the Fund was only an assistant organ of the Central Bank Board of Governors Committee, not a new authority. The Statutes of the EMCF established that the members of the Board of Governors had to be the members of the Committee of Governors of the Central Banks of the Member States.³

During the EMS discussions, there were several proposals to expand the responsibilities of the EMCF to transform it into a true European Monetary Fund or a European Federal Reserve. Although in the Werner Report the EMCF was a very ambitious project, in

² Official Journal of the European Communities (OJEC).05.04.1973, n° L 89. [s.l.]. "Regulation (EEC) No 907/73 of the Council of 3 April 1973 establishing a European Monetary Cooperation Fund".

³ Statutes of the European Monetary Cooperation Fund, Article 1.

practice the institution ended up being subsidiary to others and controlled by the Bank of International Settlements (James 2012). Eventually, the Bremen European Council established that “not later than two years after the start of the scheme, the existing arrangements and institutions will be consolidated in a European Monetary Fund” and the Resolution of the Brussels European Council confirmed that “we remain firmly resolved to consolidate, not later than two years after the start of the scheme, [...] the creation of the European Monetary Fund as announced in the conclusions of the European Council meeting at Bremen on 6 and 7 July 1978”. However, after these two years of deferral, the creation of the European Monetary Fund disappeared from the agenda.⁴

To sum up, the management of credit facilities continued being controlled by countries’ central banks and, although the EMS agreement included the creation of a European Monetary Fund, there was neither a reserve pooling nor the creation of a multilateral organ.

1.3 Was the EMS an asymmetrical system?

As it has been said, during the EMS negotiations symmetry was the main controversy. The issue of the symmetry of the EMS has generated an intense debate. Literature about EMS symmetry

⁴ Conclusions of the Bremen European Council (6 and 7 of July 1978) and Bulletin of the European Communities, December 1978, No 12. Luxembourg: Office for official publications of the European Communities. "Resolution of the European Council of 5th December 1978 on the establishment of the European Monetary System (EMS) and related matters"

distinguishes between asymmetry in the design and asymmetry in the functioning. Some authors, for example, Aldcroft and Oliver (1998), McNamara (1998), Melitz (1990), Kaelberer (2001) and Dyson (1994), claim that the design was intentionally asymmetrical. Other authors, such as Giavazzi and Giovannini (1989) and Gros and Thygesen (1998), state that the design was symmetrical but the functioning ended up being asymmetrical, due to the fact that some mechanisms conceived to introduce symmetry did not work, for example, the divergence indicator, or due to the factual functioning of some of the elements that were not defined in the initial design. Finally, other authors, such as De Grauwe (1989) and Fratianni and von Hagen (1990), affirm that both the design and the functioning of the EMS were symmetrical.

The debate about symmetry is connected to the debate about the nature of the EMS as an anti-inflationary tool or as a mechanism to stabilize exchange rates, as well as the discussion on the particular role of Germany in the functioning of the system. If the EMS was devised as an anti-inflationary instrument to facilitate the application of monetary rigour and to import Germany's reputation in price stability, then it necessarily had to be asymmetrical. The main reason for this asymmetry would be, in this case, the role of the Deutsche mark as the anchor of the system and Germany's success in controlling inflation. If the main objective of the EMS was the stabilization of exchange rates after the negative consequences of the floating during the 1970s, then the system did not require being asymmetrical. Additionally, with a symmetrical system, high inflation countries could achieve this objective with a

minor cost in terms of the need of applying restrictive policies to make the peg sustainable. In this case, the inability of these countries to obtain a more symmetrical system would be the consequence of Germany's bigger bargaining power.

It is complicated to distinct the anti-inflationary effect from the stabilization of exchange rates, since both objectives are connected. For high inflation countries, trapped in a vicious circle of depreciation-inflation in the 1970s, the reduction in the volatility in the exchange rate had a positive impact on price stability. Besides, the German bargaining power was the result of the success in fighting inflation, which was the main reason for using the Deutsche mark as the anchor of the system if its main aim was to be an anti-inflationary instrument. Furthermore, the 1970s were a period of transition in the management of monetary policy, in which Keynesian policies started being questioned, but the Monetarist paradigm was not consolidated yet. This period was characterized by an intense debate about the management of monetary instruments and countries experimented with new approaches to achieve monetary goals. The existing confusion about the use of exchange rates and money supply makes even more difficult to identify the nature of the arrangement. However, in spite of the difficulties to elucidate what was the nature of the EMS, this is a crucial factor to explain the reasons for the asymmetry of the system, since the causes for the asymmetry are different if the EMS was an anti-inflationary device or if it was a mechanism to stabilize exchange rates.

In the debate about the reasons for asymmetry, we can find explanations that fit in both accounts: some authors claim that asymmetry was the result of the anti-inflationary role of the EMS and the election of the Deutsche mark as the anchor of the system, which was grounded on the German success in controlling inflation. Other authors state that it was the consequence of Germany's bargaining power, which allowed this country to impose its preferred option, this is, an asymmetrical design. However, as previously mentioned, since these explanations are not necessarily exclusive but interdependent, some authors attribute Germany's bigger bargaining power precisely to its role as the anchor of the system.

For Giavazzi and Giovannini (1989), the main incentive for high inflation countries to join the EMS was to import German anti-inflationary reputation. As a result, the system was necessarily asymmetrical, due to the fact that other countries needed the Bundesbank's reputation. According to these authors, statistical evidence seems to confirm the idea that the Bundesbank's reputation contributed to the disinflation process, although they alert of the problems of significance of data and of timing. Since, simultaneously, there were changes in domestic economic policies, it is not clear whether disinflation took place thanks to reputation gains (but with a temporarily delay due to the fact that agents needed some time to adjust their expectations), or whether it was fostered by domestic reforms imposed by the determination to stay in the EMS or justified through the restriction imposed by the EMS.

Aldcroft and Oliver (1998) utter that high inflation countries were willing to delegate part of their monetary autonomy to the Bundesbank in exchange for lower inflation. To them, the EMS followed a gradual approach to inflation and, as a consequence, reputation gains in the EMS were slow and expectations changed gradually. In that sense, European countries were unable to implement a shock therapy to deal with inflation. In these authors' opinion, the crucial factor of disinflation was that realignments were frequent, but not enough to compensate differentials in inflation with Germany. Giavazzi and Pagano (1998) also share this view on the value of the asymmetry of the EMS as a disciplinary mechanism: by pegging the currency to the mark, disinflation costs were lower thanks to gains in credibility.

McNamara (1998) claims that the consensus around the need for monetary rigour contributed to the conception of the EMS as an effective tool to promote price stability. For EMS countries, pegging their currencies to the German mark was a mechanism to emulate Germany's economic policy and to attain the objective of price stability. To McNamara, the system was legitimised by the generalization of the neoclassical consensus on the primacy of inflation as the priority of economic policy.

Melitz (1990) considers that monetary stability was crucial to understand the incentives for high inflation countries to participate in the system, since it increased the costs of inflating and acted as a disciplinary device. However, discipline cannot explain the German interest to participate in the system. In the case of Germany, the

main purpose was to improve terms of trade. Therefore, in the German case, the objective was the stabilization of the exchange rate. In a moment in which Germany's competitiveness was worsening, becoming a member of the EMS was more attractive. According to Melitz, the EMS allowed Germany to improve competitiveness at zero cost. Germany not only enjoyed an independence that nobody else had, but the gains from taking part in the system were also more certain than those of other countries.

According to James (2012), the centrality of the Bundesbank was due to its central role and practical power in the management of the main flows of capitals, which was the result of the problems of the international financial system and the weakness of the dollar. Similarly, Dyson (1994) stresses the view of inflation as a credibility problem and states that Barro and Gordon's idea of temporary inconsistency in monetary policy was the intellectual basis of the EMS. This author explains the asymmetrical bargaining power as a consequence of the structural power that Germany and the Bundesbank had. The sources of this structural power were the control of the key currency and the German reputation. The Bundesbank had no interest in a symmetrical EMS, since this would increase the cost of intervention and would affect its priority of domestic price stability. The Bundesbank was able to impose its stances in this respect.

On the other side, Kaelberer (2001) attaches the capacity of some countries to impose its preferred options during the negotiations to their bigger bargaining power. Countries with surplus in the balance

of payments have more flexibility than countries with deficit, because they can achieve adjustment unilaterally more easily through revaluation, reflation or accumulation of reserves. On the contrary, countries with deficit cannot solve unilaterally reserve restrictions. As a consequence of this different capacity to rebalance unilaterally the balance of payments, surplus countries have a credible exit threat (the cost of their unilateral actions is lower) and have a credible exclusion threat (they can create a system without deficit countries). Since Germany was the largest strong currency and trade surplus country, it was able to exert a role of leadership in the negotiations and had bigger bargaining power than other countries. Maes and Quaglia (2006) highlight that the institutional structure of different countries, in particular the views on foreign policy making, the distribution of power among the domestic policy makers and the status of the central banks, conditioned the outcome of the negotiations.

The debate about symmetry in the design and functioning of the EMS also extends to the question of how to measure symmetry. Empirical studies trying to assess the degree of symmetry do not reach unanimous results and, in general, are not concluding. Some authors find statistical evidence of the asymmetrical character of the EMS. Apel (1998) affirms that the fact that Germany carried out only marginal interventions while other countries intervened intra-marginally together with the evolution of interest rates are consistent proofs of asymmetry. In the same direction, Dyson (1994) states that Germany set interest rates independently, while other countries fixed interest rates to defend their parities with the

German mark. Giavazzi and Giovannini (1989) use the asymmetric evolution of interest rates to affirm that the EMS became a great Deutsche mark area. Volatility of interest rates was very different in Germany compared to France and Italy. According to these authors, only Germany established monetary policy independently, while France and Italy had two options: either to accommodate to German monetary policy or to dissociate temporarily international and domestic interest rates through capital controls. For Giavazzi and Giovannini (1989), German sterilization of interventions is another evidence of asymmetry.

Gros and Thygesen (1989) use four indicators to approach symmetry: the distribution of intervention activities, the degree of sterilization of the effects of intervention in monetary aggregates by the central bank, correlations in money supply between different countries, and interest rates. With respect to the first indicator, they observe that Germany intervened only at the margin, while others intervened mainly intra-marginally. With regard to sterilization, they find that Germany sterilized interventions, even if the coefficients of sterilization are not different for EMS interventions and other currencies interventions. When assessing the behaviour of money supply, they conclude that Germany influenced other countries, but other countries influenced Germany too. However, they remark that it is necessary to take into account that their results do not specify the magnitude of the effect. Moreover, it is necessary to keep in mind that countries had to return the credits received. Since interventions normally consisted in selling marks, to return the credits it was necessary to purchase marks. This had a

contractive effect for Germany and, consequently, Germany might not be interested in sterilizing those interventions. Finally, they observe that during turbulences, French and Italian interest rates increased fast, while German rates remained stable. The authors conclude that evidence does not support the idea that the EMS reduced the cost of disinflation and hence the view of the EMS as a disciplinary mechanism, although asymmetry tests seem to be consistent for the period 1983-86, meaning that during that period the EMS might have worked as a disciplinary mechanism. The most important function of the EMS was, in their opinion, to be a mechanism to absorb shocks. Consequently, they highlight the role of the EMS in the stabilization of the exchange rates.

Bini Smaghi and Micossi (1990) state that the mid-term monetary policy was set by the Bundesbank and other countries followed it approximately, using periodical realignments to keep certain independence. However, according to the empirical tests carried out by these authors, sterilization coefficients cannot confirm or reject the hypothesis of asymmetry, it being difficult to reach to any solid conclusion.

On the other side, there are authors who state that statistical evidence supports the idea that the EMS was as symmetrical system. De Grauwe (1989) considers that, in order to assess the symmetry of the system, it is necessary to check the effects of speculation on interest rates. Since German interest rates seem to have been conditioned by other countries' interest rates, the conclusion should be that the system was symmetrical.

Fratianni and von Hagen (1990) reject the hypothesis of the German dominance both from a theoretical and an empirical perspective. According to these authors, from a theoretical point of view it is difficult to explain the incentives of Germany to provide discipline, as well as the incentives for high inflation countries to accept the German ascendancy. Empirically, they test the symmetry of the system analysing the evolution of interest rates and money supply. They find that EMS countries' interest rates reacted to German monetary policy, but also to third countries' decisions. On the other side, the Bundesbank also reacted to other EMS central banks' decisions. With regard to money supply, the results are that German money supply was independent from other countries' decisions, but other countries interacted between them and responded both to German monetary policy and third countries' policies. These authors also reject the assertion that sterilization of interventions by the Bundesbank is an evidence of asymmetry. They state that interventions had a significant impact on German money supply, but with a temporary lag. They remark that, even if there is no empirical evidence of German supremacy, there is some evidence of the fact that Germany conducted an independent monetary policy, which did not imply German dominance. Other countries had escape valves to avoid following the German discipline: capital controls and realignments. Consequently, since the EMS was not an asymmetrical system, its role in the disinflation process has been overstated and authors attribute the reduction and convergence in inflation rates to the response to external shocks, which made it possible the disinflation process, and a change in economic policies.

Cohen and Wyplosz (1989) find out that German monetary instruments affected interest rates or money growth (or both) in other countries, but France, Italy and the Netherlands also transmitted their shifts in interest rates, even if to a lesser extent than Germany. Kirchgässner and Wolters (1993) discover statistical evidence of German pre-eminence, but this pre-eminence was not restricted to the EMS. Gardner and Perraudin (1993) find similar evidences, but also discover a structural change in the data coinciding with the German reunification. Before the reunification, only US interest rates affected offshore German interest rates, while German monetary policy had a strong impact on French monetary policy. In the first year after reunification there was a switch in the roles and France assumed the leadership, although Germany seemed to regain influence again in 1990-91. On the contrary, Henry and Weidmann (1995) state that after the reunification German monetary policy became more independent, not only from France but also from the United States. Consequently, these authors conclude that the system was not asymmetrical at the beginning (German monetary policy was independent in the short term, but not in the long term), but became asymmetrical, and Germany assumed a dominant role as a consequence of the shock of the reunification.

1.4 The EMS negotiations: a not so symmetrical functioning as it could have been

Most scholars agree on the asymmetrical character of the EMS. Literature on EMS has provided several explanations about the motivations for an asymmetrical system, which can be classified in two big groups: The first group support the idea that asymmetry was the consequence of the anti-inflationary role of the system and the will of benefiting from the Bundesbank's reputation to reduce the cost of disinflation (so, asymmetry was in fact sought by high inflation countries). The second group states that, asymmetry was due to the German bargaining power, which allowed Germany to impose its preferred design (high inflation countries wanted a symmetrical system but were unable to achieve it). In empirical studies testing the symmetry of the system, there is an intense debate on how to measure it and what indicator is the most relevant. These studies measure symmetry *ex post*, analysing the functioning of the system, and, although they provide different definitions of the concept of asymmetry, they normally use a binary category, this is, they conclude that the system was symmetrical or asymmetrical.

In this section I will analyse the negotiation process leading to the EMS in order to contrast the preferences of each country with the final design, to establish what country was more able to influence the outcome of the negotiations. Following a bargaining theory approach, I will claim that non-Snake countries preferred a more symmetrical system than those in the Snake and, therefore, their main motivation was the stabilization of the exchange rate.

However, their attempts to introduce symmetry failed due to the bigger German bargaining power. The sources used are the proposals that countries presented at the negotiations, the minutes of the meetings, statements of European leaders in national Parliaments and in the press, and the European Council resolutions. I will make a clear distinction between the design and the functioning of the system. Literature has provided different definitions of asymmetry; I will use here a general one: the capacity of one of the members of the agreement to choose independently its preferred inflation rate and monetary policy. I will not use symmetry as binary category. I will introduce instead the idea of the existence of different degrees of symmetry, identifying more or less symmetrical systems in comparison to others.

The negotiations leading to the EMS did not start from zero, but were conditioned by path dependence. At that moment, some of the members of the EEC were taking part in the Snake, a monetary system created after the collapse of Bretton Woods. The rest of EEC countries had also been part of this monetary agreement, but were forced to abandon it because of their inability to maintain the peg. The Snake was the *status quo* during the bargaining of the new system and the dynamics of the negotiation can be summarized as the attempt of the countries who had been forced to leave the Snake to introduce innovations in the new system in order to render its functioning more symmetrical, while Snake countries, in particular Germany, which had become the centre of this system, were reluctant to accept these new features.

After analysing the different options to define the new system and the stances of the participant countries, this section will conclude stating that the attempts to introduce features to make the system substantially different from the Snake did not succeed and that the EMS ended up being very similar to the previous system. From a strict point of view of the definition of the system, the EMS design was not asymmetrical, since there was no explicit election of the mark as the standard of the system. However, the functioning did end up being asymmetrical. The introduction of the features suggested by non-Snake countries would have forced a much more symmetrical functioning of the system. The inability of these countries to impose these features, due to the bigger bargaining power of Germany, was the main reason for the eventual asymmetrical functioning of the EMS.

a) The Snake: the starting point of EMS negotiations

The Snake was the starting point of the bargaining process and the system which was in force during the period of the negotiations. Therefore, this system was the basis on which new proposals were made. The Snake had its origins in the Bretton Woods System. Under Bretton Woods, European currencies had to maintain their exchange rates within a fluctuation band of $\pm 1\%$ with respect to their central parities with the dollar. This created an intra-European fluctuation band of $\pm 2\%$. This maximum fluctuation of 4% was considered to be too large and, already in 1958, some European currencies signed the European Monetary Agreement to narrow their fluctuation bands with the dollar, with the aim of reducing

bilateral margins. In April 1971, central bank governors agreed to reduce intra-European fluctuation margins to $\pm 1.2\%$. This measure was bound to be implemented in June that same year. However, as a consequence of the crisis of the dollar, it was never enforced. In May 1971, the German mark and the Dutch guilder started floating. Germany suggested a joint flotation of European currencies, but France and Italy preferred to stay pegged to the dollar.

The Smithsonian Agreement of December 1971 increased fluctuation margins with the dollar from $\pm 1\%$ to $\pm 2.25\%$. Consequently, intra-European margins increased up to $\pm 4.5\%$, with a total fluctuation band of 9%. This fluctuation band was again considered too wide to guarantee the stability of European markets and the preservation of the project of European economic integration. In April 1972, with the Basle Agreement, EEC countries and three future members (United Kingdom, Ireland and Denmark) agreed to reduce intra-European fluctuation bands to half of what was allowed in the Smithsonian Agreement, this is, from $\pm 4.5\%$ to $\pm 2.25\%$, creating what was known as the “Snake in the tunnel”. The exchange rate with the dollar was the floor and the ceiling of the tunnel in which European currencies fluctuated.

Under the Snake, countries were expected to carry out unlimited interventions at the margin to support these new fluctuation bands. It was also possible to intervene intra-marginally. In order to finance interventions, new credit facilities were created: Very-Short Term Financing facilities (unlimited credit lines between central banks to be repaid in a month), Short-Term Financial Support

(three-month credits with a quantitative limit), and Mid-Term Financial Assistance (2-5 years credits with a quantitative limit). Monetary cooperation was supposed to be enhanced through the creation of the European Monetary Cooperation Fund. The Fund was set up in 1973, but it ended up having much more restricted functions than what it had been initially conceived.

In March 1973, with the collapse of the Bretton Woods system and the devaluation of the dollar, the Snake lost its tunnel. European currencies decided nevertheless to keep the Snake alive and float together. This represented an opportunity for European monetary cooperation. However, at that moment, the Snake had already turned into a Deutsche mark zone. The initial members of the Snake were Germany, France, Italy, the Netherlands, Belgium and Luxembourg. On May 1972, the United Kingdom, Ireland and Denmark joined the system. Sweden joined in March 1973, and Norway did so in May 1973. Few weeks after joining the system, in June 1972, the British Chancellor of the Exchequer claimed that internal stability could not be threatened by unrealistic exchange rates. After a speculative attack against the sterling, the United Kingdom decided to withdraw the system, and so did Ireland. In February 1973, Italy left too. These three countries would never join the Snake again. France left in 1974, re-joined in July 1975 and left again nine months later. Sweden withdrew in August 1977 and Norway did the same in December 1978. The Snake lived until March 1979. At that moment, the remaining countries (Germany, the Netherlands, Denmark, Belgium and Luxembourg) joined the European Monetary System.

According to Kaelberer (2001), from the perspective of European cooperation, the Snake was a failure. High inflation countries were unable or unwilling to stay in the arrangement and, therefore, the system quickly became a “mini-Snake” made up of countries with strong currencies. For these countries, the system was a quite stable framework, even if realignments were frequent and interventions were larger than expected when the system was created.

Giavazzi and Giovannini (1989) affirm that the main reason for the failure of the Snake were the asymmetry of the Exchange Rate Mechanism and the inadequacy of interventions to confer credibility to fluctuation bands. High inflation countries, in particular France, complained about the asymmetry of the system. When returning to the Snake, France demanded more systematic and coordinated interventions against the dollar, more symmetry in interventions to avoid placing all the burden of adjustment onto weak currency countries, and a reduction in the fluctuation bands with the dollar (James 2012). Another recurrent complaint from weak currency countries was that credit facilities were too restrictive and insufficient, so they sponsored a multilateral mechanism. However, Germany blocked every attempt to move ahead in that direction (Kaelberer 2001).

Additionally, with the conversion of the European Snake into a mini-Snake formed by strong currency countries, the European Economic Community was divided into two blocks. This was perceived by France as an evidence of the structural power of

Germany, and was one of the reasons for France to promote a new system, more symmetrical and including all EEC countries.

To sum up, the EMS negotiations did not start as a blank page. The Snake was the starting point of the bargaining process and the reference for the new system. The negotiation process was centred in the attempt of non-Snake countries to introduce new features into the EMS in order to make it more symmetrical and essentially different from the Snake. On the other side, Germany resisted to these attempts.

b) The election of the *numéraire*, the definition of intervention rules and the divergence indicator

The election of the *numéraire* and the definition of intervention rules were the most crucial aspects to determine the degree of symmetry of the system. The preferred option of non-Snake countries was the creation of a European Currency Unit (ECU), defined as a basket of currencies, which would be used to determine the margins of fluctuation. The obligation of intervention would arise once a currency reached its margin with respect to the central parity set in terms of ECUs. This proposal appeared in 1974 in the Fourcade Memorandum and was discussed in the Heyvaert Group of the Central Bank Governors Committee.⁵ This group of experts chaired by F. Heyvaert summarized the French proposals in the

⁵ Propositions françaises relatives à l'unité de compte monétaire européenne. Nr 27. Groupe d'experts présidé par M. Heyvaert, Comité des gouverneurs des banques centrales des États membres de la Communauté économique européenne, 3 décembre 1974.

following way: “à constituer une nouvelle base pour déterminer les points extrêmes auxquels apparaissent les obligations de stabilisation des cours de change: chaque banque centrale serait tenue de veiller à ce que la valeur instantanée de l'UCME dans sa monnaie, calculée sur la base du panier standard, soit maintenue entre des valeurs limites résultant de la marge choisie”. The use of the European Currency Unit as the *numéraire* of the system, to set central parities and fluctuation margins and to define intervention obligations, became one of the major requests of France, Italy and the United Kingdom. During all the bargaining process these countries insisted on the fact that it was necessary to create a system different from the Snake. For example, during the negotiations, the French President, Valéry Giscard d'Estaing, claimed that it was not desirable to “have the same snake reburned twice”.⁶ Filippo Maria Pandolfi, the Italian Minister of Finances, conditioned the Italian adhesion to the EMS to it being substantially different from the Snake.⁷ In the case of the United Kingdom, the Chancellor of the Exchequer, Dennis Healey, in a meeting of the Cabinet Committee on the EMS claimed that “our position had been that the scheme should be durable, should impose symmetrical obligations so as to present no obstacle to growth, and should be supported by adequate

⁶ Valéry Giscard d'Estaing, *Le pouvoir et la vie*. Volume 1: *La rencontre*. Paris: Compagnie 12, 1988, p. 142-145.

⁷ MP Filippo Maria Pandolfi (DC), *Atti Parlamentari, Camera dei Deputati*, 10 October 1978.

resources for intervention. In all these it would be different from the snake”.⁸

However, the option of the ECU as the reference to define intervention obligation was systematically rejected by Germany, in particular by the Bundesbank. Although Germany accepted the creation of a new currency defined as a basket, the possibility of using it to define intervention rules was radically discarded. The German alternative, outlined by the Bundesbank, was a system in which the central parities were set in terms of ECUs, these parities would be used to create a bilateral exchange rates parity grid, and fluctuation margins would be defined with respect to bilateral exchange rates. The obligation of intervention would arise when two currencies reached the bilateral margins. This manner to define intervention obligations was actually the same of the Snake, with the only difference of using the ECU to calculate the bilateral exchange rates. This use of the ECU, however, had no real impact on the intervention obligations created.

The two systems were expected to have absolutely different outcomes in terms of obligations generated. Germany was expected to be forced to intervene much more in a system in which fluctuation margins were defined in relation to the central parity in ECUs than in a system based on a parity grid. Predictably, the mark would appreciate with respect to other EMS countries, so the

⁸ 1978 Oct 10 Tu Archive (TNA). EMS: Cabinet Committee meeting on EMS (minutes), Venue: No.10 Downing Street, Source: CAB 130/1047. Reproduced in the Margaret Thatcher Foundation archive, available online, <https://www.margaretthatcher.org/document/111610>

Bundesbank would be required to intervene frequently to correct that situation. In a system based on bilateral exchange rates, two countries should always intervene and, considering the scarce availability of credit facilities and the decision of not creating any multilateral credit mechanism or reserve pooling (the other controversial element in the debate about symmetry), the burden of adjustment was expected to fall almost entirely onto the weak currency country.

The German Federal government and the Bundesbank perceived that the system based on the ECU would jeopardize German monetary autonomy and feared the possibility of importing inflation from other countries. Since domestic price stability was non-negotiable for Germany, intervention rules defined on the basis of the basket of currencies were totally discarded. On the other side, France, Italy and the United Kingdom believed that a system based on the ECU would solve the problem of asymmetry of the Snake and would alleviate the burden of adjustment for high inflation countries. The choice between these two alternative options to define intervention obligations was at the centre of the EMS discussions. Discord on this issue lasted all the second half of the 1970s and the apparent difficulties to find a solution threatened the possibility of reaching an agreement. During the mid-1970s, the German and the French stances seemed irreconcilable and it was not until 1977-78 that positions started to converge.

The Fourcade Memorandum of 1974, which summarized the French proposals, criticised the Snake's asymmetry and lack of flexibility.

This document suggested for the first time a system where the intra-EEC fluctuations would be defined in relation to a new unit of account defined as a basket of currencies. Even if most of the proposals of the Memorandum were eventually rejected, the option of the basket of currencies was used to reform the European Unit of Account after the demonetization of gold. However, the problem of what should be the basis for interventions rules in the future European Monetary System remained open.

The Giscard-Schmidt joint proposal for the Bremen European Council of July 1978 consisted in a system in which the ECU would be at the centre. The conclusions of the Council reflected this idea: “The European currency unit (ECU) will be at the centre of the system; in particular, it will be used as a means of settlement between EEC monetary authorities”.⁹ However, there was no consensus on what a system based on the ECU meant, since the crucial aspect of the new monetary system, the intervention rules, was not defined yet (Mourlon-Druol 2012). To non-Snake countries, the ECU would be at the centre of the system in the sense that central parities and fluctuation margins would be defined in ECUs. To Snake countries, the ECU would be at the centre in the sense that it would be the reference to create a parity grid, and criteria for intervention would be grounded on the marginal bilateral exchange rates.

⁹ Bulletin of the European Communities.1978, n° 6. Luxembourg: Office for Official Publications of the European Communities. "Conclusions of the Bremen European Council (6-7 July 1978)".

Disagreements on the reference to define margins and intervention obligations lasted until the meeting of President Giscard d'Estaing and Chancellor Schmidt in Aachen in September 1978, when the French abandoned the option of the basket of currencies. In Aachen, the choice adopted was known as the Belgian compromise, which, by that moment, had become the only viable option (Mourlon-Druol 2012). The Belgian compromise consisted in the adoption of the parity grid as the basis for intervention rules and the use of the ECU to create a divergence indicator, which was conceived with the objective of introducing some symmetry. The indicator defined a maximum threshold of divergence (75% with respect to the central parity defined in ECUs) and countries reaching this threshold were supposed to correct that situation.

This solution did not satisfy Italy and the United Kingdom, but once France acquiesced to this half-way option the debate about symmetry ended. Soon after the Aachen meeting it became clear that the United Kingdom was not going to participate in the new system. The British government judged the outcome of the Aachen meeting as a betrayal of the French President. The 23 October 1978 the British newspaper *The Guardian* stated: "Some British Ministers are in private quite scathing about the French President for wrapping in high-flown European rhetoric what they see to have been a sell-out to the Germans at his meeting with Mr Schmidt at Aachen on September 15. It was at this meeting that President Giscard d'Estaing, in effect, settled for re-joining the Snake as a first step towards his more grandiose vision of a European Monetary

System with its own reserve fund and its own currency”.¹⁰ For the British government, the EMS was nothing else than a revival of the Snake, now the “Snake with bells”.

The implications of the divergence indicator reopened the debate about symmetry, but, at that moment, France was not in the British and Italian side any more. Germany, Denmark and the Netherlands considered that when a currency was identified as divergent, there should be a “consultation”. France and Belgium stated that there should be “presumption to intervene”. The United Kingdom, Italy and Ireland wanted an “obligation to intervene” (Mourlon-Druol 2012). Finally, in the Brussels European Council, countries agreed that when a currency reached the divergence threshold, authorities should correct that situation through adequate measures, including intervention, measures of economic policy or changes in the central parity.¹¹ Consequently, the divergence indicator was not associated to any obligation of intervention.

Eventually, the divergence indicator ended up having no real function in the system: it did not entail any obligation and its construction had some technical problems. As a consequence, the indicator was condemned since the beginning to be irrelevant for the functioning of the system. Since the major role of the ECU was to be the basis of this indicator, in the practical operation of the

¹⁰ The Guardian, “Britain rejects both the snake and the apple”, Manchester, 23 November 1978.

¹¹ Bulletin of the European Communities, December 1978, No 12. Luxembourg: Office for official publications of the European Communities. "Resolution of the European Council of 5th December 1978 on the establishment of the European Monetary System (EMS) and related matters".

EMS the ECU became also irrelevant. In terms of the symmetry of the system and the obligations of intervention, the EMS was almost identical to the Snake, and the attempts of non-Snake countries to introduce symmetry through the ECU were a failure.

c) Credit facilities and reserve pooling

A second relevant aspect to determine the degree of symmetry of the system was the availability of credit facilities and the management of these resources. Complaints about the lack of credit mechanisms were recurrent during the Snake and, in fact, the United Kingdom claimed that this was the reason to leave the system. During the operation of the Snake, the most important credit facilities available were the Very Short-Term Financing (VSTF) facilities. VSTF were unlimited credit lines which had to be repaid in 30 days since the end of the month of the intervention.

The necessity to extend credit mechanisms to finance interventions and make parities credible emerged during the negotiation process. For France, it constituted a crucial aspect. Initially, Germany was against the extension of credit facilities, but eventually accepted the French requests. According to Kaelberer (2001), the German concessions in this respect were crucial to guarantee the French participation in the system. In comparison to the Snake, there was an extension of the repayment period of the VSTF from 30 to 45 days. In the Basle-Nyborg Agreement of 1987, the repayment period was enlarged another extra month, up to 75 days. Besides, since 1987 countries were allowed to use VSTF to finance intra-

marginal interventions, even if its utilization was not automatic. The other credit facilities (STMS and MTFA) were substantially extended, although continued being limited in amount and required previous approval.

The expansion of credit mechanisms and the extension of the repayment period of the VSTF turned out to be the only genuinely new features of the system. However, according to Dyson (1994), they were far from compensating the lack of symmetry of the system. Although credit mechanisms were the only truly new aspect, this issue generated much less debate than the other elements of the system (Mourlon-Druol 2012).

What would have represented a big difference in terms of symmetry of the system would have been the creation of a reserve pooling or a multilateral instrument. The debate on this issue took place in the framework of the discussions on the role of the European Monetary Cooperation Fund (EMCF). During the Snake, the EMCF had a subsidiary role and was controlled by the Committee of Governors of the Central Banks of the Member States. France, and later the European Commission, supported the creation of multilateral mechanisms and the reform of the EMCF in order to confer it a more active role: The Barre Plan of 1969 proposed the creation of an automatic mechanism of short-term assistance in order to avoid the politicization of financial aid; the Fourcade Memorandum of 1974 recommended creating EEC mechanisms; and the Franco-German joint proposal for the Bremen European Council also included the creation of a European Monetary Fund. However, all

along the negotiation process, the Bundesbank maintained the stance that the EMCF should be an auxiliary organ, not a new authority, and should not be a source of additional liquidity at all. Consequently, Germany systematically rejected any proposal of multilateral credit mechanisms, since it generated concern about the possibility of losing the control of money supply. As a result, in spite of the attempts of weak currency countries, the EMCF never became an independent institution with the role of financing balance of payments disequilibria. Its functions ended up being the coordination of cooperation to reduce fluctuation bands and the administration of credit facilities. Although the Bremen and Brussels European Councils established that the European Monetary Fund should be created not later than two years after the launching of the system, eventually this never occurred.

d) Fluctuation bands, realignments and capital controls

In other aspects of the system, such as fluctuation bands and realignments, Germany was much less reluctant to make concessions and did not oppose the introduction of innovations as strongly as it had done with intervention rules or the reserve pooling. In the case of the fluctuation bands, non-Snake countries and new incorporations were allowed to enjoy a wider band of $\pm 6\%$.

With respect to realignments, although there was no formal rule besides the fact that they were a shared responsibility, at the moment of the launching of the EMS they were considered a crucial aspect of the new system. One of the principles of the system was

flexibility, and realignments were the basic element to guarantee this flexibility. Realignments did not generate any controversy during the negotiations.

The EMS agreement did not include any provision about capital controls and this issue was not part of the discussions. This meant that, during the first years of operation of the system, countries were allowed to use capital controls in order to isolate their financial systems from international pressures. Giavazzi and Giovannini (1989) observe that the use of capital controls was different across countries. Weak currency countries used them intensively in order to avoid speculative pressures, while in strong currency countries controls were almost inexistent. This difference is explained by the fact that strong currency countries had little incentives to use them. For example, France reintroduced the *devise titre* (a French resident could purchase foreign assets only to another French resident) in 1981, and abolished it again in 1986. Italy reinstated controls in 1972 with a *de facto* prohibition of foreign investment with the introduction of a tax on purchases of foreign assets. This regulation was in force until 1987. Foreign credit was also forbidden in Italy. Belgium did not forbid the purchase of foreign assets, but maintained a dual exchange market. On the contrary, in Germany there were no restrictions to purchase foreign assets since the end of the 1950s, but there were administrative controls on the inflows of foreign capitals in order to limit them. These controls were progressively removed during the 1970s and, by 1981, inflows of capitals were totally liberalized.

Therefore, since the launching of the EMS until 1986-87, capital controls were a crucial element for the functioning of the system. During the negotiations, the use of capital controls as a mechanism to maintain the fixed exchange rates was never questioned. The removal of these controls represented a major break in the functioning of the monetary arrangement.

Summing up, the attempts to introduce novelties to make the EMS more symmetrical than the Snake failed, and this led to an EMS that, in terms of the definition of the system (fluctuation bands and intervention rules), was virtually identical to the Snake. However, there were some concessions regarding the particular conditions of each country in the system (wider fluctuation bands) and the mechanisms available to defend the parities (extension of credit facilities, realignments and use of capital controls). According to Kaelberer (2001), Germany eventually accepted these concessions in order to grant the participation of high inflation countries in the EMS, since these elements ended up being crucial for them in the negotiations (extension of credit mechanisms for France and wider bands and realignments for Italy). However, Germany rejected getting to a compromise in any matter that could affect its monetary autonomy and, therefore, the symmetry of the system.

The fact that the system could have been much more symmetrical was apparent before the EMS was launched. For example, in 1978, Pierre Werner pointed out the implications of using bilateral exchange rates to define intervention rules and stressed the lack of effectiveness of the EMCF: “La prétention de mettre l'ECU au

centre du système est donc atténuée par le maintien de la grille de taux pivots, reprise du système du serpent. De part et d'autre de ces taux-pivots seront fixées les marges de fluctuation de 2,25 %. On constate les fluctuations d'une monnaie par rapport à l'autre et non par rapport à l'ECU. [...] D'autre part j'aurais préféré qu'on eût d'ores et déjà donné des compétences au Fonds Européen, préfiguration du système communautaire de banques centrales, pour la coordination effective de la politique de liquidité du système monétaire, de l'harmonisation de la politique du crédit, des taux d'intérêt et de change".¹²

1.5 Conclusions

The final design of the EMS ended up being very similar to that of the Snake. In spite of the attempts of high inflation countries to introduce features to force a more symmetrical functioning of the system, their proposals were not accepted. Consequently, the outcome of the negotiations was a system whose functioning was not as symmetrical as these countries wished. The features that would have rendered the functioning of the system more symmetrical, namely the ECU as the basis for intervention rules and the creation of a true European Monetary Fund, were never endorsed. The elements that defined the system and determined its symmetry (definition of the margins of fluctuation, intervention rules and management of credit facilities) did not fulfil non-Snake

¹² Pierre Werner, *Reflets économiques. 20e anniversaire de l'ADUSEC. 1977-78, n° XIV-XVe années*. Luxembourg: Editions ADUSEC. "Le Système monétaire européen. Son fondement. Ses chances", p. 27-31.

countries aspirations. The only concessions made to these countries were related to the conditions of their own participation in the system (wider fluctuation bands) and the mechanisms to defend the parity (credit facilities, realignments and capital controls), but not regarding the definition of the system.

When comparing the two alternative designs for the EMS (ECU vs. parity grid), it is possible to conclude that the functioning of the system could have been more symmetrical than it ended up being. However, this does not necessarily mean that the design was asymmetrical. From a strict point of view of the design, it was not asymmetrical: there was no explicit election of the Deutsche mark as the *numéraire*. It was the lack of concretization of some aspects and the existence of a certain degree of discretion in interventions (marginal interventions were compulsory, but there was an extensive use of intra-marginal interventions), together with the control by the Bundesbank, as Germany was the largest surplus country, of the credit available, what led to an asymmetrical functioning of the EMS. In all, this was the result of the hegemonic position of Germany, not of the system design.

Symmetry of a monetary system is not a binary category. It is possible to establish different degrees of symmetry or asymmetry. The main difference of the final design compared to the alternative option based on the ECU is that intervention rules based on a basket of currencies would have imposed Germany a more symmetrical pattern of interventions and would have eliminated some discretion in the system. Moreover, a multilateral mechanism to finance

interventions would have eroded the Bundesbank's centrality in the system. The asymmetry of the EMS was the result of the inability of non-Snake countries to convince other countries to introduce elements that would have imposed symmetry in its functioning, as well as the lack of concretisation of the elements that were not clearly defined in the agreement, in particular, the creation of a multilateral institution to manage financing facilities for interventions, which never came into being. This allowed the Bundesbank to maintain discretion, which rendered the EMS functioning asymmetrical. Asymmetry in the functioning is revealed by the different intervention patterns in Germany and in the rest of countries, the fact that the Bundesbank assumed the responsibility of managing the exchange rate of the dollar, the evolution of interest rates, and the diverse use of capital controls in different countries.

The lack of definition of some of the important elements of the EMS led to a change in the functioning of the system along time. Two changes altered the functioning of the EMS in a fundamental way. The first is the change in the pattern of realignments. Initially, they were very frequent and compensated, at least in part, the differentials in inflation rates, but, progressively, they became less frequent and smaller. This change in the patterns of realignments is connected to the elimination of capital controls, because countries could not isolate their financial systems before realignments to prevent speculative pressures any more. The removal of capital controls forced countries to use interest rates more actively to support the peg of their currencies. With these transformations, the

EMS turned progressively into a much more rigid system that operated under the German hegemony and imposed other countries severe adjustments.

The Snake was the starting point for the EMS negotiations. High inflation countries, such as France, Italy or the United Kingdom, which had been forced to leave the Snake, demanded mechanisms to make the new monetary arrangement more symmetrical and considered the lack of symmetry of the Snake the cause of their inability to maintain their currencies in the system. One of the main advantages of the EMS for these countries was the stabilization of exchange rates. With a symmetrical system, they would be able to achieve this objective with minor costs in terms of restrictive policies and institutional reforms. For that reason, during the negotiations they argued that it was necessary to introduce elements of symmetry to make the new monetary arrangement substantially different from the Snake. In particular, their main requests were the creation of a basket of currencies to be used as the *numéraire* of the system and the reference for intervention criteria and the creation of a multilateral institution to manage credit facilities for interventions. With these features, the definition of the new system would have been fundamentally different from the Snake and would have imposed a more symmetrical functioning, since this would have obliged Germany to intervene to correct the expected appreciation of the Deutsche mark and would have eliminated part of the discretion in interventions.

High inflation countries were unable to convince Germany to accept any of these elements, as they would have threatened its domestic monetary autonomy, and obtained concessions only in the mechanisms to defend the parities, but not in the definition of the system. This German capacity to oppose any feature that would have imposed a more symmetrical functioning of the EMS reveals a bigger bargaining power. For high inflation countries, the introduction of a certain degree of symmetry to guarantee that the EMS was fundamentally different to the Snake was a necessary condition to join the system. However, those demands were never attended.

To sum up, the outcome of the EMS negotiations poses two main questions: Why was Germany able to impose its preferred option in the design of the system? Why did high inflation countries accept a design which was far from the requisites they considered indispensable and was practically the same of the system they abandoned just a few years earlier? Chapter two addresses the first question and analyses the EMS negotiation process, which was led basically by two main actors, the German and the French governments. Chapter three and four analyse high inflation countries decision of joining the EMS, in spite of the fact that the outcome of the negotiations did not satisfy their demands. Chapter three studies the case of Italy, and Chapter four the case of Ireland. In both cases, governments played a negligible part in the negotiations and the final design was far from the requisites indispensable to them. Both governments, after the Brussels European Council, requested some additional time to make their decisions, a period in which there

were intense debates in both national Parliaments on this topic. In both cases, the final decision was to join the system.

2. THE SOURCES OF THE GERMAN BARGAINING POWER

2.1 Introduction

The symmetry of the new monetary system was at the core of the discussions, and the different countries had conflicting stances on this regard. The objective of this chapter is to analyse the negotiations leading to the launching of the new system, paying attention not only to the European level, but also to the domestic debates, in order to determine which country was more able to influence the final design of the system so that the outcome of the negotiations fulfilled its preferences more. I will assess the bargaining power of each country in the EMS debates and examine the factors that might explain it using a general bargaining theory approach. The sources used in this chapter are the European documentation and proposals at the negotiation, and the resolutions approved by the European Council. Since, as I will argue, the domestic debates between the German Federal government and the Bundesbank were crucial to determine the negotiation stance of the German government, I will also use Bundesbank documentation.

This analysis of the different proposals and stances and the final agreement approved in the Brussels European Council will lead me to conclude that the system final design met all the requisites that Germany and in particular the Bundesbank deemed imperative. The

study of the negotiations under a bargaining theory approach also leads to the conclusion that there were three crucial factors that explain the bigger German negotiation power: the existence of an alternative agreement, which acted as an inside and outside option, the cost of breaking the negotiations and the distribution of this cost, and the previous commitment of the German government to a negotiation stance (which was imposed by the Bundesbank). The role and status of the Bundesbank is crucial to explain why Germany had more bargaining power than other countries. By that time, the Bundesbank was the most independent central bank in Europe, both in terms of legal and actual independence. The relationship between the Bundesbank and the German Federal government was unique in this period and was the result of German second post-war institutional architecture and the historical success of the Bundesbank in the fight against inflation. The capacity of Germany to impose its preferred option led to a system that, in terms of costs and benefits of participating in the system, was much more beneficial to Germany than it was to other countries.

This chapter is organized in four sections. Section 2.2 explains the stances of the two main actors participating in the negotiations, France and Germany, their main discrepancies on the new system and the final agreement they reached, which was clearly conditioned by the German stance. Section 2.3 analyses the factors which conferred the German government more bargaining capacity, allowing it to impose its stance on the most relevant aspects affecting the symmetry of the new system. The Bundesbank role is crucial to explain this strength. Section 2.4 explains the particular

characteristics of the Bundesbank, both in terms of its legal status and real independence, and compares it to the Banque de France, which did not have a similar role during the negotiations, even if France was the other main actor. The uniqueness of the Bundesbank prominence in this period is crucial to understand its role during the EMS negotiations. Finally, after concluding that Germany was able to impose its preferred design, section 2.5 shows how the functioning of the system was particularly beneficial for the German economy, allowing this country to improve its competitiveness at the European level without major costs in terms of loss of monetary autonomy or inflationary pressures. On the other hand, France was forced to implement restrictive economic policies with a high social cost in order to make its participation in the new system sustainable.

2.2 Conflicts about the design of the new system

The negotiations leading to the launching of the EMS were led by France and Germany. Although decisions were endorsed at the European level, in the framework of the European institutions, the core of the bargaining process to define the rules of the new monetary arrangement occurred in bilateral meetings between the French and German governments. Before the Communitarian negotiations started, many of the most relevant issues had already been previously discussed and agreed in these bilateral summits. The most paradigmatic example of this negotiation strategy is the Giscard d'Estaing-Schmidt meeting in Aachen, the 14 and 15

September 1978, in which the two leaders defined the basic aspects of the eventual design of the new system, establishing the adoption of the parity grid as the basis for intervention rules and the use of the ECU to create an indicator of divergence. This is what would be essentially endorsed in the Brussels European Council¹³. While all along the process France and Germany carried the weight of the negotiations, other countries like Italy or Ireland played a very minor role and were only able to obtain some minor concessions related to their own participation in the system.

Both France and Germany had incentives to promote monetary cooperation in the framework of the EEC, although their motivations and their preferred design for the EMS were different. In the case of France, besides the poor inflation records and the negative impact of exchange rate volatility on trade and investment during the 1970s, the government was particularly concerned about the division that the Snake created among EEC countries. To the French government, this was an evidence of the German structural power in the EEC. Moreover, this instability in exchange rate threatened the progressions towards market integration and altered the functioning of the Common Agricultural Policy (Kaelberer 2001). In order to compensate the effects of the shift in exchange rates on the functioning of the CAP, the Monetary Compensatory Accounts were created. However, these MCAs increased the cost of the CAP up to unsustainable levels. Therefore, the only way for the

¹³ Bulletin of the European Communities. December 1978, No 12. Luxembourg: Office for official publications of the European Communities. "Resolution of the European Council of 5th December 1978 on the establishment of the European Monetary System (EMS) and related matters".

French government to preserve a common market for agricultural products was to limit fluctuations in exchange rates (Apel 1998, Giavazzi and Giovannini 1989, Aldcroft and Oliver 1998). In a press release of 1978, Prime Minister Raymond Barre supported the progressive dismantlement of the MCA, which could only be achieved with the exchange rate stability provided by the EMS.¹⁴ Additionally, the failure of Keynesian economic policies and the emergence of a new consensus around the pre-eminence of low inflation over employment and growth as the priority of economic policies, together with the example of the German success with restrictive monetary policies, also contributed to foster a change in the policies applied by the French government (McNamara, 1998).

During the 1970s, President Valéry Giscard d'Estaing supported the French return to the Snake and the implementation of austerity programs. However, Prime Minister Jacques Chirac feared that the consequences of these policies would increase the support to the Socialist Party and decided to apply an expansionary economic program. The failure of this plan triggered the shift to restrictive policies at the end of the 1970s. In that context, France seemed more willing to accept the discipline imposed by the EMS and to tolerate more unemployment in exchange for price stability and international competitiveness (McNamara 1998).

Raymond Barre, appointed Prime Minister and Minister of Finances in 1976, reoriented economic policy towards price stability and

¹⁴ Raymond Barre, Hôtel Matignon press release on the European Monetary System (29 December 1978).

implemented an anti-inflationary program. Both Giscard d'Estaing and Barre were convinced that France needed the EMS to achieve domestic economic policy goals. On the other hand, the Socialist and the Communist Parties, as well as the main trade union, the CGT, were against the EMS (Frieden 2001). In fact, Chancellor Helmut Schmidt reckoned in a meeting in the Bundesbank that it would have been impossible to reach any agreement on monetary cooperation with François Mitterrand: "I say very softly: with Mr Mitterrand, I would not have dreamt of bringing forward such a proposal".¹⁵

On the other side, in spite of its success in controlling inflation, Germany had also powerful incentives to promote monetary cooperation. During the second half of the 1970s, the Snake offered a framework of certain exchange rate stability for Germany, but the continuous divergences even among the Snake members forced the revaluation of the Deutsche mark in October 1976, and again in October 1978, with respect to the other Snake currencies. According to Gros and Thygesen (1998), the concern about an excessive appreciation of the mark explains the German aspiration to stabilize intra-European exchange rates. Germany expected to improve competitiveness and to reduce the effects of the fluctuation of the US dollar and the Japanese yen (Giavazzi and Giovannini 1989). Regarding the German need to improve competitiveness of exports, the *Frankfurter Allgemeine Zeitung* highlighted the

¹⁵ Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS), 30 November 1978, Bundesbank Archives (N2/267). Translated by Margaret Thatcher Foundation (www.margaretthatcher.org).

German attempts in this concern: “Valéry Giscard d’Estaing needs an instrument to discipline his own economy and sees political advantages in the downward movement of the dollar. Helmut Schmidt wants to bring the mark out of the firing line and secure German exports within the Community, which account for half of the country’s total exports”.

The situation of the dollar was, in fact, a turning point in Germany’s approach to monetary cooperation, since it persuaded Chancellor Helmut Schmidt of the need to find a common solution to the fast decline of the dollar (James 2012, Murlon-Druol 2012, Aldcroft and Oliver 1998). Chancellor Schmidt was very dissatisfied with American monetary policy, which he judged absolutely irresponsible, and the German government was not willing to adjust domestic conditions to the inflationist pressures coming from the United States. Schmidt was convinced that the creation of an area of monetary stability would persuade the United States to change the direction of their monetary policy. Another reason for the German government to promote a monetary arrangement in the EEC was to avoid the perverse effects of the exchange rate fluctuations on the functioning of the Common market. According to Schmidt, floating exchange rates were a fundamental change in the original conditions of the creation of the Common market and would affect its operation. Finally, political considerations were also important. For Schmidt, France and Germany had to be in the same monetary area if these two countries expected to be the core of the EEC. A proper functioning of the Common market and a politically and economically strong EEC

were crucial to ensure the German influence in international affairs.¹⁶

In Germany, the main detractor of the EMS all along the negotiation process was Otmar Emminger, the governor of the Bundesbank. The main reason to oppose the EMS was the risk of inflationary tensions and the loss of monetary autonomy. The Bundesbank opposed any arrangement which could erode its autonomy or entailed the creation of a new source of liquidity through the foundation of a new currency or a new monetary institution.

Although the French and German governments' commitment to monetary cooperation and the personal understanding between the two leaders contributed to the agreement, there were fundamental discrepancies about the characteristics of the new system. These disagreements were conditioned by the experience with the Snake, in particular, in the case of France, since the inability of some countries to maintain the peg of their currencies created a division in the EEC among Snake and non-Snake countries. The main aspect of controversy was the symmetry of the system.

All along the negotiation process, President Giscard d'Estaing requested a system that avoided the tensions generated with the Snake. In his memories, the French president explained that when he discussed with Schmidt about the EMS, he stood for a new arrangement different from the Snake: "Le même serpent ne renaît

¹⁶ Helmut Schmidt, Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS), 30 November 1978, Bundesbank Archives (N2/267). Translated by the Margaret Thatcher Foundation.

pas deux fois! L'expérience était concluante: nous ne réussirions pas à faire fonctionner un système monétaire européen aussi longtemps que les monnaies les plus faibles devraient supporter seules le poids du maintien de l'écart, pendant que les monnaies fortes continueraient de caracoler en tête, sans souci de savoir si elles étaient suivies par le reste du cortège. Il faut imaginer une autre formule".¹⁷ President Giscard d'Estaing also insisted on the need for a monetary arrangement in Europe which included all EEC currencies, to avoid the division created by the Snake.

However, the French request of symmetry met the radical opposition of Germany, in particular the Bundesbank. Early in the negotiations, Giscard became aware of the impossibility of convincing the Bundesbank to accept any concession that could entail a more symmetrical system. Once it became clear that Germany was not going to accept any feature which would impose a symmetrical functioning of the EMS, Giscard was ready to renounce to his requests. Since that very moment, France, and other countries such as Italy, concentrated their efforts during the negotiations in achieving minor triumphs.

The French surrender in the battle for symmetry occurred in the meeting of President Giscard d'Estaing and Schmidt in Aachen in September 1978. In that summit the French government abandoned the option of the ECU to define intervention rules and accepted the Belgian compromise, which consisted in the adoption of the parity

¹⁷Valéry Giscard d'Estaing, *Le pouvoir et la vie*. Volume 1: *La rencontre*. Paris: Compagnie 12, 1988, p. 142-145.

grid as the basis for intervention rules and the use of the ECU to create a divergence indicator. The Aachen meeting represented a turning point in the negotiation and, in fact, the solution adopted in Aachen was finally approved in the Brussels European Council of December 1978. From that moment on, the French and German stances on the design of the system started converging. After the Aachen bilateral summit, the negotiations were centred on secondary aspects which had a very small impact on symmetry, such as credit facilities, the divergence indicator, the width of the fluctuation band or the transfers that some countries were bound to receive in exchange for their participation in the system.

Summing up, the two main actors of the negotiations had the same interest in exchange rate stability but had conflicting priorities in the design of the new system. For Germany, in particular for the Bundesbank, the priority was to maintain the independence of monetary policy. For France, symmetry was the most important requisite for the EMS. These two objectives were irreconcilable and the German victory in this conflict was absolute. In every element which would have imposed a more symmetrical functioning of the EMS, the German position, and more precisely, the stance supported by the Bundesbank prevailed: intervention rules based on bilateral exchange rates, no reserve pooling or multilateral credit facilities and no compulsory interventions originated by the divergence indicator.

Therefore, Germany proved to have more bargaining power in the negotiations and the result was a system whose operation was more

asymmetrical than it would have been if the French proposals had been accepted. France and other countries like Italy or Ireland were only able to obtain minor concessions regarding the extension of credit facilities, wider fluctuation bands, realignments or transfers of resources. None of these elements could impose a symmetrical functioning of the EMS. However, they turned out to be the core of the stances of these countries during the negotiations once the battle for symmetry was lost. Extension of credit mechanisms became France's main request; a wider fluctuation band was the most important condition for Italy; and transfers were crucial for the Irish participation. Germany was able to shape the framework of the negotiations, imposing asymmetry as a non-negotiable feature of the system and turning other minor issues into the focus of the bargaining process. Eventually, Germany consented to these requests in order to guarantee the participation of these countries.

2.3 Germany's (Bundesbank's) capacity of imposing the basic features

During the negotiations leading to the EMS, Germany was able to define the framework of the bargaining process, establishing what aspects were non-negotiable and in what aspects there could be concessions. Therefore, Germany had a decisive role in the definition of the final design. This German capacity to influence the process of negotiation is the result of a bigger bargaining capacity.

According to Muthoo (1999), in general, the bargaining power of an actor in a negotiation depends on several factors. The first is

impatience: if one actor is more patient in relation to another, its bargaining power is bigger. The second factor is risk aversion. In any negotiation, there is a risk of breakdown of the negotiation due to exogenous and uncontrollable factors. The bargaining power will depend on risk aversion, since the most risk adverse player will try to minimize the risk of breakdown. Another factor is the existence of an outside option, which conditions the credibility of the threats of not getting to an agreement. The outside option is the payoff obtained if there is no agreement. If this option is attractive enough, it will increase the negotiation power of that actor. The inside option, this is, the payoff obtained during the period in which players disagree, also determines the negotiation power. The larger the payoff of the inside option, the more negotiation power the player will have. Tactical commitments adopted by players before or during the bargaining process, through which they commit themselves to a specific stance, also increase bargaining power. These commitments are partial, since they can be revoked, but revoking them has a cost. If the costs of revoking the commitment are large enough, the player will ameliorate its negotiation capacity. Asymmetrical information determines the outcome of the negotiation too. If one of the players does not have relevant information or receives it with a delay that entails a cost, there is a risk of failure of the negotiations. Besides, the player with access to more and better information improves its bargaining capacity. The procedures and format of the negotiation are important too. Being the player making offers instead of accepting them reinforces the bargaining position of that player. Reputation also improves the

negotiation stance of players, and the actor with a poor record in bargaining frequently has less capacity to succeed in a negotiation. Finally, social pressure or public interest can also block negotiations, unless the process is confidential, except in the cases in which transparency is compulsory.

In the particular case of the EMS negotiations, the first factor of the German bargaining power is the existence of an alternative arrangement, the Snake, which was relatively successful for the German goals. Germany's both inside and outside option was the Snake, which was in force during the negotiations and would continue existing in the case of a failure in launching the EMS. Therefore, Germany was already taking part of a monetary arrangement that contributed to certain stabilization of the exchange rates with important trade partners and, in addition, was centred on the mark. It is true that during the functioning of the Snake, there was an accumulation of differentials in inflation and the Bundesbank was forced to intervene to support the North European countries currencies. These interventions, if they were not sterilized, produced inflationary tensions. Eventually, the differentials in inflation led to the "Frankfurt realignment" on the 17 October 1976, in which the Deutsche mark was revaluated against the other Snake currencies (Eichengreen 2008). As a consequence, the maintenance of differentials in inflation forced the introduction of certain flexibility in the Snake, so that this system was not able to provide exchange rate stability any more. The problems of the Snake encouraged the German government to seek an alternative arrangement. However, in spite of the problems this system had

since 1976, the German results in terms of inflation and exchange rate stability in the framework of the Snake were much better than the French results after leaving the system. During the second half of the 1970s, the French government was particularly concerned about the consequences of the floating exchange rates and growing inflation. As a result, monetary stability became one of the main priorities of the government, in particular after the appointment of Raymond Barre as Minister of Finances in 1976.

Consequently, the cost of not reaching an agreement was bigger for France than for Germany. The fact that the government was convinced of the need of the EMS to achieve domestic price stability is one of the reasons why the French government took the initiative of monetary cooperation during that period. In fact, as early as in 1972, Giscard d'Estaing wrote a letter to the President of the European Commission to create a coordination group to design a common strategy to fight against inflation: “Je vous propose donc de réunir dans les plus brefs délais le groupe de coordination des politiques économique et financière à court terme que nous avons créé dans le cadre de la résolution sur l'Union économique et monétaire, pour procéder à un examen de la situation des prix dans nos différentes économies, et des modalités possibles d'une action d'ensemble”.¹⁸ “Fear of floating” during the 1970s encouraged French officials to present several proposals to seek monetary cooperation. In the case of Germany, the interest in an EEC monetary arrangement grew at the end of the decade, in particular

¹⁸ Lettre de Valéry Giscard d'Estaing au président de la Commission européenne (1 septembre 1972).

due to the depreciation of the dollar and the problems of the Snake. In order to be successful, the system needed the German participation, since it was one of the main trade partners and the country with lowest inflation.

Another reason that explains the bigger German bargaining power is the different cost of breaking the negotiations and the distribution of this cost. Since monetary cooperation was a big concern and priority for the French government and, additionally, the government considered the EMS as the mechanism to achieve that objective, the cost of breaking the negotiations was bigger for the French government than it was for the German government. Moreover, not only the cost of breaking the negotiations was smaller, but the burden of this cost was also distributed differently. The two main actors of the negotiation were the two countries' governments. However, in the case of Germany, the Bundesbank influenced heavily the debates, suggesting alternatives and vetoing some of the proposals. The Bundesbank was, by far, the most unfavourable actor to the EMS, while the German Federal government was much more prone to make concessions. In fact, President Giscard d'Estaing himself realized since the very beginning of the negotiations that the Bundesbank was much less willing to accept a symmetrical system than the Federal Chancellor. In his memories, he wrote: "Le gouverneur de la Bundesbank, Otto Emminger, est hostile au projet. Il ne veut pas se trouver placé devant l'obligation d'agir pour soutenir des monnaies faibles en vendant des deutsche marks, ce qui risque d'alimenter l'inflation en Allemagne. Son point de vue est partagé par la quasi-totalité des

banquiers allemands”. When Schmidt asked Giscard d’Estaing if the Banque de France might be reluctant to the project, Giscard d’Estaing answered that “les autorités monétaires françaises se laisseront plus facilement persuader que les vôtres. D’ailleurs, c’est finalement notre intérêt. La vraie difficulté se pose pour l’Allemagne”.¹⁹ Consequently, if negotiations broke, the Bundesbank would be considered responsible and would assume the largest part of the cost. As an independent actor, the Bundesbank was free from political pressures. It also enjoyed a big reputation within the German society thanks to its historical success in maintaining price stability in the long term (Holtfrerich 1988), which protected the institution from criticisms. In the case of France, the government, and in particular President Giscard d’Estaing, the leader of the negotiations, would have to assume the whole cost of breaking the negotiations. The Banque de France not only was quite favourable to the project, but its governor, Bernard Clappier, worked under the direction of the government, as part of the French delegation, to reach an agreement.

Lastly, the institutional design of the German monetary policy and specifically the high degree of independence of the Bundesbank increased the German Federal government bargaining capacity, since it acted as a previous commitment to a certain bargaining strategy for the Federal government. As previously explained, the adoption of previous commitments increases the bargaining power. Bundesbank independence had this effect. Since the Bundesbank

¹⁹ D’ESTAING, Valéry (1988), *Le pouvoir et la vie*. Volume 1: *La rencontre*. Paris: Compagnie 12, 1988. 401.

could veto the agreement, the other governments were aware that the German government could not accept any provision that radically conflicted with the Bundesbank stance. As the other governments knew the limits that the Bundesbank imposed to the German government, they adapted their strategy of negotiation accordingly, bargaining only on features that they knew that the Bundesbank could finally accept. The Bundesbank's stance was clear: the new monetary arrangement could not restrict monetary autonomy or provoke inflationary pressures. Other features of the system could be negotiated and some concessions could be made if necessary. As a result of this previous commitment, the German government was much more able than other governments to get a favourable agreement.

The influence of the Bundesbank in establishing the limits of what the German Federal government could negotiate became evident in different stages of the negotiation process. There were crucial moments during the discussions about the final definition of the features of the new system in which the Bundesbank clearly determined the framework of the negotiation process. The first intervention of the Bundesbank took place after the Bremen European Council of July 1978. The conclusions of the Council established that the ECU would be at the centre of the new system. However, the specific interpretation of this statement remained open. The influence of the Bundesbank was determinant in setting the precise definition of intervention rules. In a discussion paper presented in September 1978 to prepare the debate in the Bundesbank Council, it was affirmed that intervention rules based

on a basket of currencies would force the Bank to intervene much more than a system based on a parity grid. The paper also stated that the option of the basket “stigmatized” the divergent currency. The right to adjust unilaterally the parity, the voluntary exit from the system and the suspension of intervention were considered essential. It was also claimed that it was important to establish a strict limit in the credit facilities (Neuman 1999). Consequently, the interpretation of the Bundesbank of a system based on the ECU consisted in the creation of a parity grid using the ECU and the establishment of intervention criteria grounded on bilateral exchange rates. Intervention rules defined in relation to the central parity in ECUs were radically rejected. This became the position of the German government, as well as the option finally endorsed in Aachen in the Giscard d’Estaing-Schmidt bilateral meeting of September 1978.

In Aachen, in order to convince France to accept the system based on the parity grid, the creation of a divergence indicator was proposed. The Bundesbank again conditioned the negotiations by defining the limits of what the German government could accept with respect to the implications of the divergence indicator. The Council of the Bundesbank, held on the 16 November 1978, approved only a limited use of the divergence indicator and excluded any obligation to take measures associated to this

indicator. The decision was communicated by letter to the German Chancellor.²⁰

In the last stage of the negotiations, the limits that the Bundesbank imposed to the government regarding the EMS were established in an exchange of letters between the President of the Bank Council and the Chancellor in November 1978 and in a meeting that was held in the Bundesbank on the 30 November 1978. Although it was already decided that intervention rules would be based on bilateral exchange rates, the Bundesbank still had some concerns and reservations. In the letter of 16 November 1978 sent by Otto Emminger, president of the Council of the Bundesbank, to Chancellor Schmidt, Emminger detailed the specifics about the functioning of the EMS approved by the Council of the Bundesbank. Emminger also requested that any agreement should be approved under the Article 236 of the EEC Treaty or under an inter-State agreement. Additionally, according to the Bundesbank, any regulation approved under Article 235 of the EEC Treaty should safeguard the autonomy of the Bundesbank.²¹ That point was important for the Bundesbank, since regulations under Article 236 required the ratification of all Member States, while regulations under Article 235 were enacted by the EEC Council.²² Lastly,

²⁰ Letter of the President of the Bundesbank to Chancellor Schmidt 16th November 1978, Bundesbank Archives (N2/267), Translated by the Margaret Thatcher Foundation.

²¹ Letter of the President of the Bundesbank to Chancellor Schmidt 16th November 1978, Bundesbank Archives (N2/267), Translated by the Margaret Thatcher Foundation.

²² Treaty establishing the European Economic Community and connected documents. Luxembourg: Publishing Services of the European Communities, [s.d.]. 378 p. "Treaty establishing the European Economic Community", p. 5-183.

Emminger also called for an assurance that the Federal government would protect the autonomy of the Bundesbank when monetary stability was threatened, suspending the duty of intervention if necessary. This exemption, frequently called “the Emminger letter”, is summarized as follows: “The monetary policy autonomy of the Bundesbank can be endangered in certain ways, if excessive intervention obligations arise from severe imbalances in the future EMS whereby internal monetary stability is threatened. This would make impossible the fulfilment of the statutory task of the Bundesbank. With reference to several verbal assurances from the Federal Chancellor and the Federal Finance Minister, the Bundesbank assumes that the Federal Government will protect the Bundesbank in such a case from a predicament of that kind, either by a correction of parities in the EMS or, if necessary, by an at least temporary release from the duty of intervention”.²³

With the purpose of discussing the possibility of suspending the Bundesbank’s duty of intervention and other details of the final design of the EMS, Schmidt was summoned to a meeting in the Bundesbank. For the Bundesbank, a basic prerequisite to accept the EMS was to specify the interpretation of one of the clauses of the Monetary Committee report that stated: “The temporary abandonment of the defence of the margin must be regarded as a precaution for a case of emergency. It is the last resort. For it to be possible for a country to fall back on this procedure, the grounds for its adoption must be fulfilled, that the releasing factors are of a

²³ President of the Bundesbank to Chancellor Schmidt 16 November 1978, Bundesbank Archives (N2/267), Translated by the Margaret Thatcher Foundation.

temporary nature. However, a situation could arise in which these factors are irreversible. In this case, the country in question would come back with another level of exchange". Emminger wanted the guarantee from Schmidt that this clause meant that the Bundesbank could be released of the duty to intervene if monetary stability was at risk. Schmidt replied that such a provision could not be included in the agreement, since it would provoke political tensions with other governments, but reasserted that the Bundesbank could interpret the clause as a possibility to stop intervening if interventions threatened monetary stability. Therefore, although this assurance was not included in the agreement, the Bundesbank obtained the "secret" guarantee from the government that the Bank could maintain certain discretion to decide to stop interventions if considered that monetary stability was threatened. In addition, the Bundesbank also wanted to make sure that realignments of the parities would always be a possibility to redress disequilibria. The members of the Bundesbank Council requested Schmidt to assure them that Giscard d'Estaing agreed on that topic. To them, it was crucial that while differentials of inflation existed, devaluation should be a mechanism of correction.²⁴

The implications of the divergence indicator were again tackled at the meeting. Emminger requested a formulation that granted that reaching the divergence threshold would not necessarily entail any obligation to negotiate or to take any measure. In particular, he wanted a formulation "to guarantee that, neither directly nor

²⁴ Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS), 30 November 1978, Bundesbank Archives (N2/267). Translated by the Margaret Thatcher Foundation.

indirectly, will it be stipulated that there is an obligation to negotiate whenever these deviation thresholds or divergence thresholds, – as the new expression has it – are reached, rather than that there even then remains the possibility of doing nothing. That one indeed gives a couple of reasons for so doing, but has no need of a great procedure, that the situation does not require a negotiation. That is all. We do not want a quasi-automatic obligation to come into being or that the thing will be so formulated that, when a country is convinced that there is nothing to negotiate, that no special measures are needed, this country must exculpate and excuse itself like a defendant, so to speak, and have to make a big thing of it. If some such neutral formulation were successfully to be found here, which made clear that not negotiating is just as much an option as negotiating, then this point would be resolved to our satisfaction”.²⁵ Emminger wanted to include the possibility of correcting parities as one of the options related to the divergence indicator. He also radically rejected compulsory interventions in dollars. Schmidt confirmed that it was already established that reaching the divergence threshold would only lead to consultations. After this, there would be four options available: doing nothing, make changes in domestic economic policies, take an intra-marginal intervention and make changes in central parities. Schmidt also explained to the members of the Bundesbank Council that, at a meeting with Giscard d’Estaing, Barre and the governor of the Banque de France, Bernard

²⁵ Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS), 30 November 1978, Bundesbank Archives (N2/267). Translated by the Margaret Thatcher Foundation.

Clappier, it was resolved that doing nothing would be an option. Emminger accepted that formulation.

Another of the preoccupations of the Bundesbank, the creation of a European Monetary Fund, was also discussed at the meeting. The Bundesbank insisted on the fact that the potential creation of this Fund should be considered an experiment, nothing permanent. Similarly, the ECU as a new mean of payment should not be established definitively. Initially, the ECU should be used only as an instrument for settling balances between central banks. It was crucial, according to the Bundesbank, to introduce some clauses to have the possibility of revoking any decision taken with respect to the reserve pooling, for example, having the possibility of claiming back part of the reserves deposited.²⁶

Summing up, the restrictions that the Bundesbank imposed to the German government were four: First, intervention rules under the EMS should be grounded on marginal bilateral rates; second, the Bundesbank should be allowed to stop interventions which might potentially threaten domestic monetary stability; third, reaching the divergence threshold should not entail compulsory measures; and fourth, the creation of a European Monetary Fund should be considered an experiment, something not necessarily permanent. In short, the final design of the EMS should not affect German monetary autonomy. These restrictions conditioned the position of the German government during the negotiations. For the

²⁶ Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS), 30 November 1978, Bundesbank Archives (N2/267). Translated by the Margaret Thatcher Foundation.

Bundesbank Council members, it was important to make clear to other countries that the Bundesbank standpoint was also the view of the government. At the meeting, they requested Schmidt “to convey our partners the impression that this is not just the stance of the Bundesbank, but that the Federal Government stands right behind it, and that full agreement exists between the Federal Government and the Bundesbank, as is indeed the case”.²⁷

Exchange rate policy and the participation in exchange rate agreements are competences of the government. However, it would have been difficult for the German Federal government to adopt a decision with the absolute opposition from the Bundesbank. This capacity of the Bundesbank to veto a government decision that could have an incidence on monetary policy was the consequence of its very particular status within the German institutional architecture.

2.4 The decisive role of the Bundesbank: differences in institutional design of monetary policy

The Bundesbank was able to decisively condition the stance of the Federal government and, consequently, the final design of the system. This situation contrasts with the role of other central banks during the same process, in particular, with the case of France, the other protagonist of the negotiations. Contrarily to what happened in Germany, in France, Bernard Clappier, the governor of the

²⁷ Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS), 30 November 1978, Bundesbank Archives (N2/267). Translated by the Margaret Thatcher Foundation.

Banque de France, was part of the French delegation during the discussions and worked under the direction of the French government. The main reason why the Bundesbank had this influence on the government and the final design of the system, while other central banks did not, is its status within the German institutional design and its high degree of independence.

Central bank independence is normally approached from two perspectives: the degree of legal independence (granted by legislation) and the degree of actual behaviour independence (the real capacity of the central bank to implement an independent monetary policy free from government pressures). At the end of the 1970s, the Bundesbank was much more independent than the rest EEC central banks.²⁸ This independence was not only the result of differences in legislation, but also differences in the political tradition, the institutional design and the relative historical success in the management of monetary policy.

The Bundesbank has its origins in the Landeszentralbanken, the central banks of the Landers created during the Allied occupation, and the Bank deutscher Lander (BdL), the bank created as the coordinator of the Landers' central banks. The BdL was designed as a decentralized institution, with a federal committee on economic and monetary issues and independent from the Federal government. In 1957, the BdL and the Landeszentralbanken merged to create the Deutsche Bundesbank and the regional central banks became delegations of the newly created central bank. The Bundesbank Act

²⁸ See, for example, Goodman (1991), Maier and De Haan (2000).

of 26 July 1957, in Article 12 “Relationship of the Bundesbank with the Federal government”, established that: “The Deutsche Bundesbank is compelled to support the general economic policy of the Federal Government while assuring its mission. It is independent of instructions from the Federal Government the exercise of its powers under this Act.”²⁹ Article 3 “Mission” of the Act defined the task of the Bundesbank: “The Deutsche Bundesbank, by means of the monetary policy powers it is entitled to exert under this law, regulates the circulation of money and the credit supply of the economy with the aim of safeguarding the currency, and ensures bank-based settlement of payments both domestically and abroad”.³⁰ This Bundesbank mission of safeguarding the currency is unique in Europe and the USA (Kennedy 1991) and is an evidence of the importance of the principle of monetary stability in the German political culture.

On the contrary, the Banque de France appears as one of the less independent in international comparisons and its legal autonomy before 1993 was very weak (Blancheton 2014). Before 1914, the Banque de France, although it was not independent in the strict sense of the term, had a certain room of manoeuvre and, in the interwar period, it was able to exert influence and demonstrated its “independence” under a left-wing government. However, in 1936, under Léon Blum’s government, the State assumed the exclusive control of the Bank. In 1945, during the government of Charles de Gaulle, the bank was formally nationalized. From that moment on,

²⁹ Bundesbank Act, 26 July, 1957. Article 13.

³⁰ Bundesbank Act, 26 July, 1957. Article 5.

the Bank became totally depended from the Ministry of Economy and Finances. During the 1950s and the 1960s, the relationship between the State and the Bank led to an effective reduction of the influence of the Bank in economic and monetary policies (Bouvier 1988). In 1973, a new legislation that regulated the mission and function of the Banque de France was approved. In the discussion about this law, the Bank's governor, Olivier Wormser, requested more autonomy for the Bank, while the French government insisted on the subordination of the Bank to the Ministry and the government. Eventually, a compromise was reached. According to Article 1 of the Law, the Banque de France "receives from the State the general mission to watch over money and credit".³¹ Consequently, the State held monetary power but delegated it to the bank. Article 4 defined the functions of the Bank. It stated that: "The Banque de France is empowered to give advice on all questions relating to the currency. It contributes to the preparation and participates in the implementation of the monetary policy adopted by the Government".³² Therefore, the Banque de France participated in the process of decision making, but the Ministry had the last word. It was not until the new Law of 1993 that the Banque de France became truly independent.

Not only the legal status of central banks was different, but also diverse political traditions and institutional designs explain the different power of the Bundesbank and the Banque de France. In Germany, although formally the Bundesbank is not a branch of the

³¹ LOI N° 73-7 sur la Banque de France (du 3 janvier 1973). Article 1.

³² LOI N° 73-7 sur la Banque de France (du 3 janvier 1973). Article 4.

constitutional powers, the principle of monetary stability is almost a constitutional principle. Since the Bundesbank had the statutory mission of safeguarding the currency, it became almost a fourth constitutional power whose mission was to protect the currency (Kennedy 1991 and Holtfrerich 1988).

The historical success of the Bundesbank in price stability also contributed to consolidate this view of the Bundesbank as part of the Constitutional architecture of the country. Reputation is a crucial factor to explain the power of the Bundesbank. Independence was granted not only through the legal status of the Bundesbank, but also through the prestige of the institution. Although sometimes Bundesbank independence was seen as a Constitutional provision, in fact it could be modified with a conventional law. Besides, the Bundesbank capacity of action was restrained by the election of the exchange rate, the definition of fluctuation bands, or any other provision regarding the participation in any monetary arrangement, which were government decisions. Additionally, even though the Bundesbank was autonomous from the government, the Federal Government had certain ascendancy on it: directors were appointed by the Federal President according to a government's proposal, members of the cabinet had the right to attend the meetings of the Bundesbank Council (they could not vote but could make proposals) and the government could suspend temporarily a Bundesbank decision (this was not a real power but a suspension could send a message). On the other hand, the Bundesbank did not have an equivalent institutional power on the Federal government economic policy. The Bundesbank had the

right to be consulted on economic matters and had also the obligation to support the government economic policies (Kennedy 1991).

Therefore, although the Bundesbank Act granted a high degree of independence, much higher than other central banks, the government had certain influence on the Bank's decisions. Consequently, reputation and the historical success of the Bundesbank in price stability, which enhanced the prestige of the Bank among the German society, were crucial to grant a larger autonomy than it was effectively conceded by legislation (Quaglia 2007). The German legislation did not have any provision for the cases of conflict between the Bundesbank and the Federal government. The capacity of the Bundesbank to impose its stance in moments of conflict with the government was decisive to reinforce its effective autonomy. One example of these cases of conflicts is the disagreement between Chancellor Konrad Adenauer and the President of the Bundesbank, Wilhelm Vocke, on the interest policy of the Bank in 1955. Adenauer tried to admonish the Bank, but the response was categorical. Another example took place at the beginnings of the 1960s when, after the full convertibility of the mark, inflows of capital produced inflationary tensions. The president of the Bundesbank, Karl Blessing, was in favour of revaluation, but Adenauer opposed it. In these cases of conflict, the Bundesbank tended to use a rhetoric that placed the emphasis on its obligation to "safeguard the currency" (Kennedy 1991). Other arguments that were used to defend the stance of the Bundesbank were that the government and the Parliament should not finance

deficits through money issuing (which in the past ruined the value of the currency) and that it is better to have independent experts than politicians managing monetary policy, since politicians have incentives to inflate for electoral purposes (Holtfrerich 1988). Along history, the Bundesbank has appealed to the German constitutionalism to justify that the Bank was in a better position than governments, and has confronted the Bank expertise and concern for the public welfare to the government partisan interests. During the 1970s, the Bundesbank's prestige increased substantially thanks to its success in controlling inflation. This reputation reinforced the arguments in favour of its independence against those who questioned it.

Therefore, although the government had mechanisms to influence the Bundesbank's decisions (exchange rate policy, capacity of suspending decisions, or even reforming the Bundesbank Act), the reputation of the Bank, based on its success in fighting inflation as well as its capacity to impose its judgement over the government in moment of disagreement, forced the different German governments to accept the Bank's interpretation of its statutory mission of protecting the currency as a Constitutional principle. According to this interpretation, the Bundesbank absolute and unique priority was to fight inflation (even the concept of a slight inflation is alien to the Bundesbank). The acceptance of the goal of safeguarding the currency as a Constitutional principle and the view of the Bundesbank as almost a Constitutional power made the reform of the Bundesbank Act very unlikely (Kennedy 1991).

The political philosophy of the German federal structure and constitutionalism contrasts radically with the French republican tradition, which influenced the French approach towards monetary policy and central bank independence. In France, not only the Banque de France was very dependent from a legal point of view, but also the idea of central bank independence had very little acceptance in society, since it was perceived as contradictory with the Republican values. In fact, before 1991, none of the majoritarian political parties supported this idea. According to Howarth (1999), French aversion towards central bank independence is based on several factors. The first lies on the Republican tradition. French society disagreed with the idea of an independent institution not subject to democratic controls being responsible for monetary policy, which had important consequences for the whole society. The second has to do with the relationship between monetary policy and economic policy. Most of the French policymakers believed that monetary and economic policies could not be separated. Monetary stability should not be pursued independently from other goals. This contrasts with the German view of price stability as a categorical imperative related to the maintenance of law (citizens have the right of a stable currency). Third, from an academic point of view, French researchers questioned the relationship between price stability and central bank independence. They believed that anti-inflation policies did not necessarily require an independent central bank. Finally, the Treasury was concerned about the possibility that an independent central bank could reduce its political and institutional power. In fact, the Treasury had a direct

control on monetary policy and dominated credit provision until the liberalization of financial markets in 1985 (Howarth 2009). The negative judgement of central bank independence among the majority of the French society and political agents contributed to maintain the Banque de France as a very dependent institution under the control of the government until 1993, the moment in which the advances towards the European Monetary Union forced a reform of the French central bank.

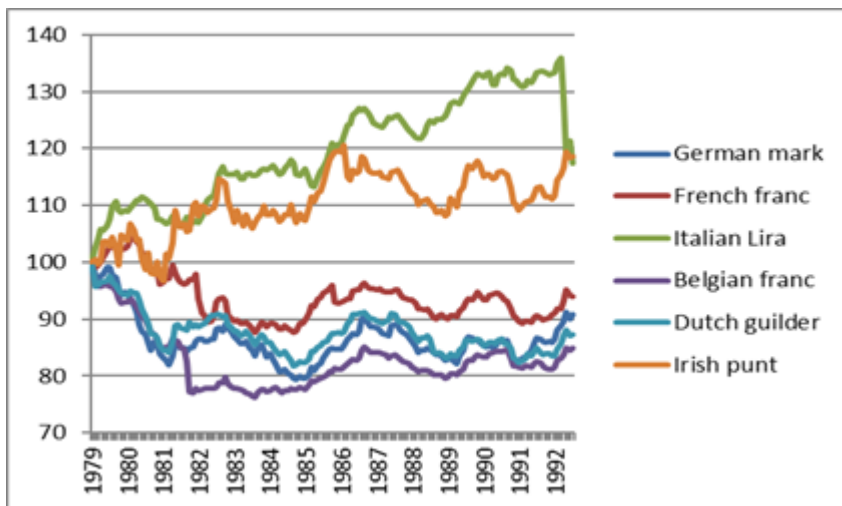
Summing up, the exceptional status and the high degree of independence of the Bundesbank, based not only on its legal definition, but also on the German political tradition and the Bank's reputation on behalf of its success in keeping price stability, explain the capacity of the Bundesbank to shape and define the framework of the negotiations of the EMS. The Bundesbank established what aspects were not negotiable (all the features affecting domestic monetary autonomy) and in what aspects the German government could make concessions. The German Federal government had to adhere to these limits imposed by the central bank, since it was very difficult for a government to take relevant decisions affecting monetary aspects with the opposition of the Bundesbank. On the other side, the role of the Banque de France during the negotiations was totally different. Bernard Clappier, its governor, worked under the orders of the government providing technical assistance. The Banque de France had no influence in determining the position of the government.

2.5 The advantages of the EMS for Germany

The bigger bargaining power of the German government, attributable to a large extent to the status and role of the Bundesbank, led to a final design of the EMS system which fulfilled German preferences. The success of the German bargaining strategy can be measured in terms of the cost and benefits of the system for Germany, compared to the other countries, and, in particular, France, which was the other main actor. For Germany, the main expected benefit of the EMS was the stabilization of the exchange rates, with the objective of improving competitiveness and fight the excessive appreciation of the Deutsche mark. The main potential cost was the loss of autonomy and the risk of importing inflation from the other countries of the system. For high inflation countries, such as France, the main advantages were the stabilization of the exchange rate and the anti-inflationary effects, thanks to potential gains of reputation. The main costs were the loss of competitiveness and the tensions in the balance of payments and the need for restrictive economic policies in order to support the fixed exchange rate. An analysis of the functioning of the system shows how Germany was able to benefit from the potential gains of the EMS without negative consequences in terms of inflationary pressures or loss of control of monetary policy, while other countries suffered deterioration in their competitiveness and were forced to implement restrictive measures to make the peg sustainable. The reduction of inflation was attained, but required unpopular measures and reforms.

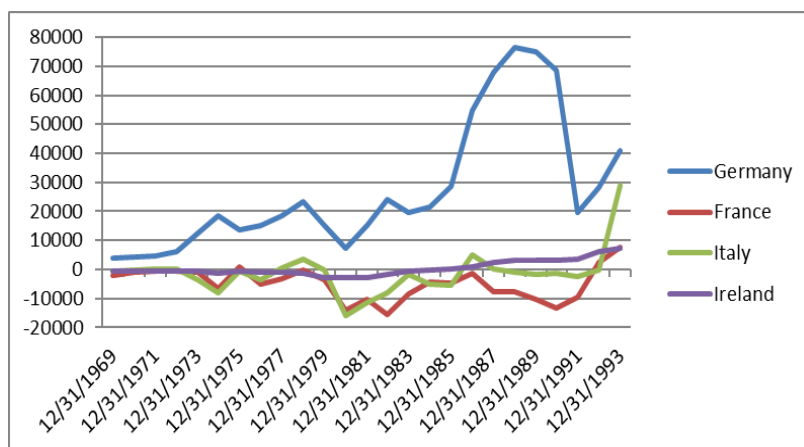
The capacity of the German government to block any of the proposals which would have forced a more symmetrical functioning of the system led to an EMS that provided substantial advantages for Germany. Since Germany was the country with the lowest inflation and, although realignments were allowed, they did not compensate entirely the differentials in inflation, the German competitiveness improved. This led to a fast increase in the German trade surplus, in particular after 1986, when realignments became less frequent and the EMS became implicitly a fixed exchange rate system (see figures 2.1 and 2.2). So, one of the major concerns of the German government, the excessive appreciation of the mark (Gros and Thygesen 1998), was tackled thanks to the EMS.

Figure 2.1. Real effective exchange rates, 1979-92 (1979=100)



Source: Bank for International Settlements

Figure 2.2. Balance of Payments Goods Surplus/Deficit, 1969-93 (USD)

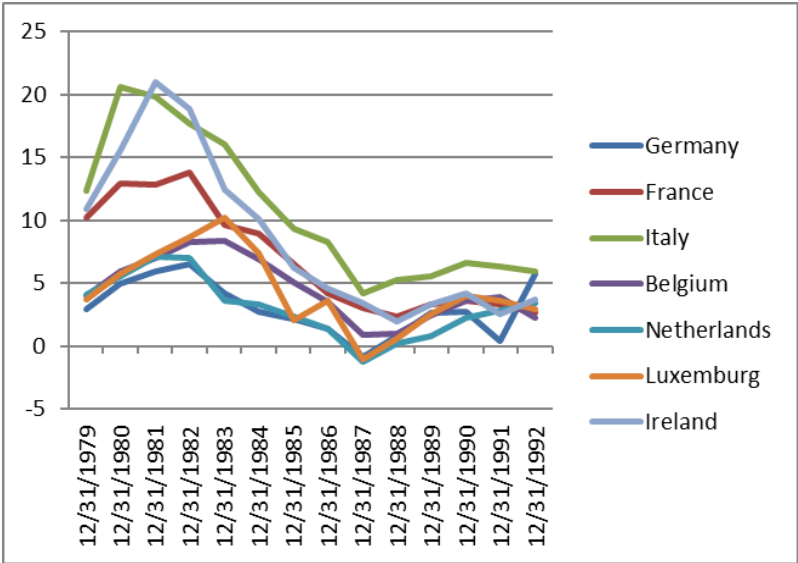


Source: Mitchell, B. R., *International historical statistics: Europe, 1750-2000*, New York: Palgrave Macmillan

On the other side, the main worry of the German government and the Bundesbank, the potential loss of autonomy of monetary policy and the risk of inflationary tensions never happened. Thanks to the asymmetrical functioning of the EMS, the cost for Germany in terms of intervention obligation ended up being much smaller than it would have been in a more symmetrical system. Thus, the EMS did not entail an increase in the German inflation rate. On the contrary, other countries tended to converge to the German levels (see figure 2.3). The concessions that Germany made, namely the extension of credit mechanisms, realignments, larger fluctuation bands or side payments did not have a real cost in terms of competitiveness for the German products. Wider fluctuation bands or side payments had no impact on competitiveness. Realignments could have led to a deterioration of the German balance of payments if other countries had used changes in the central parities

to regain competitiveness. However, since realignments never compensated the differentials in inflation entirely, Germany was able to keep the improvements in competitiveness resulting from its lower inflation rate. After 1987, when the system moved to a *de facto* fixed exchange rate system, there was a considerable increase in the German trade surplus. Finally, even if credit mechanisms were extended in comparison to the Snake, they continued being bilateral credit lines between central banks, so the Bundesbank could control the effects of the intervention on money supply and sterilized the effects of those interventions to a large extent. Additionally, these credit lines ended up being infra-used due to the prevalence of intra-marginal interventions, which could not resource to the credit facilities before 1987.

Figure 2.3. Inflation rates, 1979-92



Source: Mitchell, B. R., International historical statistics: Europe, 1750-2000, New York: Palgrave Macmillan

To sum up, the EMS contributed to a clear improvement of the German competitiveness, which resulted in a large increase in trade surplus, in particular after 1986-87. These EMS benefits for Germany did not entail costs in terms of loss of monetary autonomy or inflationary tensions. The concessions that Germany was forced to make to guarantee the other countries' participation did not cause relevant costs.

Conversely, the asymmetrical functioning of the EMS had relevant costs for high inflation countries in terms of the need to adopt austerity programs to make the pegs sustainable. In the case of France, the other main actor of the negotiations, the Giscard d'Estaing-Barre government objective of controlling inflation and reducing volatility of exchange rates was achieved, although there is debate if the determinant factor was EMS membership or the reforms introduced during the 1980s. Since the start of the EMS, the competitiveness of the French products deteriorated and tensions in the balance of payments emerged, imposing the need for substantial reforms to defend the parity of the franc.

In 1981, Françoise Mitterrand won the elections. The new government was headed by Pierre Mauroy and there were some members of the Communist Party in the Cabinet. The franc had depreciated 12% with respect to the Deutsche mark. Inflation rate continued rising and there were some realignments. At that very moment, the French government had to choose between monetary rigour or leaving the EMS. The Communist Party, the pro-Communist trade union CGT and some sectors of the Socialist Party

were against austerity and supported devaluation and leaving the EMS. Mouroy's faction of the Socialist Party was in favour of staying in the EMS, even if this meant austerity. Mitterrand's faction of the party was in a mid-way between these two stances.

In March 1983 France was suffering severe tensions in foreign reserves and was forced to devalue. Mitterrand had to take a decision about EMS membership. Eventually, he decided to devalue and stay in the system. In his statement to the French, he justified his decision arguing that he did not want to isolate France from the rest of Europe. Besides, he argued that this would serve to fight unemployment, inflation and external deficit (Védrine 1996). According to Lionel Jospin, two factors determined Mitterrand's decision: the fact that leaving the EMS was a drastic measure without any guarantee of success in the correction of the trade balance, and his ambition to advance towards a *grande politique européenne* (Védrine 1996). From that moment on, the consensus on anti-inflationary policies and the EMS seemed to consolidate in France and the credibility of the French commitment with the EMS increased (Frieden 2001).

Thus, France achieved the objective of stability of prices and exchange rates. However, the EMS generated a loss of competitiveness and triggered important tensions, which forced the French government to adopt measures of rigour in order to make the peg sustainable. A more symmetrical functioning of the EMS probably would not have entailed such big costs in order to stabilize the exchange rate.

2.6 Conclusions

The two main actors participating in the process of negotiation of the EMS, France and Germany, had very different capacity of determining the final result of the bargaining process. Germany was able to impose its stance in the majority of aspects considered crucial, this is, any feature which determined the degree of symmetry in the functioning of the system. For the German leaders, the preservation of domestic monetary autonomy was a non-negotiable condition, and this request was incompatible with the French demand of a symmetrical system. The main factor which explains the bigger German bargaining power during the process is the status of the Bundesbank within the German institutional architecture. Although it did not participate directly in the negotiations, the Bundesbank had a decisive incidence in the stance of the German Federal government and also ameliorated the bargaining position of the German representatives *vis à vis* other governments' delegates.

The German government had already an advantageous position in the negotiation with respect to the French and others governments thanks to the good results in managing inflation during the 1970s and the position of the German balance of payments. The deplorable results in terms of monetary stability urged high inflation countries to reach an agreement that necessarily had to include Germany. Furthermore, Germany was already participating in a monetary arrangement, the Snake, which would continue to be in force in the case of failure of the EMS negotiations. Although the

Snake started suffering tensions during the second half of the 1970s, the German results in the framework of this arrangement were much better than those of France, Italy, the United Kingdom or Ireland, who were forced to abandon the Snake and performed awfully in terms of price stability and exchange rate volatility. Therefore, for these countries, reaching a European solution for monetary cooperation was much more compelling than it was for Germany. These factors placed Germany in a much better bargaining position.

Beside the factors which allowed Germany to have this advantageous position to negotiate, the role of the Bundesbank was decisive in obtaining an agreement that was particularly beneficial for Germany. The Bundesbank played two important functions for the German government: it would assume the cost of breaking the negotiations in case of disagreement, and it compelled the Federal government to a specific stance during the bargaining process. The Bundesbank was able to undertake both roles thanks to its high degree of formal and real independence and the reputation it enjoyed among the German society.

With respect to who would assume the cost of breaking the negotiations, in the case of France, the government placed a great importance to the creation of the EMS as a mechanism to achieve domestic economic policy goals, and took the initiative in the negotiations. Thus, the failure in reaching an agreement would have had a high political cost. In the case of Germany, since the German Federal government was much more willing to make concessions than the Bundesbank, which was very reluctant to the EMS, in the

case of a breakdown of the negotiations, the Bundesbank would assume the largest part of the responsibility.

In relation to the German government bargaining strategy, the Bundesbank set the framework of the negotiations, determining which aspects could be negotiated and the limits of what the German government could accept. The Bundesbank capacity to veto an agreement that did not observe those limits, as well as the fact that the other countries were aware of this veto power, allowed the German government to impose its stance in the discussions and to influence decisively the final outcome of the negotiations. On the contrary, at that time, the Banque de France was one of the most dependent central banks and its political influence during the negotiations was very small, and subordinated to the French government objectives.

The conditions that the Bundesbank imposed to the German Federal government were the following: intervention rules should be defined on the basis of the bilateral exchange rates, the Bundesbank should be allowed to stop interventions if the objective of price stability was at risk, the divergence indicator (based on the ECU) should not entail any obligation, and no multilateral credit instruments should be created. With the only exception of the possibility of stopping interventions, the final design of the EMS met totally the Bundesbank conditions. With respect to the only requisite not included in the agreement, the Bundesbank obtained a “secret” guarantee from the Federal government that the bank could stop interventions if considered that domestic stability was

threatened. Therefore, the Federal government allowed the Bank to “violate” the aspect of the agreement that was against its stance.

In all, the different institutional designs of monetary policy and, in particular, the status of the central bank, affected decisively the bargaining power of the respective governments during the negotiations and, therefore, the final result. The independence of the Bundesbank is a crucial factor to understand the outcome of the negotiations leading to the EMS, since the German central bank was able to set the rules of the bargaining process and was ready to assume the cost of the breakdown of the negotiations instead of the government. As a result of the higher bargaining power of the German government, the final design ended being very advantageous for Germany in terms of gains of competitiveness with a minor cost in terms of intervention obligation, risk of inflationary tensions or loss of autonomy of monetary policy. On the other hand, France was forced to introduce severe reforms in order to achieve the monetary rigour required to make the peg sustainable.

3. THE ITALIAN DECISION OF JOINING THE EMS: EXCHANGE RATE COMMITMENT AS A POLITICAL ARGUMENT IN FAVOUR OF INSTITUTIONAL REFORMS

3.1 Introduction

The 5 December 1978, when the agreement of the European Monetary System (EMS) was signed by six of the nine members of the European Economic Community, Italy, as well as Ireland, requested for some additional time to take their final decision, whereas the United Kingdom decided to stay out of the system. Shortly after, the 12 December 1978, the Italian government announced that the country would join the EMS. The reason for the Italian government not to sign the agreement immediately was that the final design of the system did not meet the conditions deemed essential to ensure the sustainable participation of the country. Initially, the stance of the Italian government, headed by the Christian Democrat Giulio Andreotti, was that Italy was not going to join the system unless it was substantially different from the existing one, the Snake (which Italy withdrew due to the impossibility to sustain the parity of the lira), entailed a symmetrical distribution of the burden of adjustment, and included mechanisms of financial aid and cooperation. But the Italian government played a very minor role during the process of negotiation, since the relevant advances towards an agreement were made in bilateral or trilateral meetings in which Italy did not participate. Eventually, the design

failed to fulfil the Italian requests and Italy was only able to obtain some minor concessions related to the particular conditions of its participation in the system, but not concerning the general design. Therefore, for Italy, the choice was either entering a system that was far from its requests or staying out. Eventually, the Italian government reversed its initial stance and decided to join the EMS. This poses the questions of what were the factors that led to this change in the stance of the Italian government and what were the reasons for Italy to enter a system that was essentially the same it had abandoned a few years before.

In order to examine the Italian government's decision to join the EMS, I will analyse the stance of the Italian government during the European negotiations to explain to what extent the Italian demands were not satisfied. The sources used are the European documentation and resolutions from the European Council and discourses and statements of the members of the Italian government in the Parliament and the Senate and in the press. After the Brussels European Council, there was an intense debate among Italian politicians and social groups on the convenience of joining the system, even if the outcome of the negotiations was far from the Italian preferred option. In order to assess the positions of the different domestic actors and the main reasons to support or oppose the EMS, I will analyse Parliamentary debates and government documents, the publications of the Banca d'Italia, academic articles by Italian scholars, and the generalist newspaper *Il Corriere della Sera*.

Literature has suggested different explanations for the Italian decision of joining the EMS, based on factors such as the optimization of monetary instruments to reduce inflation, the outcome of the confrontation between interest groups or partisan competition and political strategies to stay in office, or the general sympathy for European integration and expectations of further advances (see, for example, Giavazzi and Giovannini 1989, Frieden 2001 and Bearce 2003).

After the analysis of the Italian debate, I will argue that, in the dreadful circumstances of fast acceleration of inflation, the loss of control of money supply, growing unitary labour costs and economic stagnation of the second half of the 1970s, EMS membership was the mechanism that some Italian scholars and policymakers used to impose institutional reforms that, although very unpopular, they considered crucial to address the problems of the Italian economy, in particular inflation. During the second half of the 1970s, in the framework of the generalization of floating exchange rates, there was an intense theoretical debate in Italy on the causes of inflation and the use of monetary instruments. This led to the emergence of an academic and political elite which started supporting the need for a change in the approach to the management of monetary policy. This elite lacked the political and social support to implement these new policies, but found in the EMS a strong argument to support the reforms they proposed. The two big reforms of that time tackled the two main sources of inflation that accelerated the vicious circle of inflation-depreciation during the period of floating exchange rates of the 1970s: cost-push inflation

(generated by growing labour costs) and monetization of the deficit. These reforms were the reform of the *scala mobile* (the mechanism of wage indexation) and the “Divorce” of the Banca d’Italia and the Treasury, which removed the obligation of the central bank to purchase unsold Treasury bills and stopped the automatic monetization of deficit.

The chapter is organized in four sections. Section 3.2 reviews the literature on exchange rate decisions in the European and Italian case. Section 3.3 explains the Italian domestic debate about the convenience of participating in the European Monetary System, and analyses the stances of political parties and social groups about the system and how they changed once the design of the EMS was definitively set. Section 3.4 studies the debate that took place in the 1970s on the use of exchange rates as a tool of economic policy. Sections 3.5 and 3.6 analyse the two main reforms that tackled the two main sources of inflation, cost-push inflation and deficit monetization, and how the debate on these measures was connected to the EMS debate: Section 3.5 analyses the debate on the *scala mobile* and section 3.6 analyses the “Divorce” between the Banca d’Italia and the Treasury.

3.2 Exchange rate decisions in Italy

Exchange rate decisions have been analysed from very different perspectives, from the attempt to achieve monetary stability to societal preferences or partisan and electoral motivations. In Political Economy literature, fixed exchange rates and central bank

independence are considered alternative instruments to reach the objective of price stability.³³ The election of one particular monetary instrument over another is analysed according to the costs and benefits of each instrument for a particular government, the characteristics of the political system, and the preferences of interest groups. In this sense, according to this general analytical framework, the Italian decision of joining the EMS could be explained in terms of the election of the monetary instrument aimed at solving the problem of inflation that minimized the cost of achieving this objective. This is the approach of Giavazzi and Giovannini (1989) to explain the Italian decision of joining the EMS. According to these authors, the selection of a monetary anchor (money supply or fixed exchange rate) is irrelevant for the final result, but has important consequences during the process, since the cost of disinflation might be different for each case. A fixed exchange rate might be less costly in those cases where there is a substantial gap in the credibility of the different countries participating in the agreement. To them, the Italian adhesion to the EMS aimed at gaining credibility, borrowing reputation from the Bundesbank. This imported credibility reduced the cost of disinflation.

The notion of imported credibility is based on the idea developed by Kydland and Prescott (1977) and Barro and Gordon (1983), among others. According to these authors, there is a problem of time-

³³ For example, BERNHARD, W., BROZ, J.L. and CLARK, W.R (2002), BROZ J. L. (2002) analyse nowadays exchange rate decisions assuming that central bank independence and fixed exchange rates are alternative tools to achieve price stability.

inconsistence in monetary policy due to the fact that there are short-term incentives to increase the inflation rate above the expected level in order to stimulate output, although in the long-term it has negative consequences, because it results into a higher level of inflation than the optimal. The solution to the time-inconsistence problem is to commit to a fixed rule on inflation. In practice, such rules are difficult to apply and there is a trade-off between discretion, which allows certain flexibility, and fixed rules, which brings more credibility. There are several solutions to this problem, including pegging to another currency or delegating monetary policy to a “conservative” central banker. Therefore, according to Giavazzi and Giovanni (1989), by pegging to the mark, Italy enjoyed important reputational gains, which reduced the cost of disinflation.

However, in the case of European monetary integration, this theoretical framework, which assumes that countries have alternative tools to address the problem of time-inconsistence and credibility, does not explain exchange rate policies and central bank reforms properly. In the case of many European countries, from the late 1970s, fixed exchange rates and central bank independence do not seem to have been independent or alternative tools to reach the same objective. On the contrary, the election of a fixed exchange rate was the driving force of many institutional reforms in the management of monetary policy, including measures leading to more independent central banks. Both Italy and France embody this phenomenon. In both countries, it was the advancement of the process of monetary integration what accelerated central bank

independence. The process of disinflation was not only achieved thanks to the exchange rate commitment and imported credibility, but it was also the result of significant institutional reforms that affected monetary and fiscal policies, the role of the central bank, and the functioning of the labour market.

Exchange rate decisions in the framework of European integration and the creation of the Single Market can also be explained in terms of the partisan or group interests on weak vs. strong currency and the connection between advances in monetary cooperation and other fields of integration. Bernhard and Leblang (2002), assuming that internationalization reduces the autonomy and the capacity of governments to influence economic outcomes, conclude that in a context of growing international openness (for example, in the case of European integration), governments use exchange rate commitments to isolate a country from the consequences of internationalization. They observe that EMS participation prolonged the duration of governments.

Following a similar approach, Bearce (2003) analyses the exchange rate decisions as the outcome of conflicting interests under the Mundell-Flemming model, in which countries have to choose between monetary autonomy and stability of exchange rates. According to this author, producers of goods that compete with imports or of non-tradable products prefer autonomy of monetary policy, while export oriented sectors and international investors prefer exchange rate stability. Capital is not bounded to a country, so it prefers exchange rate stability, while labour, which depends

more on the domestic economy, prefers autonomy. Following this approach, Bearce concludes that one of the conditions for the construction of the European Monetary Union was the prevalence of right-wing governments and in fact he observes that the countries that stayed out of the EMU in 1999 were all of them ruled by left-wing governments.

On the other hand, Frieden (2001) explains the French and Italian exchange rate commitments and the decision of joining the EMS on the grounds of the connection between monetary cooperation and other areas of European cooperation. According to Frieden, the majority of the political parties and social groups in both countries were more pro-EEC than anti-strong currency. This is what led them to accept monetary rigour and a design of the EMS that was far from their preferences, because it was a condition to advance in other areas of European integration. Frieden (2002) claims that real factors were more important than monetary goals in the process of European monetary integration, and that there is very weak evidence of the use of the Exchange Rate Mechanism as an anti-inflationary tool. The incentives for high inflation countries, according to Frieden, were not related to price stability, but to the advances in other areas of cooperation and the positive effects of the EMS on trade and investment.

The experience of the negotiations leading to the EMS and the subsequent developments and reforms are however not consistent with those explanations. In the case of the EMS, although in many countries the decision of joining the system was taken by right-wing

governments (Giscard d'Estaing in France, Andreotti in Italy and Lynch in Ireland), the institutional reforms required to make the exchange rate sustainable were implemented by left-wing governments (Mitterrand in France and Craxi in Italy). When these governments found themselves facing the dilemma of either putting in place unpopular reforms or breaking the exchange rate commitment, they chose the former option. Besides, although EMS membership increased the duration of governments compared to the non-members (during the 1980s), in France, Italy and Ireland the political parties that took the decision of joining the EMS lost the following elections. Additionally, it is true that there were big expectations of progress in other fields, however, nothing specific was agreed in this regard. In fact, in the case of Italy, during the negotiations on EMS membership, many political parties, entrepreneurial groups and trade unions complained about the lack of agreements and advances in other areas of cooperation and the fact that the EMS did not entail any commitment in other fields such as industrial, agrarian or cooperation policies. This was precisely one of the arguments against the system. Considering that the majority of the Italian society protested about this lack of advances in economic cooperation, it is implausible that they supported joining the new monetary system, in spite of the costs that it entailed, precisely for that reason. Obviously, expectations of further advances could have played a role, but this does not seem consistent with the state of public opinion.

Talani (2000) adapts Frieden's model to the particular Italian historical reality and domestic debate during the late 1970s. To

Talani, the debate about the EMS was a mechanism for industrial and banking capital to shift the power struggle from the domestic to the European level to impose their preferred macroeconomic policies, at a moment in which there was a decline in trade union membership, but trade unions were still an obstacle to introduce institutional reforms, in particular regarding to wage setting. Talani's explanation is quite useful to understand how the EMS contributed, at least in part, to impose the reform of the system of wage indexation, which was the biggest political discussion of that period. Regarding the need for a reform of this system, the stances of the different agents were very clear and the confrontation between those who wanted to reform the system and those who wanted to maintain it had a strong presence in the public opinion.

However, Talani's approach does not explain properly the other major reform of the system, the introduction of a certain degree of central bank independence through the elimination of the obligation of the Banca d'Italia to purchase unsold Treasury bonds. In this case, the stances of the interest groups were not so well defined and, in fact, among the members of the majoritarian political party, the Christian Democracy (DC), there was no consensus on this issue. Actually, the way to make this reform, through a private agreement between the Banca d'Italia and the Treasury, without any Parliamentarian or Cabinet discussion, reflects the lack of support to the measure. Therefore, the approach based on interest groups cannot explain the approval of this measure, since there was a political majority against it.

3.3 The domestic debate about the Italian participation in the EMS

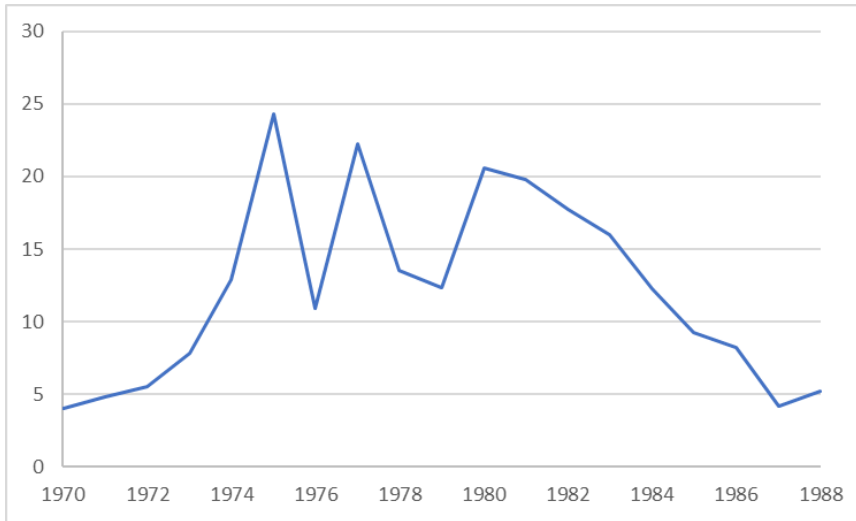
In order to analyse the Italian decision of joining the EMS, it is important to examine what were the demands of the Italian government regarding the definition of the system, and to what extent these demands were met. It is also pertinent to explain the stances of the different economic and social agents regarding EMS membership. The purpose of this chapter is to explain the position of the Italian agents on EMS, and how the opinions changed after the Brussels European Council, when the system was definitively arranged.

The major advancements in the definition of the features of the EMS took place in Franco-German bilateral meetings. The Italian government participated in the European Council negotiations and took part in some bilateral meetings, but had a negligible influence on the final design, and was only able to obtain some concessions regarding the conditions of Italian participation (the most important one, a wider fluctuation band). The Italian requests for the new system to be accepted were: symmetry, a fair distribution of the burden of adjustment, a system that ensured enough flexibility, sufficient credit mechanisms and the creation of a European Monetary Fund. The final outcome of the negotiations was far from the Italian demands. This left Italy with the decision of either joining a system that was expected to operate under the German hegemony and was very similar to the Snake or staying out.

An EMS that met the Italian basic conditions would have had a general support in Italy. The vast majority of the Parliament, business associations and trade unions would have been in favour of such a monetary agreement. The fact that the final design was so far from the Italian preferences is what triggered a split in the Italian public opinion on the decision of adhering to the system. There was a wide variety of stances inside the Parliamentary majority that supported the government, and also inside the different parties and the government itself. These different positions reflected not only ideological stances or the support to different interest groups, but also the diversity of theoretical approaches towards the management of economic policies and institutional reforms.

The debate about EMS membership took place in a particularly difficult economic environment. There was a deceleration of economic growth, an increase in unemployment and inflation was out of control (see figure 3.1). Italy was forced to leave the Snake in 1973 and, since then, the exchange rate of the lira had been very volatile. Besides the impact of the oil shocks, inflation rates were worsened by two reforms introduced in 1975. First, there was the reform of the Treasury Bonds market, which compelled the Banca d'Italia to purchase all Treasury bonds that were not sold in ordinary issuances. This reform led to a high degree of deficit monetization and the loss of control of money supply. Second, there was the reform of the *scala mobile*, the mechanism of wage indexation, which increased the lowest wages compensations for inflation and resulted in average wages which were indexed at more than 100% of the inflation rate, creating cost-push inflation.

Figure 3.1. Italian inflation rate, 1970-88



Source: ISTAT

The Italian political situation was also particularly intricate at the end of the 1970s. The 1976 election generated the most polarized results of the Italian history. The Communist Party (PCI) obtained its highest support in history, but did not surpass the Christian Democracy (DC). Eventually, a Christian Democrat government, led by Giulio Andreotti, with the Parliamentary support of the Communist Party, was formed. This government was known as the “governo monocolor di solidarietà nazionale” (national solidarity single-party government), but also as “governo della non sfiducia” (no distrust government), since it was created thanks to the non-opposition of the Communist Party and some other small parties. In January 1978 there was a government crisis when the Communist Party threatened to return to the opposition. However, after Aldo Moro’s murder in May 1978, the PCI accepted to let Andreotti form a new government.

In such a complicated economic and political environment, the introduction of economic reforms to address the main challenges of the Italian economy was very difficult. Right before the creation of the European Monetary System, the most relevant reform project was the Pandolfi Plan, a three-years plan designed by Filippo Maria Pandolfi, the Minister of the Treasury, and presented to the political parties and trade unions the 31 August 1978. The main objectives of Pandolfi's proposals were the reduction of government spending and the increase in labour productivity. The implementation of the measures included in the plan generated an intense debate in the Italian public opinion. This political instability and economic distress, together with the discussion on Pandolfi's economic measures, conditioned the debate on the convenience of the Italian participation in the new monetary system. This debate took place in two phases, before and after the EMS final design was definitively established. In the first phase, there was the expectation that the system would include some of the Italian requests regarding symmetry. In the second stage, it was already clear that the EMS design was going to be very similar to the Snake.

a) The debate before the final definition of the rules of the game

Andreotti's government was in favour of the Italian participation in the EMS, provided that the new system included the features considered crucial to ensure the sustainability of the lira exchange rate. The 10 October 1978, the Minister of the Treasury, Filippo Maria Pandolfi, summarized the Italian stance in the European

negotiations to the Parliament. At that time, the final design was still not defined and the British participation had not been discarded yet. In his account to the Parliament, Pandolfi referred to a system that included, at least in part, some of the Italian requests. Pandolfi highlighted the main advantages of the new system for Italy: most advanced economies would be forced to place more emphasis on measures to foster economic growth, the new system would encourage the consolidation of the European market, it would enlarge credit mechanisms to facilitate the fight against speculative attacks, and it would contribute to the control of inflation arising from the unjustified exchange depreciations. In his account of the advantages, Pandolfi was assuming the idea, expressed by economists such as Nino Andreatta, that part of the Italian inflation was originated by the depreciation of the lira in international markets, which increased the cost of imports and, since imports were relatively inelastic, increased inflation. Thus, a credible fixed exchange rate system would contribute to stabilize expectations on the evolution of the value of the lira and would contribute to reduce inflation. In spite of all this, according to Pandolfi, there were also risks for Italy: limitation in the use of the exchange rate, additional rigidities in the use of monetary and fiscal policies and deflationary tensions due to current differences among members.

Consequently, the Italian objective in the negotiations was to attain a favourable definition and functioning of the exchange rate mechanism, the creation of the European Monetary Fund and the concession of transfers for the less advanced economies. The Italian requisites for the new monetary system were the following: First, a

realistic and durable system (Italy could not possibly afford an exit from the system, which would predictably have disastrous consequences). Second, a system that included all the Communitarian currencies, in order to avoid further divergences in the economic performance of different countries. This referred not only to the need to find a system that brought together all EEC countries to avoid the creation of a two-velocity Europe, but also to the entrance of the sterling pound into the system, which was, according to the Italians, a guarantee that the EMS would not become a deflationary area. Third, the system should not be isolated or opposed to the international monetary system and other monetary areas, because one of the main concerns for Italy was that the EMS could be used as a tool to fight the depreciation of the dollar (one of the major worries of the German government in that moment), transforming the EEC into a deflationary area. Fourth, in case of deviation from central exchange rates, a balanced distribution of the cost of adjustment between deficit and surplus countries should be enforced. Fifth, it should guarantee an adequate degree of flexibility, not only with regard to the possibility of changes in the parities, but also regarding the width of the fluctuation bands. Sixth, the system should be supported by broader monetary arrangements, in particular the creation of a true European Monetary Fund.³⁴

When evaluating the two alternative models to define intervention rules which emerged after the Bremen European Council of July

³⁴ MP Filippo Maria Pandolfi (DC), Atti Parlamentari, Camera dei Deputati, p. 22050-22051, VII Legislatura, Discussioni, Seduta Antimeridiana del 10 Ottobre 1978.

1978, that based on the ECU and that based on bilateral exchange rates, Pandolfi focused the attention on the costs of each model for Italy. In the case of fluctuation bands defined in relation to the central parities in terms of ECUs, Pandolfi's main concern was that each currency had different weight in the calculations of the value of the ECU, according to the importance of their economies in international trade. Those currencies with more weight in the ECU would have more room for fluctuation in terms of their bilateral relationship with other currencies. Besides, there were some technical issues concerning the realignments of central parities, the width of the fluctuation bands and temporary exits from the system. The model in which fluctuation margins were defined on the basis of bilateral exchange rates was, according to Pandolfi, basically identical to the Snake. The only difference was that it would include all the Communitarian currencies and enlarged credit facilities.

In relation to the "compromise" solution (fluctuation margins defined on the basis of bilateral exchange rates and the creation of a divergence indicator based on the ECU), Pandolfi claimed that Italy would be in favour of such an option if the technical definition of the system met the Italian basic requisites. Specifically, this required fluctuation bands wide enough to guarantee flexibility and a divergence indicator that entailed the obligation to intervene in exchange markets and to introduce changes in domestic economic policies to correct divergences. In addition, the European Monetary Fund should have important operative functions. Essentially, Pandolfi stated that it was an unnegotiable condition for the Italian

participation that the new monetary arrangement was different from the Snake.³⁵

Pandolfi's *a priori* positive stance on the EMS, conditioned to the requisites mentioned before, was shared by the majority of the Italian political parties, trade unions and business associations. The Christian Democracy (DC) and the majority of the members of the Cabinet, with the remarkable exceptions of the Minister of Trade, Renato Ossola, and the Minister of Industry, Romano Prodi, who had some concerns about the real capacity of Italy to participate in the EMS, were in favour of the Italian adhesion to the new system. Both the Italian Communist Party (PCI) and the Italian Socialist Party (PSI), although they supported the EMS, were against a re-edition of the Snake. Luciano Barca, the head of economic affairs of the PCI, believed that the monetary agreement could be acceptable under the conditions of including all the EEC countries, not being a simple return to exchange rate rigidity and allowing autonomous domestic monetary policies. However, Barca complained that Schmidt proposals did not meet those conditions.³⁶ Fabrizio Cicchitto, the head of the economic section of the PSI, stated that, in addition to wider fluctuation bands, it was necessary to have specific mechanisms of adjustment for weak currencies in order to avoid speculative attacks, and maintained that the British

³⁵ MP Filippo Maria Pandolfi (DC), Atti Parlamentari, Camera dei Deputati, p. 22051-22053, VII Legislatura, Discussioni, Seduta Antimeridiana del 10 ottobre 1978.

³⁶ Barca (PCI) preoccupato per lo SME", *Il Corriere della Sera*, 10 November 1978, p. 13.

participation (or semi-participation) was fundamental.³⁷ The Italian Republican Party (PRI) was probably the least critical to the EMS and supported the Italian membership independently of the final design.³⁸ The main trade unions, following the stance of the European Trade Union Confederation (ETUC), believed that the EMS would be a positive agreement that would lead the EEC towards a monetary union, but, to them, a disguised re-edition of the Snake was not acceptable. Italian trade unions added a few conditions to accept the EMS: monetary mechanisms should be flexible enough to guarantee a fair and symmetrical distribution of the obligations among the different participants, an appropriate coordination of industrial policies, a rebalancing of agricultural policy, an enlargement of the resources of the Community and a consolidation of regional and social policies.³⁹ Luciano Lama, the general secretary of the Confederazione Generale Italiana del Lavoro (CGIL), stated that, although the trade union was in favour of the EMS, the final design of the system was crucial, since there were important aspects affecting the interests of workers still to be defined. According to Lama, these were not only technical issues, but important political decisions that should not be excluded from the debate.⁴⁰ Business associations also supported the EMS, but claimed that some conditions were required to guarantee a successful participation. For example, Paolo Savona, the general

³⁷ “Le perplessità del PCI e del PSI seguono Andreotti a Bruxelles”, *Il Corriere della Sera*, 4 December 1978, p.2.

³⁸ “Andreotti a Lussemburgo per lo SME”, *Il Corriere della Sera*, 11 November 1978, p. 11.

³⁹ I giudizi sullo SME”, *Il Corriere della Sera*, 30 November 1978, p. 12.

⁴⁰ Lama, Luciano, “Isolati a difendere la causa dei deboli”, *Il Corriere della Sera*, 2 December 1978, p.11.

director of Confindustria, argued that Italy needed to introduce some reforms to address the problems of labour costs and budget deficit, and that European institutions should deal with the crisis of the dollar. Savona regretted that none of these conditions were apparently going to be met in the next future.⁴¹

In spite of the general positive stances on the EMS among Italian political parties and interest groups, there were some critical voices. The most relevant was that of Paolo Baffi, the governor of the Banca d'Italia. Baffi, although he never opposed the project openly, was quite hostile since the beginning.⁴² He believed that it would be virtually impossible for the lira to stay in a fixed exchange rate system. Baffi was also quite doubtful about the possibilities of success of the EMS in general. He thought that the system would not last due to the big differences among the participants. Under the request of the Prime Minister, Baffi prepared a short report specifying the conditions in which Italy might join the system and, in this report, he placed all the emphasis on the possibility of enjoying a wider fluctuation band and the reception of some transfers of resources. In a meeting with Andreotti and Schmidt in Siena on the 1 November 1978, Baffi proposed the creation of two separated currency areas: the core of the system would be formed by Snake countries (and perhaps France), while other currencies would form a second "skin" of the Snake (a sphere of fluctuation). These two areas would be connected, allowing countries to leave

⁴¹ Savona, Paolo, "Purtroppo il prezzo del successo passa attraverso la stagnazione", *Il Corriere della Sera*, 2 December 1978 p.11.

⁴² Guateli, Arturo, "I tormenti di Giulio, i dubbi di Baffi, le urla di Ruggiero" in *Il Corriere della Sera*, 24 November 1996.

the “parking area” to join the Snake or to leave the Snake to enter the “parking area”.⁴³

This scepticism about the Italian capacity to maintain a fixed exchange rate was shared by the economist Mario Monti. Among academic economists, Monti was probably the most critical voice to the EMS. According to Monti’s calculations based on the purchasing power theory, in three years after the creation of the EMS, the lira would depreciate 32.7% with respect to the weighted average of EEC currencies, and 41.8% with respect to the German mark. The lira could depreciate even more, depending on other external circumstances. Consequently, if Italy maintained the differential of inflation, strong interventions would be required to preserve the fluctuation band of $\pm 6\%$. As a result, according to Monti, it was very risky to participate in the EMS. He believed that the country had only started the structural reforms it needed, and joining the EMS would require a drastic acceleration of those reforms, which could result unfeasible for Italy. Thus, the Italian accession might not be internationally credible. He claimed that the decision to join the EMS was premature and recommended delaying adhesion.⁴⁴ Monti was part of the group of economists who believed that Italy still needed the instrument of the exchange rate in order to correct unbalances and supported the need of important reforms before entering a fixed exchange rate.

⁴³ Glisenti, Paolo (1978), “Schmidt rassicura Andreotti: la lira verrà protetta nell’Europa monetaria” in in *Il Corriere della Sera*, 2 November 1978, p.1.

⁴⁴ Monti, Mario (1978), “Arduo con la nostra inflazione assumere vincoli di cambio”, in *Il Sole 24 Ore*, 5 December 1978.

On the other side, the most positive academic stance in favour of the EMS was Franco Modigliani's. In the framework of the debate about the role of the exchange rate as an instrument of economic policy, he supported the Italian incorporation to the EMS. To him, Italy needed to peg its currency to another currency, since the exchange rate was useless as an instrument because of the loss of control of money supply. Modigliani also disagreed on the idea that pegging the lira to the mark would entail a cost in terms of economic growth, considering that for Italy it was already impossible to avoid the consequences of a lower German growth rate, which reduced the German demand for Italian products, with an independent exchange rate policy. In addition, according to Modigliani, it would be easier to convince Germany to try to increase its growth rates being inside the system than from outside. Modigliani believed that the true decision that Italians had to take was not on EMS membership, but on economic and monetary policies: it would be possible to stay out of the EMS and endorse the decisions leading to price and exchange rate stability. Modigliani stated that those who were against the EMS were, in fact, unwilling to eliminate the mechanism of devaluation-inflation, which actually was based on the delay in the adjustment of wages to prices. The trade-off between unitary labour costs, unemployment and price stability was unclear. This delay in the adjustment actually served not to deal with that trade-off and postponing the accession to the EMS as a way to keep on the confusion.⁴⁵

⁴⁵ Modigliani, Franco (1978), "I pro e i contro per l'Italia", in *Il Corriere della Sera*, 1 December 1978 p.2.

To sum up, the majority of the Italian public opinion was in favour of the Italian participation in the EMS, provided that the new monetary agreement was different from the Snake and included some degree of flexibility and measures to encourage economic convergence of the less advanced economies. The most noteworthy adversaries to the Italian adhesion to the EMS (the governor of the Banca d'Italia, Paolo Baffi, the Minister of Trade, Renato Ossola, the Minister of Industry, Romano Prodi, and the economist Mario Monti) opposed the Italian EMS membership on the basis of the inability of the country to join successfully the system and the technical difficulties. In the Brussels European Council, in which the EMS was approved, Andreotti held a position consistent with this favourable public opinion under certain conditions. He stated that Italy did not want a reedition of the Snake, even if it was improved. According to the Prime Minister, transfers of resources to less developed economies were a basic element for the proper functioning of the system. Regarding the potential British decision to stay out of the EMS, the Italian government favoured an agreement that included all the members of the EEC.⁴⁶

When it became clear that the final design approved in the Brussels European Council was not going to satisfy the Italian demands and that the British would stay out of the system, Andreotti decided to postpone the final decision about the Italian adhesion and requested

⁴⁶ 1978 Dec 4 Mo Archive (TNA), EMS: Brussels European Council record of conversation (Session 1) (memorandum), Venue: Brussels, Source: PREM 16/1643.; 1978 Dec 5 Tu Archive (TNA), EMS: Brussels European Council record of conversation (Session 2), Venue: Brussels Source: PREM 16/1643, Reproduced in the Margaret Thatcher Foundation archive, available online, <https://www.margaretthatcher.org/archive>.

a period for reflection. The fact that the EMS did not introduce major innovations with respect to the Snake broke the general positive assessment among the Italian public opinion. At that moment, important disagreements about the convenience of joining the new monetary system emerged, and a new debate started.

b) The debate after the Brussels European Council

Immediately after the Brussels European Council, the discontentment of the different Italian political parties and social groups with respect to the outcome of the negotiations focused on the issue of transfers to less developed economies. Andreotti justified his decision of asking for additional time on the basis of the lack of solidarity of the other members and the closure of the discussions on the regional fund well below the expectations created at the Bremen European Council.⁴⁷ Pandolfi added that, besides the lack of solidarity, there were serious doubts, not only related to the measures of support to less developed economies, but also related to symmetry, intervention obligation, adjustment and credit mechanisms.⁴⁸ In spite of all these concerns and previous opinion that the EMS should not be a re-edited Snake, the majority of the members of the DC changed their opinion and argued that obstacles were surmountable and that Italy should not stay out. One of the strongest supporters of the EMS inside the DC was Senator Beniamino Andreatta, who insisted on the need to introduce some

⁴⁷ “L’Italia per ora non entra nell’Europa delle monete”, Andreotti chiede una pausa di riflessione alla CEE”, in *Il Corriere della Sera*, 6 December 1978, p. 1.

⁴⁸ “Pandolfi: ‘Non abbiamo trovato sufficiente solidarietà’, Andreotti chiede una pausa di riflessione alla CEE”, in *Il Corriere della Sera*, 7 December 1978, p. 1.

reforms, independently of the decision of joining the monetary arrangement, to promote the balancing of the Italian economy that the EMS would impose. Andreatta suggested the introduction of voluntary discipline in the exchange rate, the reform of the mechanism of wage indexation and freezing prices and wages for 6 months.⁴⁹

The PCI in general applauded Andreotti's decision of postponing the final decision. In an article published in *L'Unità*, the PCI newspaper, the government's decision was considered the result of an objective and responsible assessment of the possibility of participating in the EMS with enough guarantees.⁵⁰ Luciano Barca (PCI) recommended the option for Italy to wait together with the United Kingdom. Enrico Berlinguer, the general secretary of the party, after a meeting with Andreotti, claimed that the objective results of the Brussels Councils were not satisfactory enough to recommend entering the EMS. To Berlinguer, the minimum conditions for Italy to join had not been achieved in Brussels.⁵¹ The PSI shared this satisfaction with Andreotti's decision. They claimed that the situation of fluctuation and towing with respect to the dollar was not sustainable, but it was not a good idea to replace the dollar hegemony with that of the mark.⁵²

The only party that openly criticized the decision of not joining the EMS immediately was the PRI, since, according to them, EMS

⁴⁹ Ibid.

⁵⁰ *L'Unità*, 7 December 1978.

⁵¹ "I leader a consulto in Palazzo Chigi", in *Il Corriere della Sera*, 9 December 1978, p. 1.

⁵² Ibid.

membership was indispensable. Its leader, Ugo La Malfa, threatened to leave the Parliamentary majority if the government decided not to join the system.⁵³ The rest of the minoritarian parties, PSDI, PLI, DN, SVP and MSI had mixed opinions. On the one side, they disliked the final outcome of the negotiations, but, at the same time, were not willing to miss the opportunity and didn't want to adopt a stance that would isolate Italy from the rest of the Community and slow down the process of European integration.

Business associations were, in general, critical with the position of European leaders towards the Italian requests, but still supported the Italian participation in the EMS. On the other side, trade unions supported Andreotti's decision to wait and in general had a negative judgement on the adhesion to the EMS.⁵⁴

Summing up, after the Brussels European Council, the cohesion of the Italian public opinion on the EMS broke up and an intense debate started, once the final features of the system were defined. This debate started with Pandolfi's intervention in the Senate the 7 December 1978, where he supported a gradual entrance into the EMS, considering that it was not possible to get a better deal.⁵⁵ Senator Beniamino Andreatta, after a meeting with Pandolfi and other Christian Democrat MPs, stated that the Italian position in the negotiation had been achieved at 90%. According to Andreatta,

⁵³ "La Malfa: usciamo dalla maggioranza se il governo non accetta lo SME", in *Il Corriere della Sera*, 7 December 1978, p. 1.

⁵⁴ "Imprenditori e sindacati: Andreotti ha fatto bene", in *Il Corriere della Sera*, 7 December 1978, p. 11.

⁵⁵ De Stefano, Demetrio (1978), "Pandolfi al Senato per un'entrata "graduata" nello SME", in *Il Corriere della Sera*, 8 December 1978, p. 1.

Italy had two alternatives: an immediate accession and rapid application of the Pandolfi Plan or an accession with the suspension of the clause of intervention obligation (together with the other emergence measures to reform the wage indexation mechanism).⁵⁶ The majority of the Christian Democrat MPs endorsed the option of joining immediately. Accordingly, the 12 December, after a meeting with the Council of Ministers, Andreotti announced to the Parliament that Italy would join the EMS. In his discourse, the Prime Minister highlighted that the creation of an area of monetary stability was a shared goal and that the alternative would be protectionism and isolation. He also stated that the entrance into the EMS was consistent with the Italian economic objectives, whereas not joining would generate doubts on the Italian willingness to achieve these goals. In addition, the absence of monetary stability would have consequences on the volume of trade. To justify his decision of joining in spite of the disappointment after the Brussels European Council, Andreotti stated that the requested flexibility was obtained through the wider fluctuation band and that the Italian demand of the divergence indicator was also accepted (although Italy insisted on the necessity of compulsory intervention emerging from reaching the divergence threshold, which had been totally excluded). Finally, Andreotti claimed that with the creation of a monetary arrangement with only six countries, a two velocity Europe would be formed, something that Italy totally opposed.⁵⁷ In

⁵⁶ Ibid.

⁵⁷ MP Giulio Andreotti (DC), *Atti Parlamentari, Camera dei Deputati*, p. 24876-24883, VII Legislatura, Discussioni, Seduta del 12 dicembre 1978.

short, Andreotti used these minor achievements to support his change in position.

After the government announced Italian entrance into the EMS, there was a Parliamentary debate on this matter the 12 and 13 December. The voting threatened to provoke a cabinet crisis, since the parties supporting the government had different stances with respect to the adhesion to the EMS. At that moment, the cabinet, composed only by members of the Christian Democracy (DC), had the Parliamentary support of the Italian Communist Party (PCI), the Italian Socialist Party (PSI), the Italian Social Democratic Party (PSDI), the Italian Republican Party (PRI) and the South Tirol Popular Party (SVP). The DC supported a rapid adhesion to the system. To the Christian Democrats, the Italian participation in the EMS was the proof of the government's commitment to the reduction of inflation and a mechanism to improve the credibility of the Italian policies.⁵⁸ The PCI opposed the EMS arguing that the Brussels agreement was dangerous for weak currency countries and was unacceptable for Italy without further guarantees. Communists criticized the deflationary bias of the system and the lack of symmetry, which would force Italy to reduce its inflation to the German levels. The PCI concluded that the EMS would damage the Italian competitiveness and reserves, forcing the country to choose between frequent realignments of the parity or very restrictive

⁵⁸ MP Giovanni Galloni (DC), Atti Parlamentari, Camera dei Deputati, p. 25001-25005, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

policies.⁵⁹ The PSI criticised the technical aspects of the agreement; however, the Socialists claimed to be politically in favour of the project and showed concern about the possibility of missing this opportunity.⁶⁰ The PSDI also expressed political support to the project, although casted some technical doubts about the final design of the system.⁶¹ Finally, for the PRI, joining the EMS was indispensable, so they conditioned their support to the government to the final decision on the Italian adhesion.⁶² On the other hand, opposition parties (Italian Social Movement, the Radical Party, the Italian Liberal Party and the Proletarian Democracy), with the only exception of the Proletarian Democracy, supported the Italian adhesion to the EMS.

The EMS motion presented by the DC was voted in three separated parts and the ballot was secret. The PCI voted against the main part, which declared an immediate adhesion into the EMS and set the objective of inflation below 10%, and abstained in the other two. The PSI abstained in the whole motion, whereas the Proletarian Democracy voted against. The rest of the parties voted for. However, not all MPs observed parties' discipline. At least 30 MPs

⁵⁹ MP Luigi Spaventa, *Atti Parlamentari, Camera dei Deputati*, p. 24892-24899, VII Legislatura, Discussioni, Seduta del 12 dicembre 1978 and MP Giorgio Napolitano (PCI), *Atti Parlamentari, Camera dei Deputati*, p. 24992-25000, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

⁶⁰ MP Fabrizio Cicchitto (PSI), *Atti Parlamentari, Camera dei Deputati*, p. 24982-24991, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

⁶¹ MP Pietro Longo (PSDI), *Atti Parlamentari, Camera dei Deputati*, p. 24973-24978, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

⁶² MP Ugo La Malfa (PRI), *Atti Parlamentari, Camera dei Deputati*, p.25005-25009, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

disobeyed parties' instructions.⁶³ Eventually, although the PCI decided not to support the government decision to join the EMS, they decided not to abandon the Parliamentary majority supporting the cabinet, and thus avoided a government crisis.

To conclude, Italy had almost no influence on the outcome of the negotiations of the EMS. Most of the requisites that the government deemed essential to participate were not met. The final design was very similar to the Snake, something that almost all political parties and social groups found unacceptable at the beginning. However, eventually the government decided to join. To justify this change of stance, Andreotti's government presented minor achievements, such as the wider fluctuation bands, as big successes. However, in terms of the implications for autonomy of monetary policy, obligation to reduce inflation and cost of adjustment, the new system was identical to the Snake. This raises the question of why did the government decide to participate in this system that at the beginning of the negotiations was considered unacceptable, forced hard reforms, was about to produce a government crisis, and was almost identical to the system that Italy had abandoned few years earlier.

⁶³ Manfellotto, Rosario (1978), "La Camera approva l'ingresso immediato nello SME. Voto contro il PCI, si astiene il PSI: ma non ci sarà crisi", in *Il Corriere della Sera*, 14 December 1978, p. 1.

3.4 The academic debate on the use of the exchange rate as monetary instrument during the 1970s

Besides the political discussion on EMS membership, in order to explain the Italian decision of joining the EMS it is necessary to take into consideration the existing academic debate during the second half of the 1970s. The adhesion to the EMS was approved at a moment when there was a debate about the use of monetary instruments. After the collapse of Bretton Woods, several economists in different countries started questioning the sustainability of floating exchange rates. In Italy, the discussion about the role of exchange rates in monetary stability was particularly intense, and there was no agreement on how exchange rates should be used to promote price stability and economic growth. At that time, traditional Keynesian postulates started being questioned in Italy and a new orthodoxy, which still had a minority support, started consolidating (Petrini 2017). Policymakers still followed a Keynesian approach, but a group of intellectuals started proposing alternative approaches and models for the management of monetary instruments.

Already in 1973, the economists Augusto Graziano and Franca Meloni criticised the strategy of devaluation of the lira as part of the scheme of economic policy. According to these authors, devaluations had two perverse effects: they allowed companies to transfer the higher costs of inputs to prices without losing

international competitiveness and generated an inflationary spiral which also affected wages (Graziani and Meloni 1973).

The economists Franco Modigliani and Tomaso Padoa-Schioppa, in an article published in 1977, analysed the situation of an economy in which wages are indexed 100% or more to inflation and has a deficit in the balance of payments. According to these authors, this economy will never attain the three main objectives of macroeconomic policy at the same time (full employment, price stability and equilibrium in the balance of payments). Neither monetary policy, fiscal policy nor the use of the exchange rate would be useful to achieve these three objectives simultaneously (Modigliani and Padoa-Schioppa 1977). Consequently, Modigliani rejected the idea that Italy needed to retain the capacity of using the exchange rate to correct differentials of inflation and to fight against unemployment and, therefore, supported a fixed exchange rate system. Modigliani claimed that real wages did not reflect the situation of the market or the exchange rate, but the strength of social groups, in particular, trade unions. Real wages were protected by the mechanism of wage indexation, so they were independent from inflation. In an economy in which real wages are totally indexed, devaluation has very little effect as instrument of economic policy. Consequently, according to Modigliani, the only way to reduce inflation in Italy was through a fixed exchange rate. He held that the advantages of a fixed exchange rate would be the same, no matter whether the currency was pegged to a strong or a weak currency; this is, pegging to the mark or to the dollar provided the same advantages. According to Modigliani, in order to keep the

exchange rate as an instrument to correct unit labour costs and unemployment it was necessary to introduce important modifications in the Italian economic organization, mainly on wage indexation. The mechanism of devaluation-inflation to correct unemployment was based, according to him, on the delay in the adjustment of wages to prices.⁶⁴

Beniamino Andreatta, an influent member of the Christian Democracy and Aldo Moro's main economic advisor, who later became Senator and Minister of the Treasury, shared Modigliani's views and favoured the adoption of a fixed exchange rate. Andreatta endorsed Modigliani's ideas to criticise the mechanism of wage indexation and requested the use of a fixed exchange rate to stop the spiral prices-wages (Petrini 2017). Also, according to Andreatta, in 1978, the transmission of inflation to the exchange rate occurred in the opposite direction: countries which accommodated money supply to the objective of employment and growth suffered a depreciation of the value of their currencies in international markets, and this depreciation led to the import of inflation due to the high degree of international openness. According to Andreatta, "in the economies with the highest rates of inflation, the depreciation of the exchange rate has frequently preceded domestic inflation".⁶⁵ This explanation of inflation was endorsed by Minister Pandolfi in his explanation of the advantages of the EMS.

⁶⁴ Modigliani, Franco, "I pro e i contro per l'Italia", in *Il Corriere della Sera*, 1 December 1978, p. 2.

⁶⁵ Andreatta, Beniamino (1978), "Le conseguenze economiche del Sistema monetario europeo per l'Europa e per l'Italia" in *Thema* 2, 82-94.

Similarly, the economist Rainer Stefano Masera criticised Kaldor's stances on the idea that the exchange rate was the only instrument effective to guarantee external equilibrium at the desired growth rate.⁶⁶ According to Masera, if workers are not under monetary illusion, the exchange rate will not solve the problems of economic stagnation and deficit in the balance of payments simultaneously.⁶⁷ To conclude, with the deterioration of the Italian balance of payments during the period of floating exchange rates in the 1970s, the assumption that devaluations had effects only in the short term started gaining support, and more economists began to accept that exchange rate was useless as an instrument to achieve economic objectives (Masini 2004).

Other economists were not so optimistic about the use of fixed exchange rates as a mechanism to rebalance the economy. Paolo Baffi, who served as the governor of the Banca d'Italia between July 1975 and September 1979, was more dubious about the convenience of joining a fixed exchange rate system. According to Baffi, in spite of the high degree of synchrony and international openness of the European economies, which were arguments in favour of fixed exchange rates following Mundell's model, differentials in inflation and the divergences between wages and productivity in different countries imposed caution in the decision

⁶⁶ Kaldor, Nicholas, "Conflicts in National Economic Objectives", in *The Economic Journal*, Vol. 81, No. 321 (Mar., 1971), pp. 1-16 (16 pages)

⁶⁷ Masera, Rainer Stefano (1974), "Tassi di cambio fluttuanti, commercio internazionale e stabilità economica interna", in *Bancaria*, pp. 1261-1271; Masera, Rainer Stefano (1974), "L'esperienza italiana in materia di cambi fluttuanti e il *serpente comunitario*", in Banca d'Italia – Servizio Studi (1974), *Contributi alla ricerca economica*, Centro stampa della Banca d'Italia, Roma.

of pegging the currency. To Baffi, the rigidity of a fixed exchange rate had to be compensated with wage flexibility (Masini 2004). Baffi considered that the intellectual preference for fixed exchange rates was at the foundation of the Bretton Woods agreement, the Treaty of Rome and the supports to the monetary integration in Europe; however, to him, the belief in the effectiveness of fixed exchange rates, which forced authorities to acquiesce with managing the rest of the economy, was a motive of preoccupation (Talamona 1990). He was, in general, reluctant to the EMS project as he believed that differences between countries were too big and, in particular, advised against the Italian participation because he believed that Italy required exchange rate flexibility to compensate other rigidities.

Similarly, the economist Mario Monti showed scepticism about the Italian possibilities of joining successfully a fixed exchange rate agreement. According to Monti, several measures of domestic economic policy would be necessary before adopting a credible exchange rate commitment. For Monti, it was necessary to take action with respect to other magnitudes, such as labour costs, public spending or money supply, and not only the exchange rate. Monti recommended a monetary policy based on the announcement of a target of inflation (on the basis of the growth rate and international comparisons) and, consistent with this target of inflation, there should be a maximum growth of money supply. This shift in the organization of monetary policy should allow a reduction of uncertainty with respect to monetary behaviour, independently from fiscal policies and the evolution of the labour market. This would

trigger a reduction of inflation without negative consequences in the midterm on growth and employment. In an open economy, reducing inflation to the competitors' level would allow growth to be the result not of devaluations and black market, but of the preservation of competitiveness and the exchange rate.⁶⁸

These two stances reflect the existing debate on the use of the exchange rate as a mechanism to fight inflation. These different positions not only reflected ideological differences, but a diversity in theoretical approaches to the management of the exchange rate policy in a period of transition from the Keynesian to the Monetarist paradigm. Thus, the debate on the EMS was not only characterized by conflicting interests between different social groups, but also by theoretical discussions of that period, in which the use of monetary instrument was a topic of intense academic debate. A new theoretical approach, resulting from this debate taking place during the period of floating exchange rates, ended up having a very strong influence in the decision of returning to fixed exchange rates. The influence of these economists and policymakers who endorsed new theories on the management of monetary policies was crucial for the decision of joining the EMS and implementing institutional reforms.

Some political leaders and scholars used the debate on the EMS to introduce other debates and justify the need of reforms that otherwise would not have had enough political and social support to

⁶⁸ Monti, Mario, "Contro l'inflazione giocare d'anticipo", in *Il Corriere della Sera*, 13 July 1978.

be undertaken. In particular they pointed out the need to revoke or review the reforms introduced in 1975 that were aggravating inflation: the reform of the *scala mobile* that unified compensation for all workers and the reform of the Ordinary Treasury Bonds market that compelled the Banca d'Italia to purchase unsold bonds. Although these reforms did not require EMS membership or any fixed exchange rate agreement to be implemented, EMS membership had a crucial role in both debates and was used as a mechanism to secure them at a moment when they lacked the necessary political or social support.

3.5 The reform of the *scala mobile*

The debate of the EMS was highly conditioned by the discussion on the need of reforming the *scala mobile*, the Italian mechanism of wage indexation. The objective of this section is to analyse the connections between these two debates and point out how both defenders and detractors of the EMS used the *scala mobile* as an argument in favour or against the monetary system. In order to examine the relationship between the two debates, I will analyse the stances of different policymakers on the relationship between the new monetary system and the system of wage indexation, and the Italian academic debate on the election of the exchange rate regime in a framework of indexed wages and on the proposals to reform the system. I will conclude that in an environment of intense social confrontation, the EMS became a strong argument for those who supported the need for a reform in the system of wage indexation.

EMS membership increased the cost of not reforming the *scala mobile* because the only way to preserve it was to leave the monetary system, which had also political cost.

The *scala mobile* was probably the most polemic economic issue during the second part of the 1970s. According to the system of wage indexation created in 1951, an increase in the cost of living should be matched by an equivalent increase in wages. This wage increase varied according to age, gender, qualification and economic sector. The 25 January 1975, the agreement between the main trade unions and Confindustria, the most important business association, gave birth to the *scala mobile a punto unico di contingenza*. This reform unified the cost of living compensation for all workers, which led to higher than proportional increases in low wages. These bigger increases for the lowest wages were justified on the reasoning that increases in the cost of living harmed low-income groups more than the average. The *scala mobile a punto unico di contingenza* was considered a major achievement of left-wing parties and trade unions.

The 1975 reform of the *scala mobile* generated immediately an intense academic debate, known as the “Modigliani controversy”, since it started after the publishing of a very provocative article by Franco Modigliani in *Il Corriere della Sera* the 9 March 1975.⁶⁹ In this article, Modigliani criticised the unification of the cost of living compensations. His criticisms to the reform rested on four

⁶⁹ Modigliani, Franco (1975), “Se un operaio guadagnasse mezzo milione al mese”, in *Il Corriere della Sera*, 9 March 1975.

arguments: First, the mechanism that granted bigger increases to the lowest wages had important redistributive effects, which might be socially justified, but should not depend on the evolution of inflation. Second, it would have real effects on industrial costs, increasing more the costs of companies paying the lowest wages (typically, the smallest firms). Third, if the mechanism increased wages (and labour costs) more than inflation, it would generate a destabilizing effect, accelerating inflation. Fourth, if the compensation set for all workers was equal to the compensation for the highest wages, aggregate wages would increase more than proportionally to prices, leading to an increase in average wages, this is, if highest wages were 100% protected from inflation, and all wages received the same compensation, lowest wages would increase more than the increase in inflation. The article concluded that the system would have distorting effects for the economy and suggested a reform that prevented increases in wages more than proportional to increases in prices.

The debate about the *scala mobile* was deeply connected with the debate on the EMS. In fact, Modigliani based his support to the EMS on the reasoning that in an economy in which wages are absolutely indexed, the exchange rate policy has a scarce effect on competitiveness. As a consequence, the EMS did not entail the loss of the exchange rate as an instrument of economic policy, and the

best way to fight inflation was pegging the lira to another currency.⁷⁰

Inside Christian Democracy, Senator Beniamino Andreatta was one of the biggest supporters of the EMS and one of the biggest detractors of the *scala mobile*. He connecting both issues in many occasions. For example, in the Christian Democrat economic conference in Bologna on the 9 December 1978, Andreatta strongly supported the Italian participation in the EMS, but made it clear that “even if Italy did not join the new monetary system, the *scala mobile* should be reformed or eliminated anyway”. He supported the suppression of indexed contracts and the need to find mechanisms to reduce labour conflicts. In his discourse, he was particularly critical to trade unions and the Communist Party, blaming them for not having contributed to overcome social conflicts at all.⁷¹ At the Senate, in an intervention to support the EMS, Andreatta also insisted on the need of reforming the *scala mobile*. He stated: “if you don’t want to join the EMS, this can be discussed, but the problem of wage indexation must be addressed immediately”.⁷²

Among those who opposed the EMS, concerns about the implications of the new monetary regime on the sustainability of wage indexation were very frequently shown and became one of the

⁷⁰ Modigliani, Franco (1978), “I pro e i contro per l’Italia”, in *Il Corriere della Sera*, 1 December 1978, p. 2.

⁷¹ “Duro attacco ai sindacati al convegno economico dc”, in *Il Corriere della Sera*, 10 December 1978, p.2.

⁷² Senator Beniamino Andreatta (DC), Senato della Repubblica, 346^a Seduta Pubblica, p. 25001-25005, VII Legislatura, Seduta del 7 dicembre 1978.

main arguments to oppose the system. These preoccupations often emerged during the Parliamentary debate on EMS membership held after the Brussels European Council. Members of the Proletarian Democracy expressed their fear that the EMS offered an opportunity to those who wanted to eliminate the *scala mobile*. They referred explicitly to Senator Andreatta's intention to use the EMS as an argument to dismantle wage indexation.⁷³ MP Lucio Magri stated that the government, instead of focusing its attention on unpopular reforms (such as the *scala mobile*), concentrated on the debate on the EMS. But, according to Magri, joining the EMS would necessarily force a reform in the system of wage indexation. Magri accused EMS supporters to be in favour of the monetary agreement not on behalf of its benefits, but as a mechanism to impose reforms and dismantle some of the achievements of the labour movement. According to him, this should be a powerful reason for left-wing parties and trade unions to oppose the EMS.⁷⁴ Luciana Castellina expressed similar concerns. She claimed that the EMS would impose drastic measures and that Italy could not solve its problems with artificial measures, such as giving priority to rigid exchange rates instead of implementing the necessary structural and convergence policies to hold that fixed exchange rate.⁷⁵

Trade unions showed similar preoccupations about the consequences of the EMS on the preservation of the *scala mobile*.

⁷³ MP Gorla, Massimo (DP), Atti Parlamentari, Camera dei Deputati, p.15197-15203, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

⁷⁴ MP Magri, Lucio (DP), Atti Parlamentari, Camera dei Deputati, p. 24959-24964, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

⁷⁵ MP Castellina, Luciana (DP), Atti Parlamentari, Camera dei Deputati, p. 25037-25039, VII Legislatura, Discussioni, Seduta del 13 dicembre 1978.

Right after the approval of the Italian accession to the EMS, the leaders of the main trade unions expressed publicly their unwillingness to accept any reform in the mechanism of indexation. Giorgio Benvenuto (UIL) claimed that the attitude of the government in the EMS affair had been humiliating. He accused Andreotti of expecting to use the Snake as a “rope on the neck” of the labour movement. The General Secretary of the CGIL-CISL-UIL expressed pessimism about the possibility that the accession to the EMS could freeze wages, block social claims and alter the *scala mobile*. Similarly, Luciano Lama (CGIL), in an interview, claimed that there were important political and economic forces who wanted to use the EMS to attack the *scala mobile*.⁷⁶ On the other hand, business associations also connected the issues of the exchange rate agreement and the mechanism of wage indexation. They stressed the importance of the change in the direction of economic policy and the introduction of reforms, and claimed that the EMS could be an external link to economic problems. They focused on the mechanisms of wage setting as the main aspect that needed to be reformed. For example, Guido Carli, the president of the Confindustria, at a conference in the Foreign Trade Institute, warned that Italy was not going to be European only by joining the EMS. It was necessary to introduce important reforms, even harder than those detailed in the Pandolfi Plan. In particular, it was urgent to reform the mechanisms of wage setting.⁷⁷ As Talani (2000)

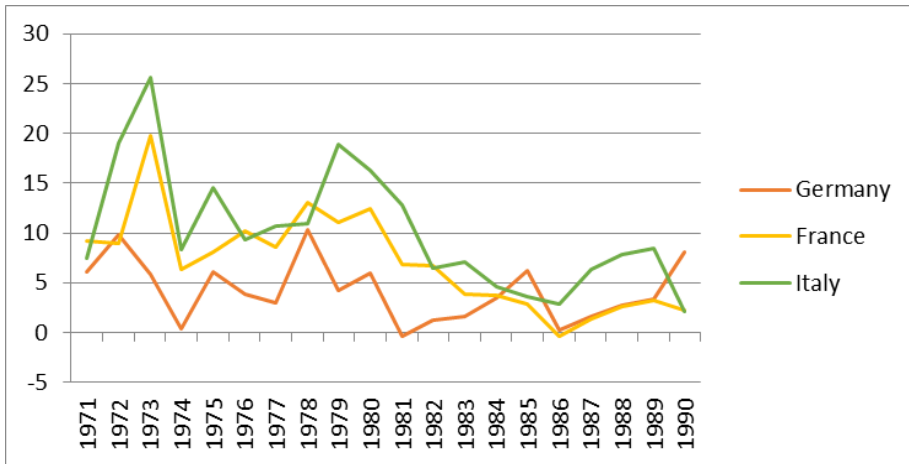
⁷⁶ “Lama insiste: la scala mobile non si tocca”, in *Il Corriere della Sera*, 21 December 1978, p. 12.

⁷⁷ Sacchi, Valeria, “SME. Ora siamo obbligati a cambiare rotta”, in *Il Corriere della Sera*, 13 December 1978, p. 9.

observes, in a framework of high polarization of domestic actors, the EMS debate was the mechanism to move the debate from the domestic to the European level. According to Talani, although workers' organizations were experiencing a reduction in membership, they were still strong enough to become an obstacle for anti-inflationary policies.

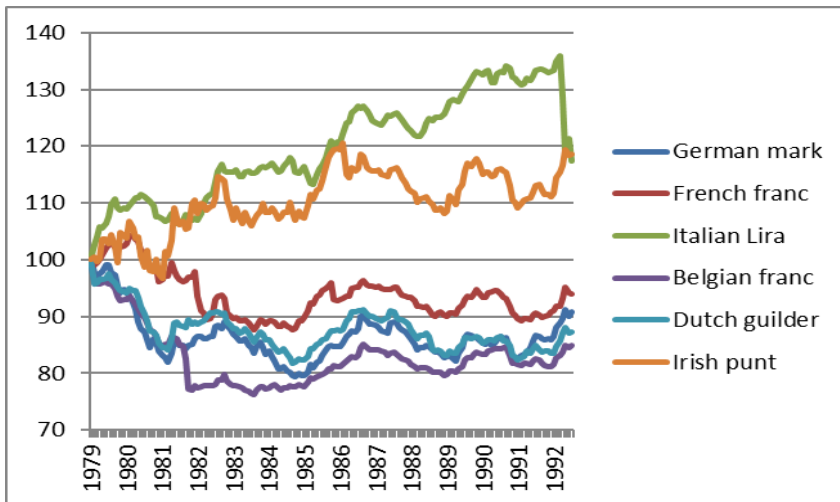
To conclude, during the debate on the EMS, the distributive conflict emerged in the form of discussions about wage setting. Eventually, after Italy joined the EMS, keeping the mechanisms of price indexation in a framework of a fixed exchange system became untenable. Higher increases in wages in comparison to other members of the EMS, together with the appreciation of the real exchange rate of the lira, led to a deterioration in the Italian competitiveness (see figures 3.2 and 3.3). The resulting deficits in the balance of payments generated tensions in reserves and forced several devaluations of the lira during the first years of the EMS (see figure 3.4). Consequently, the EMS ended up forcing effectively a deep reform in the *scala mobile* and became the most important argument to justify this need.

Figure 3.2 Unit labour costs, national currency basis (1971-90), percentage of increase.



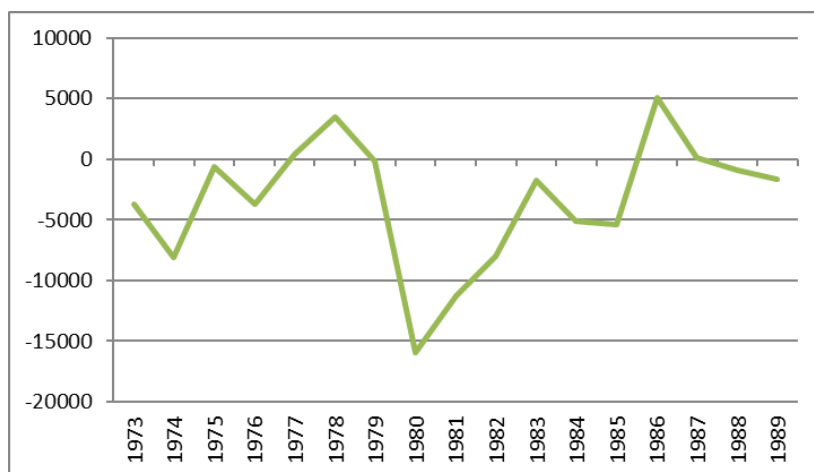
Source: International Labor Comparisons, Bureau of Labor Statistics.

Figure 3.3. Real effective exchange rates (1979=100)



Source: Bank for International Settlements

Figure 3.4. Italian Balance of Payments Goods Surplus/Deficit (USD)



Source: B.R. Russell, International Historical Statistics, New York: Stockton Press

As a consequence of the deterioration of the Italian external balance, the debate about the *scala mobile* became more passionate in the first years of the 1980s. In January 1980, Romano Prodi, Minister of Industry, after discarding the convenience of another devaluation of the lira due to its inflationary effects, pointed out the need to reform, at least partially, the mechanism of wage indexation: “At the moment of joining the EMS, we should have taken actions in that area, and now the need is even more evident”.⁷⁸ Carlo Azeglio Ciampi, the governor of the Banca d’Italia, also joined those who claimed that the devaluation could not solve the problems of the Italian economy. Ciampi recommended a reduction in government spending and an increase in productivity as the main guidelines for economic policy. He also stood for changes in the

⁷⁸ Prodi, Romano, “Una strategia contro l’inflazione”, in *Il Corriere della Sera*, 5 January 1980, p. 1.

mechanism of the *scala mobile* in order to make sustainable the participation of the lira in the EMS.⁷⁹

During the first months of 1981, the situation of the lira quickly deteriorated and, for the first time since the 1975 reform, the government considered freezing the *scala mobile*. In an emergency meeting of the Prime Minister, Arnaldo Forlani, and some members of the Cabinet with the governor of the Banca d'Italia, the current economic program was abandoned and the government started discussing drastic measures to control inflation.⁸⁰ In these awful economic circumstances, some economists presented proposals to reform the mechanism of wage indexation. The most prominent economists participating in that debate were Franco Modigliani, Sylos Labini, Mario Monti and Ezio Tarantelli. Tarantelli was murdered by the *Brigate Rosse* precisely for his participation in the reform of the *scala mobile*.

Ezio Tarantelli, the former president of the Banca d'Italia, considered that the problem of the *scala mobile* was that it was indexed to the past. As a result, it could not grant keeping workers' purchasing power in circumstances of high inflation, and it could not decelerate inflation either, because companies were induced to assume a constant increase in labour costs. According to Tarantelli, this indexation to the past should be abandoned and, instead of that, social groups should agree on an expected inflation rate and,

⁷⁹ "Banca d'Italia: la svalutazione non serve a risanare l'economia", in *Il Corriere della Sera*, 20 October 1980, p. 1.

⁸⁰ "Improvviso vertice. In discussione il blocco della scala mobile", in *Il Corriere della Sera*, 21 March 1981, p. 1.

simultaneously, implement a pack of measures to keep the purchasing power of wages and reduce inflation.⁸¹

Mario Monti placed emphasis on the perverse effects that raw materials, particularly oil, had on the Italian rate of inflation. According to Monti, to reduce inflation it was crucial to eliminate the effects of the price of oil and other commodities from the calculation of the *scala mobile*. This would decelerate labour costs and would reduce domestic demand, restraining inflation. Monti acknowledged the recessive effects of such a policy and proposed measures to compensate them.⁸²

Another suggestion came from the economist Sylos Labini: Labini highlighted the effects that some basic consumption goods with regulated prices and public service fees had on the inflation rate. Containing these prices and fees, the *scala mobile* compensations for the increase in the cost of living would be lower and inflation should be reduced.

Modigliani discarded Tarantelli's proposal, arguing that it would be impossible to increase productivity without a general stagnation of the economy. To Modigliani, any agreement about the *scala mobile* should come hand in hand with an agreement on productivity, so that if productivity increases did not come into being, there should be no increase in wages. Modigliani endorsed Monti's and Labini's proposals, but in the case of the second, he highlighted that, for it to

⁸¹ Reina, Mario (1981).

⁸² Monti Mario (1981) "Il governo della scala mobile e ti governo dell'economia", in *Il Corriere della Sera*, 4 April 1981.

be effective, the reduction in labour costs should be at least equal to the increase in government costs resulting from the reduction of fees. Tarantelli replied to Modigliani's criticisms claiming that it would be difficult to convince trade unions to accept to set wages according to productivity, and this would make workers even more suspicious with respect to the potential reforms of the *scala mobile*. On the other side, according to Tarantelli, setting compensations in advance, this is, announcing a wage policy based on a deceleration of the *scala mobile*, could influence companies' expectations about inflation.⁸³

All these proposals were the basis of the negotiations between the government, business associations and trade unions, although no substantial agreement was reached. Eventually, in 1983-84, with the progressive transformation of the EMS from a fixed but adjustable exchange rate system to a *de facto* fixed exchange rate system, pressures to reform the *scala mobile* increased.⁸⁴ Gradual reduction in compensations and delays in the payments were introduced. In 1984, after a long and unsuccessful negotiation with trade unions (the CISL and the UIL accepted the reform but the CGIL opposed), the DC-PSI-PRI-PSDI-PLI coalition government led by the Socialist Bettino Craxi decided to approve a drastic cut in the *scala mobile* compensations through a decree-law known as the Saint Valentine's decree, because it was passed the 14 February 1984. Eventually, the law was approved the 12 June 1984. This decision

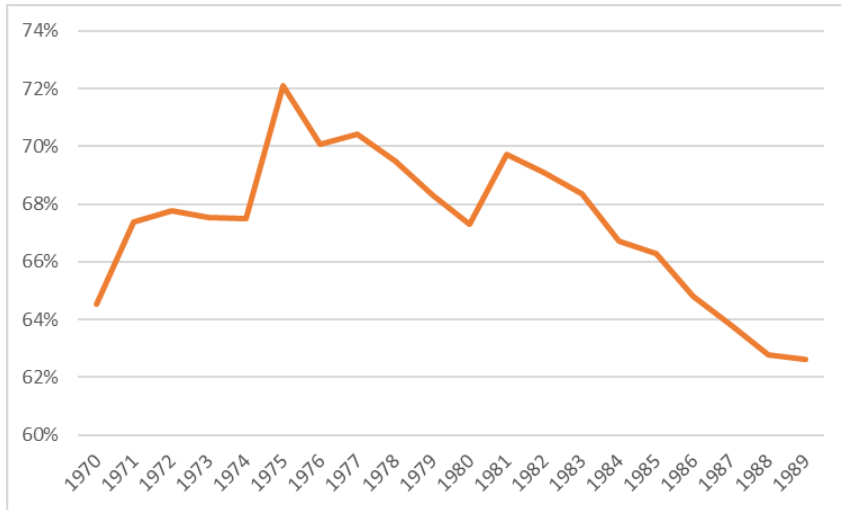
⁸³ Reina, Mario (1981).

⁸⁴ Between 1979 and 1983 the informal rule that realignments would be used to compensate inflation differentials was observed. Between 1983 and 1987, this informal rule was not as generally implemented as before. (Dyson 1994)

generated a strong division among trade unions and unleashed big criticisms from the Communist party. The PCI started an intense mobilization against the reform, including a campaign against Craxi, and proposed an abrogative referendum, which was eventually held on the 9 and 19 June 1985. In the referendum, the “No” obtained 54% of the votes and, consequently, Craxi’s reform was maintained.

To sum up, the *scala mobile* was an issue that generated an enormous confrontation. Since the introduction of the unification of compensations in 1975, there was a strong division in public opinion about the benefits and risks of the mechanism of wage indexation. For trade unions and left-wing parties, the 1975 reform was a historical achievement and, therefore, they were very combative in its defence. In fact, during the period between 1975 and 1985, the PCI experienced the most important growth in its electoral support in its history, in part thanks to voters’ perception about its role in the improvement of the living conditions of workers. The introduction of the unification of compensations and, afterwards, the reform of the *scala mobile*, had important consequence in income distribution and the labour share in national income (see figure 3.5).

Figure 3.5. Labour share in national income, 1970-89



Source: Piketty-Zucman (2014), "Capital is Back: Wealth-Income Ratios in Rich Countries, 1700-2010" in *The Quarterly Journal of Economics* (2014), 1255–1310

Due to these noteworthy distributive effects, together with social and political implications, any reform of the mechanism of wage indexation generated strong opposition and social unrest. Although, a priori, the exchange rate policy and the labour market legislation are not necessarily connected, during the EMS debate, the *scala mobile* was very present in both the arguments in favour and against the Italian participation in the new monetary arrangement. In the academic debate, the Modigliani-Padoa Schioppa model, which concluded that in an economy where wages are totally indexed the exchange rate is ineffective as an instrument of economic policy, had a strong impact and became a powerful theoretic reason to support a fixed exchange rate system such as the EMS. Eventually, the Italian incorporation into the EMS created an economic atmosphere that facilitated and provided arguments to reform the

wage indexation mechanism. The continuous devaluations that the Italian government was forced to carry out were a clear sign of the unsustainability of the Italian situation. The loss of competitiveness, produced by the fact that devaluations did not compensate entirely the differentials of inflation, and the subsequent tensions in reserves made it urgent the introduction of reforms in order to maintain the lira in the EMS. The progressive reduction in the number and size of realignments after 1983 made the reforms even more pressing. EMS membership was used as a powerful argument by those who claimed the need for the reform of the *scala mobile*, which was probably the most important anti-inflationary measure endorsed after the Italian entrance into the EMS.

3.6 The Banca d'Italia-Treasury divorce and the change in the status of fiscal and monetary policy

The other big institutional reform of the period, the reform of the relationship between the Treasury and the Banca d'Italia, addressed the other main source of inflation in Italy during the 1970s, this is, the monetization of government deficits. This reform triggered much less debate than the *scala mobile* and the discussions took place mainly once the decision was already endorsed. Although in the political debate on EMS, monetization of deficits had a marginal impact, this issue was at the centre of the academic debate on the management of monetary policy. The objective of this section is to explain the role of the EMS in the the academic debate on the autonomy of central bank. I will argue that, during this period, there

was a growing number of scholars and some policymakers who started supporting the need for more central bank independence, although this idea still had a minority support among policymakers. I will conclude that EMS membership was used by this minority who intended to reform the status of the Banca d'Italia in order to force a reform of the relationship between the Treasury and the central bank that lacked the necessary political support to be endorsed.

Besides cost-push inflation, the Italian inflation rate also increased fast during the 1970s due to the dependence of monetary policy from fiscal policy. The Treasury could get financing directly from the Banca d'Italia through two channels: First, according to the reform of the Ordinary Treasury Bonds market introduced in 1975, the Banca d'Italia was compelled to buy all the residual Treasury bonds that were not sold to the public in ordinary issuances (in which the Treasury set the minimum interest rate for every issuance), which led to a high degree of monetization of the budget deficit. Second, the Treasury was allowed to keep an overdrawn with the Banca d'Italia up to 14% of the government spending.⁸⁵

The increase in government spending during the 1970s, which was, to a large extent, monetized, led to an absolute loss of control of money supply. This situation triggered concerns among a group of experts, who highlighted the need for major changes in the

⁸⁵ Draghi, Mario (2011), "Una riflessione a trent'anni dalla lettera del Ministro Andreatta al Governatore Ciampi che avviò il "divorzio" tra il Ministero del Tesoro e la Banca d'Italia", in Convegno "L'autonomia della politica monetaria", Roma, Palazzo Altieri.

management of monetary policy. However, at the end of the 1970s and beginnings of the 1980s, only a minority supported this idea. Most political leaders and members of the government still gave priority to fiscal policies and growth. The emergence of this group of academicians and policymakers who supported the need to regain control of money supply facing those who still prioritized fiscal policy as a mechanism to achieve growth was part of the theoretical and ideological revolution that slowly replaced the traditional Keynesianism, bringing about the new orthodoxy. These new ideas found in the EMS an important justification to introduce reforms in the management of monetary policy. The “Divorce” of the Banca d’Italia and the Treasury was a clear example of this process.

Right after 1975, when the Ordinary Treasury Bond market reform was introduced, the first opinions requesting more autonomy for the central bank started emerging. Paolo Baffi, the governor of the Banca d’Italia, in his *Final Considerations* at the annual Ordinary General Assembly of the Banca d’Italia in 1975, complained about the absence of legislation to provide a legal basis to the central bank objective of price stability, similar to the laws existing in other countries, such as Germany, the Netherlands or Sweden. According to Baffi, “the budget deficit generates a volume of liquidity that tends to exceed the amount corresponding to the need of the economy in non-inflationary circumstances”.⁸⁶

⁸⁶ Baffi, Paolo (1976), *Considerazioni finali*, Assemblea Generale Ordinaria 1975, Banca d’Italia.

Baffi's successor as governor of the Banca d'Italia, Carlo Azeglio Ciampi, appointed in October 1979, shared his predecessor's opinion on the need for more autonomy of monetary policy. In his *Final Considerations* in 1979, Ciampi stressed the necessity of coherence with the objective of joining the EMS, which required important measures that had not been adopted after the accession to the new monetary system. For Ciampi, the main problems related to EMS membership in 1979 were the fast increase in inflation, the loss of competitiveness, the pressures generated by the budget deficit and the deficit in the balance of payments. According to Ciampi, monetary measures were not enough, since the origins of the problems were essentially real. He claimed that it was crucial to reduce the budget deficit, promote productivity growth and address the deep causes of inflation. In what concerned the Banca d'Italia, he announced monetary discipline.⁸⁷

Beniamino Andreatta, the big supporter of the EMS in the Christian Democracy, appointed Minister of the Budget and Economic Programming in 1979 and Minister of the Treasury in 1980, also endorsed the stance of the need of more autonomy for the central bank. In a letter to the governor of the Banca d'Italia, in February 1981, he stated: "I have thought through the idea that many of the problems of the management of monetary policy have been worsened by the insufficient autonomy of the Banca d'Italia in front of Treasury's financing needs". He then suggested "a system in which the Banca d'Italia intervention in the Treasury bond market

⁸⁷ Ciampi, Carlo Azeglio (1980), *Considerazioni finali*, Assemblea Generale Ordinaria 1979, Banca d'Italia.

would be a free decision of the Banca and in which market competition would determine the price of bonds”.⁸⁸

Some economists also shared the idea of increasing the autonomy of the central bank. In 1978, Mario Monti requested a different institutional relationship between monetary and fiscal policy. According to Monti, monetary policy should act “in advance” and not “after” government and Parliament actions which conditioned public spending, cost of labour, price formation and income distribution. Monti recommended a monetary policy based on the announcement of a target of inflation and the observance of a maximum growth of money supply. He acknowledged that the main objection to his proposal would be that it entailed giving priority to the objective of disinflation at the expense of growth and employment, but Monti rejected this objection arguing that, in the mid-term, this monetary plan would reduce the inflationary effects of fiscal and labour market policies without any negative consequence on growth and employment, thanks to the avoidance of the negative impact of inflation on investment.⁸⁹

Thus, by the end of the 1970s and the beginning of the 1980s, the stance in favour of the change in the relationship between monetary and fiscal policies, the reduction in government deficits, which were considered a main source of inflation, and the request for more autonomy for the Banca d'Italia consolidated among a group of

⁸⁸ Andreatta, Beniamino, letter to Carlo Azeglio Ciampi, 12 February 1981. Available in Andreatta, N. et al. (2011), *L'Autonomia della Politica Monetaria. Il Divorzio Tesoro-Banca d'Italia trent'anni dopo*, Il Mulino, Arel, Bologna.

⁸⁹ Monti, Mario, “Contro l'inflazione giocare d'anticipo”, in *Il Corriere della Sera*, 13 July 1978.

economists, some policymakers and the top officials of the central bank. Although they did not have the support of the government and the Parliament, this minority accelerated the advent of the central bank independence and eliminated the primacy of fiscal policy over monetary policy. The participation in the EMS helped them to justify the reforms in front of a majority that still awarded priority to economic growth over monetary stability.

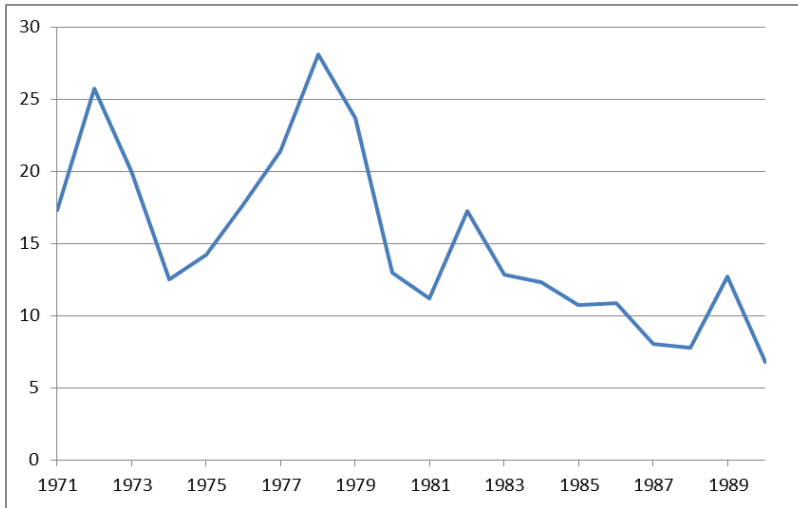
The reform eventually occurred in 1981 with the “Divorce” of the Treasury and the Banca d’Italia. After an exchange of letters in February 1981, the Minister of the Treasury, Beniamino Andreatta, and the governor of the Banca d’Italia, Carlo Azeglio Ciampi, agreed to revoke the Banca d’Italia obligation to purchase all the bonds that the Treasury could not sell in ordinary issuances. The “Divorce” did not happen as the result of any legal or institutional reform, and there was no Parliamentary debate or Council of Ministers agreement. It was just a “private” agreement between Andreatta and Ciampi, who established that the central bank would not have any more the commitment to finance the Treasury. In fact, Andreatta decided to endorse this decision leading to more central bank independence without any support among the members of the Cabinet. He was aware that it would be very difficult to convince the rest of the Cabinet to approve that measure, so he decided to plot with Ciampi, with the expectation that it would be very difficult to repeal the decision once it had been implemented. Both Andreatta and Ciampi used the EMS as an argument in favour of the “Divorce”. According to Andreatta, “the imperative was to change the economic policy regime and I had to do so in a

ministerial team in which I didn't have any allies, but colleagues obsessed with the ideology of economic growth at any cost, based on low real interest rates and a weak exchange rate. Our presence in the EMS was then under threat".⁹⁰ It must be remembered that the Socialist Party abstained in the Parliament vote on the adhesion to the EMS and that in 1981, Socialist ministers had a *de facto* veto power on the economic policy. In fact, after the "Divorce", once the effects started becoming noticeable, Nino Andreatta and the Minister of Finance, the Socialist Rino Formica, had a public disagreement on the convenience of the "Divorce" and how to address the issue of the government deficits. This personal conflict between the two Ministers was known in the press as the *lite delle comari* (the quarrel of the godmothers) and led to the fall of the government led by Giovanni Spadolini and the formation of a new government headed by Amintore Fanfani.

The "Divorce" between the Banca d'Italia and the Treasury generated more debate after its implementation than before, basically due to its consequences for the government finances. As a result of the decision to stop monetizing the deficit, there was a reduction in the increase in money supply and, therefore, an increase in interest rates (see figures 3.6 and 3.7).

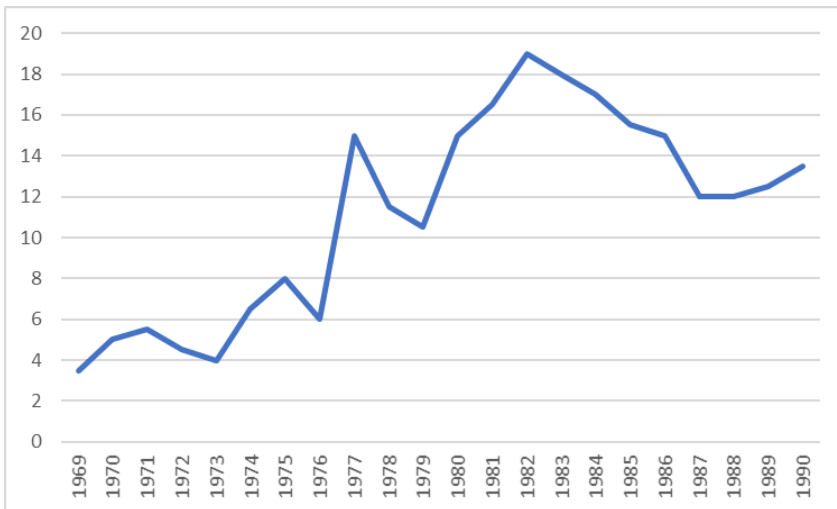
⁹⁰ Andreatta, Nino, "1981: un divorzio per tutte le stagioni", in *Il Sole 24 Ore*, 26 July 1991.

Figure 3.6. Percentage of increase of M1, 1971-90



Source: Banca d'Italia

Figure 3.7. Banca d'Italia discount rate, 1969-90

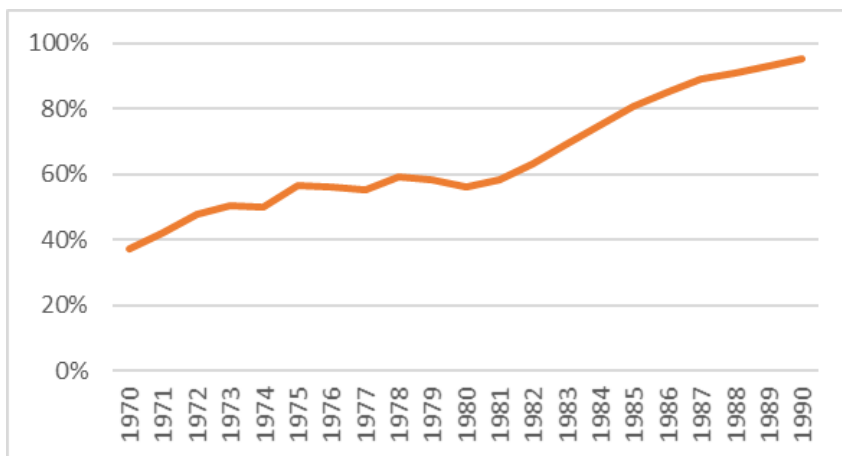


Source: Banca d'Italia

The suppression of the automatic financing of the Treasury by the Banca d'Italia led to a rapid accumulation of debt to GDP and an

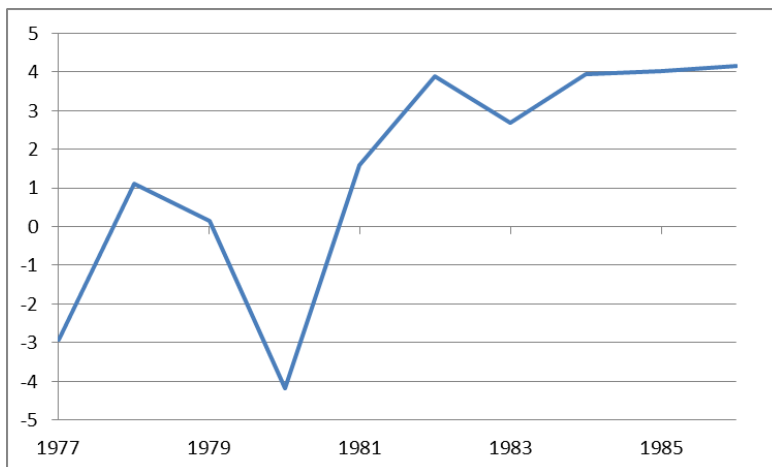
increase of the real interest rates paid by the long-term Ordinary Treasury Bonds (see figures 3.8 and 3.9).

Figure 3.8. Italian Debt/GDP (1970-90)



Source: ISTAT

Figure 3.9. Ordinary Treasury Bonds long-term real interest rates (1977-86)



Source: HOMER S., SYLLA R., Storia dei tassi di interesse, Laterza, Bari, 1995

As a result of these difficulties, in October 1982, the Banca d'Italia was forced to intervene and finance the government budget deficit, since the Treasury was unable to sell an important part of the bonds issued. In January 1983, the Parliament approved an extraordinary loan to the government of 8 trillion lire. As a consequence of the problems to finance the government deficit and the general increase in interest rates, an intense debate about the "Divorce" started. Some members of the government and part of the public opinion started questioning the bigger autonomy of the Banca d'Italia and proposed to revoke it. Others held the opposite stance. Not only they wanted to maintain the "Divorce", but also expected to extend it and to introduce further reforms to make it sustainable.

The supporters of the "Divorce" rejected the idea that this reform entailed the inability of the Banca d'Italia to reduce interest rates, but just bestowed the central bank with the capacity to take discretionary actions on that matter. They also championed other measures, such as the increase in the political costs of budget deficits, an institutional reform of the Banca d'Italia to grant it a determinant role (this is, more institutional autonomy), and the divorce of the Treasury and the regulation of financial markets.⁹¹ Another argument of the supporters of the "Divorce" was that the real problem was not the extended autonomy of the Banca d'Italia, but the dimension of the budget deficit and, therefore, they advocated a reduction in government spending.

⁹¹ Monti, Mario, "Tesoro e Banca d'Italia", in *Il Corriere della Sera*, 5 December 1982, p. 1.

On the other side, the critics with the “Divorce” claimed that it did not contribute to the reduction of inflation but accelerated it instead. The higher cost of financing government’s debt increased the deficit, triggering more inflation.⁹² Another criticism was that the “Divorce” increased interest rates, which had a negative impact for firms and the economic growth. They also claimed that the higher interest rates made it more difficult to reduce the budget deficit.⁹³

Although the Banca d’Italia was forced to intervene in few occasions as a consequence of the problems to finance government deficits, the “Divorce” was maintained and, with the advancement of the process of monetary integration, it was consolidated and extended. The Italian example shows that fixed exchange rates and central bank independence are not necessarily alternative tools to achieve the objective of price stability. In the case of Italy, it was precisely the EMS adhesion what accelerated the reform in the organization of monetary policy and encouraged the introduction of autonomy for the central bank. In spite of the progressive consolidation of an academic trend which backed the need for a change in the approach in the management of money supply and the concession of more autonomy to the Banca d’Italia, there was not enough political and social support to central bank independence at that moment. Thus, the supporters of this measure decided to do it through a private agreement and used the EMS to justify their decision. Once the consequences of the measure became evident

⁹² Sunseri, Nino, “Presto un’asta “competitiva” per un nuovo rilancio dei Bot”, in *Il Corriere della Sera*, 15 October 1982, p. 15.

⁹³ “De Michelis: denaro meno caro di 4 punti altrimenti andiamo al tracollo finanziario”, in *Il Corriere della Sera*, 8 April 1983, p. 15.

and the public debate started, it was more difficult to revoke the “Divorce” than it would have been if it had been never applied. EMS membership also contributed to create an environment which made it difficult to repeal the measure.

3.7 Conclusions

The Italian government had a very small influence in the EMS negotiations at the European level. The final design of the system did not satisfy the Italian expectations. Italy advocated for a symmetrical system, with a balanced distribution of the costs of adjustment, enlarged credit facilities and transfers to less developed economies, all this embedded in a set of broader agricultural, industrial and regional policies. Eventually, the EMS ended up being very similar to the Snake and incorporated only minor concessions to the Italian position. In spite of this, following the reflection period requested after the Brussels European Council, the Italian government changed its stance and decided to join the EMS.

The Italian decision of joining the EMS has been frequently analysed from the international perspective, as a mechanism to import credibility from the Bundesbank, or as the result of the preferences of interest groups with respect to the exchange rate policy. However, a thorough examination of the Italian internal debate shows the importance of the domestic political, economic and social issues in the decision of joining the European Monetary System. In particular, the deliberations about the institutional

reforms which tackled the main sources of the very high inflation rates and the volatility of the lira, which, by that moment, had entered a vicious circle of depreciation-inflation, were crucial. These discussions took place in the framework of an intense academic debate on the causes of the Italian inflation, the relationship between inflation and the depreciation of lira, the sustainability of floating exchange rates and the management of monetary instruments and its relationship with fiscal policy.

The two main actions aimed at controlling inflation undertaken during this period were the reform of the *scala mobile* and the “Divorce” between the Treasury and the Banca d’Italia, which addressed cost-push inflation and deficit monetization respectively. These measures did not necessarily require a fixed exchange rate agreement to be implemented, however, EMS membership was used by some economists and policymakers as an argument to justify and enforce these decisions in the absence of enough political and social support. In the case of the *scala mobile*, any reform of the mechanism of wage indexation, which had important redistributive effects, was bound to create an intense conflict. For the Communist Party, other left-wing parties and trade unions, the 1975 reform of the *scala mobile* was a major achievement for the working classes and had to be forcefully defended. Therefore, any attempt of reform suffered an intense opposition and produced important tensions and social unrest. The adoption of a fixed exchange rate and the subsequent loss of competitiveness led to rising tensions in the balance of payments and forced continuous devaluations of the lira during the first years of operation of the

EMS. This situation made the need for a shift in the direction of economic policies evident. EMS membership turned the reform of the *scala mobile* unavoidable, and the only way to escape it was leaving the system. Consequently, the cost of not carrying out this reform became much higher than it would have been if Italy had never joined it. EMS membership ended up being a powerful argument for those willing to amend the wage indexation mechanism.

The other big reform related to the control of inflation affected the relationship of the Treasury and the Banca d'Italia. At the end of the 1970s, monetary policy was wholly subordinated to fiscal policy as a result of the commitment of the Banca d'Italia to purchase the Treasury bonds unsold in ordinary issuances, which led to a large monetization of the public deficit. The revocation of this obligation, known as the "Divorce", was carried out through a "private" agreement between the Minister of the Treasury and the governor of the Banca d'Italia. This decision was taken unilaterally, without any support of the Cabinet or the Parliament, since both the Minister and the governor of the Bank were convinced of the opposition of the rest of the government and the Parliament to that reform. Although the "Divorce" did not trigger major debates when it was implemented, once its effects (an increase in the cost of government's debt and an increase in interest rates) became noticeable, some voices raised to demand its repeal. The EMS was used as a strong argument to maintain, and later expand, the autonomy of the central bank. In an environment in which most of the policymakers still accepted the primacy of fiscal policy over

monetary policy and, therefore, measures aimed at conferring more autonomy to the central bank lacked the necessary support, the Minister of the Treasury and the governor of the Bank expected that this decision would be easier to maintain once it had already been implemented than to endorse it for the first time. The two officials were strong supporters of the EMS and EMS membership increased the cost of repealing the decision.

At a moment of transition in the management of monetary policies, characterized by an intense debate on the use of monetary instruments, in which the Keynesian predominance started declining and being replaced by new Monetarist ideas, but the new consensus was not consolidated yet, some Italian economists and policymakers used the fixed exchange rate commitment and, more generally, the European obligations, as a mechanism to introduce institutional reforms which they deemed crucial for stabilization, but lacked the necessary support. Since the implications of exchange rate or monetary policy decisions were less noticeable (and hence less conflictive) than those of fiscal and incomes policies, it was easier for policymakers to take actions affecting the exchange rate or the role of the central bank than related to government spending or wage setting. Accordingly, they used exchange rate decisions to bind unpopular institutional reforms, and EMS membership increased the cost of not endorsing or repealing these unpopular decisions.

4. IRELAND IN THE EMS NEGOTIATIONS: BETWEEN THE BEGGING BOWL STRATEGY AND THE BREAK WITH THE STERLING POUND

4.1 Introduction

For Ireland, the decision whether to join or not the European Monetary System involved another dilemma: what would be the relationship of the Irish punt and the sterling pound if Ireland joined the system? The Irish adhesion to the EMS entailed a very high probability, even in the implausible case that the British government consented to enter the system from the beginning, of being constrained to break up the one-to-one exchange rate with the sterling, which had been in force for 150 years. If Ireland joined the EMS and the United Kingdom decided to stay out, it would be impossible for Ireland to maintain the peg. On the other side, if the United Kingdom also joined the EMS, the Irish government theoretically could decide to maintain the peg to the sterling. However, in practice, this would mean that the Irish punt would be forced to follow the sterling every time that the British government decided to realign the parity. The decision of breaking up the peg had important consequences, not only because the United Kingdom was Ireland's main trade partner, but also because it would require the introduction of capital and exchange controls, which would have important economic and political consequences, particularly relevant for the future relationship with Northern Ireland.

Besides the issue of the relationship with the sterling, joining the EMS entailed important challenges for Ireland, the country with the lowest GDP per capita of the EEC and one with the highest inflation rates. Joining a monetary arrangement which was expected to operate under the hegemony of the lowest inflation country in the EEC required severe austerity measures and reforms that represented a huge task for the Irish economy.

In spite of the serious implications of the decision of joining the EMS for the Irish economy and the expected difficulties to maintain the peg, technical aspects such as the symmetry of the system, the definition of intervention obligations, credit facilities to support parities or the width of fluctuation bands, which defined how the new system was going to operate and the costs for Ireland of joining, had a minimum influence in both the domestic debate and the Irish government stance during European negotiations. In fact, the Fianna Fáil (centre-right) government, led by Jack Lynch, did not fight actively for a symmetrical system, the possibility of a wider fluctuation band or the creation of a European Monetary Fund, as other high inflation countries did. The domestic political debate on EMS membership and the Irish government demands during negotiations with the future European partners concentrated on the quantity of transfers that Ireland would receive in exchange for its participation in the system. During the talks with representatives of other governments, the Irish leaders claimed that the decision of joining the EMS would be taken on the basis of the amount of aid received, and did not make the requested aid dependent of the characteristics of the system. Similarly, during the

domestic political debate, the main reason argued by the government to support the admission to the EMS was its satisfaction with the amount of resources promised, while opposition parties' criticisms focused on the inadequacy of the transfers that Ireland was granted and the incapacity of the government to obtain a better deal, the result, the opposition said, of a poor bargaining strategy. This was qualified in several occasions, both in the press and the Parliament, as passing the "begging bowl" among the European partners.⁹⁴

The government's lack of attention to the technical aspects of the system is even more surprising when this negotiation strategy is contrasted with the official stance on the future relationship with the sterling. The Irish government affirmed that even if the United Kingdom decided not to join the system, the link with the sterling would be maintained. This position was consistent with the preferences of social and economic groups, which expressed an almost unanimous preference for the preservation of the one-to-one exchange rate. However, regarding the definition of the system, the Irish government supported or endorsed options which made less probable the British participation in the EMS and the maintenance of the peg. The best examples of this contradictory attitude of the Irish government are the support to the option of the parity grid to define fluctuation bands and the decision to opt for the narrow

⁹⁴ John Cooney, "Europe: built on money or not at all", *The Irish Times*, 17 July 1978, p.7; Dáil Éireann debate - Thursday, 30 Nov 1978. European Monetary System: Statement by Taoiseach (<https://www.oireachtas.ie/en/debates/debate/dail/1978-11-30/3/>); Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

fluctuation bands. The justifications for these choices were very weak or even based on false assumptions.

The Irish government attitude during the EMS negotiations was inconsistent. During the European talks, the Irish leaders insisted on the need for financial aid as a condition to join the system. Eventually, the amount agreed with the European partners was much lower than the minimum requested by the Irish government, but Ireland joined the system anyway. With respect to the breakup with the sterling, contradictions are quite striking. Although it was evident that the EMS was incompatible with keeping the peg to the sterling, in particular if Ireland joined the system and the United Kingdom did not, the government stated that the link with the sterling would be preserved. The government held this standpoint until the day in which the breakup occurred, just a couple of weeks after the launching of the system.

These incongruities seem to indicate that there was another intention behind the government strategy. The objective of this chapter is to analyse the Irish debate on the EMS and contrast the government's position in the European discussions and in the domestic debate with the decisions finally adopted, highlighting the existing contradictions. My hypothesis in this chapter is that the Irish government actually wanted to use the EMS to force the breakup with the sterling, against the will of the vast majority of economic agents. The sources used are the records of the European debates and the resolutions of the European Council, the debates in the Dáil Éireann, the lower house of the Oireachtas (the Irish

Parliament), government documentation, and the generalist newspaper *The Irish Times*.

The chapter is organized in five sections. Section 4.2 explains the advantages and disadvantages of the maintenance of the peg with the sterling for Ireland. Section 4.3 summarizes the stances of the Irish social and economic groups on the EMS and the potential breakup of the link with the sterling. Section 4.4 examines the official stance of the Irish government on the EMS and the relationship with the sterling and its participation in the European negotiations. Section 4.5 explores the domestic political debate, which was centred essentially in the sufficiency or not of the aid promised and the bargaining strategy of the government, but also addressed some technical characteristics of the system, the potential breakup of the peg with the sterling, and the consequences of the end of the link with the sterling for Northern Ireland.

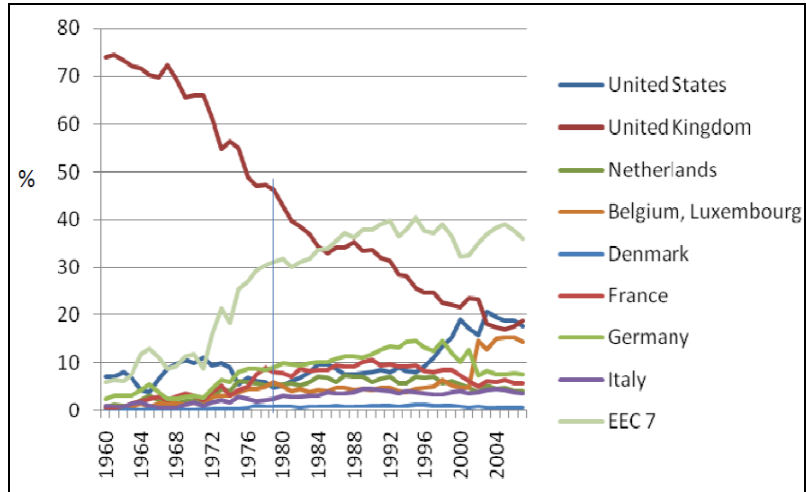
The chapter will conclude that there were important contradictions between the official stance of the Irish government, supported both at the European and domestic level, and the actual decision endorsed. The government claimed that the peg with the sterling would be preserved. However, not only this was almost impossible to ensure, but also the Irish government adopted strategies and decisions which made less probable the British participation and forced an earlier breakup with the sterling. The government's actions seem to indicate that the government preferred actually to end the link, against the preferences of most economic actors, who

gave priority to the maintenance of the peg, and used the EMS as an excuse to enforce out this decision.

4.2 The pros and cons of the one-to-one peg with the sterling

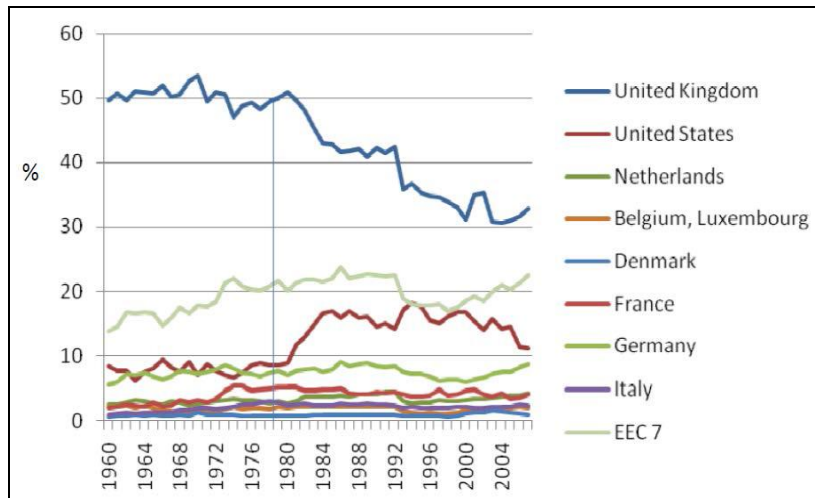
The one-to-one peg to the sterling provided several advantages to Ireland. The main benefit was the stabilization of the exchange rate with its main trade partner. Before the Irish incorporation into the EEC in 1973, exports to the United Kingdom accounted for around 70% of total exports. Although this figure tended to fall after the entrance into the common market, by 1979, the year in which the breakup with the sterling happened, exports to the United Kingdom still represented almost half of total Irish exports (see figure 4.1). With respect to imports, the figure was very similar, with almost half of the Irish imports coming from the United Kingdom (see figure 4.2). This dependence from British imports made the Irish inflation rate very sensitive to the British rate.

Figure 4.1: Share of Irish exports by destination, 1960-2007



Source: HONOHAN (2015), “Currency choices in Ireland past and present”, Presentation by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at Queen’s University, Belfast, 31 March 2015.

Figure 4.2: Share of Irish imports by destination, 1960-2007



Source: HONOHAN (2015), “Currency choices in Ireland past and present”, Presentation by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at Queen’s University, Belfast, 31 March 2015.

Another important advantage of the peg to the sterling was free movement of capitals between Ireland and the United Kingdom. The Exchange Control Act of 1954, in force in Ireland at that moment, excluded Northern Ireland, Great Britain, the Channel Islands and the Isle of Man, from the application of controls.⁹⁵ A potential breakup with the sterling to join the EMS would entail restrictions in this free movement of capitals for two reasons. First, without the use of controls, it would be very difficult to bring interest rates down with respect to the British, and the reduction in interest rates was one of the most important expected advantages of the EMS. Second, if there were no controls and the United Kingdom offered higher rates, capitals would fly to London (or Belfast) in search for higher returns. This reduction in the supply of funds would inhibit industrial investment, and would increase its cost. Actually, in November 1978, the government passed an amendment of the Exchange Control Act to extend this application also to the United Kingdom.⁹⁶

Restrictions in free movement of capitals were expected to have big consequences in Northern Ireland. Before the breakup with the sterling, both the sterling and the Irish pound were accepted in Northern Ireland, and banks from both sides of the border took deposits in both currencies. Northern Ireland was one of the most important markets for the Republic of Ireland. From the political point of view, the implications of the breakup of the sterling link for

⁹⁵ Exchange Control Act, 1954 (Act 30 of 1954).

⁹⁶ Exchange Control (Continuance and Amendment) Bill, 1978.

future prospects of reunification generated big discussions in the Dáil Éireann.

In spite of the existence of economic and political reasons to maintain the one-to-one peg to the sterling, the poor results of the United Kingdom in terms of inflation rates after the collapse of the Bretton Woods system, which resulted in the inability of the British government to maintain the sterling in the Snake, opened the debate about the sustainability of the peg to the sterling. During the central years of the 1970s, even before the beginning of the EMS negotiations, for the first time since the independence, the Irish government started considering the possibility of breaking up with the sterling. According to Honohan and Murphy (2010), the main arguments in favour of such a move were the fact that the United Kingdom, historically considered the epitome of financial strength, was not able to provide stability anymore, and the perception that the British long-term economic decline would continue during the following years. The instability of the sterling was blamed for the high inflation and interest rates in Ireland after Bretton Woods (see table 4.1).

Table 4.1: Irish inflation rates and interest rates (%), 1970-79

	Irish inflation rate	Short term interest rate	Long term interest rate
1970	8,19	7,31	9,85
1971	8,96	4,81	8,47
1972	8,61	8,00	9,45
1973	11,42	12,75	12,32
1974	16,96	12,00	16,84
1975	20,88	10,00	14,62
1976	17,99	14,75	15,47
1977	13,63	6,75	11,29
1978	7,63	11,85	12,82
1979	13,24	16,50	15,05

Source: GERLACH, S. and STUART, R. (2014) “Money, Interest and Prices in Ireland, 1933–2012”, Central Bank of Ireland Technical Paper 07/RT/14.

Eventually, the proposal of the creation of the European Monetary System accelerated the Irish decision about the relationship with the sterling pound. The EMS opened different scenarios. In the case that the United Kingdom joined the system, Ireland could decide to break up the link and float against the sterling within the EMS fluctuation band, or maintain the one-to-one peg with both currencies in the system. In this second case, if the British government decided to realign the sterling to other EMS currencies, the Irish government would be forced to follow the sterling to maintain the peg. In the case that the United Kingdom decided not to join the EMS from the beginning, the Irish government had also the option of staying out (and perhaps join later if the British did so) and keep the link to the sterling, or joining without the British, breaking up with the sterling immediately or when the sterling (and

thus, the punt) reached one of the bilateral margins of fluctuation, moment in which the Irish government would be obliged to break up with the sterling to maintain the punt within the fluctuation margins with EMS currencies. Eventually, the option endorsed was the last one, to join the system without the United Kingdom and maintain the peg until the punt reached EMS fluctuation margins. This happened the 30 March 1979, just a couple of weeks after the EMS launching, when the sterling reached the upper-band against the Belgian franc. However, contrarily to what was expected, the breakup took place due to an appreciation of the sterling, instead of a depreciation.

4.3 The position of the Irish economic agents on the EMS and the breakup with the sterling

Frieden's political economy model of election of the exchange rate (Frieden 1991 and 2002) explains countries' election of the exchange rate regime on the basis of the preferences of interest groups. In the case of European integration, emphasis is placed on exchange rates' real effects on trade and investment. According to Frieden, those countries with a large percentage of exports to Germany and Benelux or with a large trade surplus were much more likely to peg to the Deutsche mark than other countries. Therefore, according to this model, the stances of economic agents are important to understand exchange rate decisions.

The public debate about EMS membership was, in the case of Ireland, much less intense than in other countries like France or Italy. In general, the position of the government was much more favourable to the EMS than that of the majority of economic agents. What clearly generated a big consensus among economic agents, from agricultural producers' associations and trade unions to banking and business associations, was the preference for the maintenance of the peg to the sterling. With respect to the advantages and disadvantages of the EMS, there was a variety of different opinions, depending on the preferences and interests of the groups.

The major worry of agricultural producers about the EMS was its impact on the Common Agricultural Policy, in particular if it entailed the breakup with the sterling. Although agricultural products would be protected from the appreciation of the Irish punt thanks to the Monetary Compensatory Accounts, there was still concern, since the breakup with the sterling could have an impact on the calculation of the MCAs. Farmers also feared the possibility of the Green pound being replaced by the ECU, which could entail a reduction in common farm prices. Additionally, an appreciation of the Irish punt with respect to the sterling would endanger the competitiveness of agricultural products not included in the CAP (potatoes and processed food).⁹⁷ The Irish Farmers Association criticised the inability of the government to obtain some extension

⁹⁷ Paul Tansey, "Business and farming fear break with £", *The Irish Times*, 24 November 1978, p. 1; "EMS could lead to a reduction in farm prices", *The Irish Times*, 23 November 1978, p.7.

of the regional funds, which they judged indispensable for the Irish participation in the EMS. Another source of concern for the sector was the fact that some countries, in particular the United Kingdom, but to some extent also Germany, were using the EMS discussion as an opportunity to bring up the possibility of reconsidering the Common Agricultural Policy. In general, farmers' assessment on the EMS, unless it entailed big transfers of resources, was quite negative, especially if it required breaking up with the sterling.

With respect to industrial producers, the Confederation of Irish Industry (CII) initially expressed a positive opinion on the EMS and supported joining. Liam Connellan, the CII general director, in a speech at the Irish Congress of Trade Unions seminar on "The control of large corporate organisations", claimed that the EMS would promote industrial activities in Ireland. The main advantages of the EMS, according to Connellan, were the stabilization of exchange rates, which would make Ireland more attractive for investment, and the reduction in inflation. The EMS imposed, nevertheless, the need for measures to contain costs, in particular wages, in order to keep them in line with EEC low inflation countries.⁹⁸ However, once it became clear that the British were not going to join the system, doubts on the convenience of participating in the EMS emerged. In an interview on the 27 November 1978, Connellan, although acknowledging the long-term positive effects on the EMS, expressed concern about the transitional period. If Ireland joined without the United Kingdom, risks would be much

⁹⁸ "EMS could help industry, says CII", *The Irish Times*, 1 November 1978, p.4.

bigger. In particular, Connellan alerted of the possibility of speculative attacks against the sterling that could produce a depreciation beyond what would be justified by differences in costs and inflation rates. In that case, Irish industries would require some kind of safeguards (in the form of transfers) to prevent losses in employment and output.⁹⁹ Once the breakup with the sterling seemed imminent, some industrial sectors became more and more sceptical about the potential benefits of the EMS, warning that membership could result in job losses. Clothing and footwear manufacturers and the Apparel Industries Federations alerted that in the case of a breakup with the sterling and a revaluation of the Irish punt, there would be not only a reduction in exports, but also a fall in the share in domestic markets. Both organizations opposed the breakup.¹⁰⁰ In conclusion, business associations were in favour of the EMS for the expected positive impact on the stabilization of prices and reduction in interest rates. They also supported measures to contain costs, in particular wages. But there was a general perception that a breakup with the sterling would have a negative impact on Irish industrial activities competitiveness.

The banking sector also applauded the expected positive effects of the EMS on inflation and interest rates. Bankers were the only group that did not consider that transfer of resources in exchange for participation in the system were crucial to take the decision. For example, Ian Morrison, managing director of the Bank of Ireland,

⁹⁹ “More valuable punt can spell problems for jobs and output – CII chief”, *The Irish Times*, 27 November 1978, p. 14.

¹⁰⁰ Paul Tansey, “Business and farming fear break with £”, *The Irish Times*, 24 November, p. 1.

one of the largest banking groups of the country, stated that joining the EMS was an advantage in itself, and financial aid should be looked upon as a bonus, not a condition to join.¹⁰¹ Although bankers expressed a positive stance on the EMS, the sector opposed the breakup with the sterling and the introduction of capital controls. When, after the decision of joining the EMS, the Central Bank of Ireland introduced exchange controls, brokers complained about the expected fall in profitability due to the reduction in the volume of business with the United Kingdom. Brokers were also particularly concerned by the possibility that the Bank of England also introduced controls, since this would restrict British investments in Ireland, and large British institutional investors were very important for the Irish financial markets.¹⁰² The sector also believed that there was a risk both in breaking up with the sterling and in not being able to keep the exchange rate in the EMS. Brendan Menton, in an article published in the *Allied Irish Banks Quarterly Review*, alerted of the possibility that once in the system, having broken up with the sterling, Ireland might be constrained to leave the EMS if the restrictive policies required by the system were not applied.¹⁰³

Trade unions were openly against the EMS and the breakup with the sterling, and they were very critical towards the government attitude during the negotiations. The Irish Transport and General Workers Union general secretary, Michael Mullen, argued that

¹⁰¹ Bill Murdoch, "Bank of Ireland profits rise by only 2.1% to £20.8 m", *The Irish Times*, 8 November 1978, p. 14.

¹⁰² Aidan O'Sullivan, "Stockbrokers fear slump in dealings", *The Irish Times*, 18 December 1978, p. 1.

¹⁰³ "Banker sounds note of caution on new EMS", *The Irish Times*, 4 December 1978, p. 22.

Germany would obtain all the advantages from the system and none of the disadvantages. Mullen was also sceptical about the transfers of resources, claiming that meaningful transfers of resources from rich to poor countries were not going to occur. He also accused the government of appealing to Irish nationalism to hide the negative impacts of the EMS.¹⁰⁴ The Irish Congress of Trade Unions opposed radically to the EMS too. According to the ICTU, the EMS not only entailed a danger to the protection of employment, but also would cause interferences in the normal process of collective bargaining. It could also imply the subjection of domestic policies to directives from outside the country. Once the government took the decision of joining the system, the ICTU declared that trade unions were not going to cooperate in any sense with the measures required by the new monetary arrangement.¹⁰⁵

Considering the position of the majority of economic agents and sectorial associations, it is difficult to justify the government's decision in favour of Ireland's EMS membership under conditions that made the breakup with the sterling very likely, on the basis of Frieden's political economy model of determination of exchange rate policies (Frieden 1991 and 2002). According to Park (2003), the key factor to explain the government's capacity to impose the entrance into the EMS against the opinion of many groups of interests was the strength of the single-party government supported by a strong Parliamentary majority. According to Park (2003), in

¹⁰⁴ "Mullen opposes EMS link", *The Irish Times*, 10 November 1978, p. 5; "Stand firm, says Mullen on monetary system", *The Irish Times*, 7 December 1978 p. 7.

¹⁰⁵ Eugene McEldowney, "Government warned by ICTU on EMS entry", *The Irish Times*, 15 December 1978, p.7.

comparison to other Parliamentary systems, the Irish political system grants great powers to the Taoiseach (Prime Minister). This fact, together with the tight control that Irish political leaders exert over their parties, bestows the Taoiseach with a power that other leaders do not enjoy. This would explain why the government was able to impose the decision of entering the EMS (and breaking up with the sterling) in spite of the negative perception of many social agents. Yet, the question of why the government decided to join despite failing in achieving the amount of financial aid it considered indispensable still remains open. The next sections explain the official stance of the government during the negotiations and the domestic debate, and compare it with the decisions finally adopted.

4.4 The official stance of the Irish government and Ireland's participation in European negotiations

The official position of the Irish government on EMS membership was to join the system provided that Ireland received enough transfers of funds from its European partners. The Irish government justified “these measures to strengthen the economies of the least prosperous States” on the basis of the potential negative consequences stemming from EMS membership. This economic aid was demanded to finance the structural transformations necessary to make the monetary commitment sustainable and compensate the potential negative effects from the expected loss of competitiveness. This official stance was set in the Irish White Paper on EMS, published in December 1978: “The Government are satisfied that there are no inherent drawbacks in the European Monetary System,

as settled by the Brussels Council, which would preclude Ireland's membership provided agreement could be reached on the transfer of adequate resources to Ireland".¹⁰⁶ This was also the position that the members of the Cabinet supported in the Parliament and public discourses. According to all these government statements, the decision on EMS membership depended exclusively on the reception of transfers, and was not conditioned to the final design of the system or the British participation. However, the government stated that they preferred the United Kingdom to join the system and claimed that one of its priorities was to maintain the peg to the sterling.

According to the Taoiseach, Jack Lynch, the EMS would have positive effects on investment and trade and would reduce inflation and unemployment, although "fiscal and monetary policies to sustain growth, encourage employment and keep down costs" would also be required. However, EMS membership would raise difficulties too. First, a bigger degree of economic integration within the EEC would increase the tendency of central areas to draw wealth and resources from the periphery. Second, there would be a potentially severe strain on competitiveness produced by the fact that, in the first stages of the new monetary system, in which necessary adjustments would not be completed yet, the Irish pound would be overvalued with respect to the other EMS currencies. Third, it would be necessary to reduce rapidly to a much lower level

¹⁰⁶ Stationery Office, Irish White Paper on the EMS, Dublin, 1978. Available online on https://www.cvce.eu/obj/irish_white_paper_on_the_european_monetary_system_december_1978-en-0d8c67e5-3d29-4f8c-a63d-a3a3f76de59b.html

the deficit on the current account balance in order to maintain stable parities without an excessive loss of reserves.¹⁰⁷

These risks, according to the Taoiseach, justified the reception of Communitarian resources to promote the adjustment in the mid-term, deal with the consequences until the adjustment was achieved, and support the parity of the Irish pound in the short-term. The government considered that it would be a mistake to achieve such an adjustment through deflation or reduction in investment. On the contrary, the objective should be to increase investment in order to expand the exporting capacity and reduce import dependence as a mechanism to reduce trade deficit. This required an improvement in the productive structure and, to that purpose, the reinforcement of the regional and sectorial policies in the framework of the EEC were crucial. Therefore, the Irish negotiation strategy was concentrated in getting the financial aid and transfers of resources deemed crucial to achieve those transformations.

At the domestic level, the Irish government was in a quite strong position to impose its plans on the EMS. The Fianna Fáil (centre-right) government had a majority of 84 TDs (Teachta Dála, member of the parliament, called the Dáil Éireann) out of 148, so, unlike what happened in countries like Italy, there were no difficulties to approve EMS membership in the Parliament. Both opposition parties, the Fine Gael (right), with 43 TDs, and the Labour Party, with 16 TDs, voted against joining the system. The Fine Gael and

¹⁰⁷ Jack Lynch (Fianna Fáil), Dáil Éireann debate - Tuesday, 17 Oct 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-17/22/>).

the Labour Party were very critical towards the deal obtained by the government with its European partners. Although they had important ideological differences, these two parties' criticisms were very similar, and in the Dáil debates they showed good judgement in their stances. In fact, even if the Fine Gael was considered to be at the right of the Fianna Fáil and the Labour Party was considered to be at its left, there were several coalition governments Fine Gael-Labour during the 1970s and the 1980s, even if, theoretically, they were ideologically far from each other. Both the Fine Gael and Labour Party reasons to oppose the entrance into the EMS were focused on the conditions of membership and the aid received, more than on the system itself.

The bargaining power of the Irish government during the negotiations with other European countries was, by far, much smaller than that of other governments. Ireland was rarely invited to the meetings of Prime Ministers to debate about the technical aspects of the system and the Irish government had important difficulties to get any prominence during the European Councils. This marginalization of the Irish government from the process of negotiation generated criticisms in Irish society. For example, the editorial of the British Times of the 20 October 1978 alerted of the "dangers of bilateralism" within the EEC. According to the newspaper, "Bilateralism between Paris and Bonn is institutionalised in the Franco-German Treaty, and the proposed EMS is, of course, the best current example of this fruit. Bremen was basically a Community endorsement of a Franco-German

plan”.¹⁰⁸ Ignoring the Irish government during the preparation for the Bremen European Council also generated confusion on the Irish stance. According to the account of Honohan and Murphy (2010) of the pre-Bremen meetings, President Giscard d’Estaing assumed that the Irish would follow the British decisions and, consequently, Callaghan’s refusal to the proposals meant that the Irish were against them too. In order to refute this assumption, the Irish government decided to react positively to the proposals and requested a meeting with the other European negotiators. During the Bremen Council, the Taoiseach explicitly expressed his discontentment with the treatment that the European partners conferred to Ireland. Despite the efforts of the Irish leaders to dissociate their positions from those of the British, according to the journalist John Cooney, during the following meetings continental States continued “regarding Irish Ministers as hirelings of the British”. In Cooney’s view, “our emergence on the EEC stage was rather like a butler accompanying the eccentric John Bull. Ireland was that island behind an island”.¹⁰⁹

Consistently to the stance of being favourable to the EMS conditioned to the reception of financial aid but independently from the characteristics of the arrangement, during the negotiations at the European level the Irish government did not fight for a symmetrical system nor placed any importance to the technical aspects of the system, such as fluctuation margins, definition of intervention rules

¹⁰⁸ “Excuse Us!”, *The Irish Times* (editorial), 20 October 1978, p. 11.

¹⁰⁹ John Cooney, “Ireland’s independent line”, *The Irish Times*, 23 October 1978, p. 6.

or the role of the European Monetary Fund. The main request of the Irish government, in the European Councils and in meetings with other European leaders, concentrated on the demand for transfers of resources big enough so as to promote investments and the structural transformation of the Irish economy to make the exchange rate agreement sustainable.

During the Bremen European Council of July 1978, the Irish government did not make any substantial proposal about the general design or the technical features which defined the system. The main Irish requests had to do with the general structure of the EEC and the regional and sectorial policies. In particular, they advocated the need for a stronger and more coherent regional policy and the maintenance of the Common Agricultural Policy in its current design. At some point of the negotiations, the British government proposed a reform of the CAP as a condition for their participation in the EMS, and the Irish government, despite the will that the British took part in the agreement, radically opposed a reform of the CAP. Regarding the Irish government stance on the EMS, according to the notes taken by the British delegation during the meeting, “Mr Lynch said that in principle the Irish Government supported the idea but it was important to have regard to realistic matters: they could not think that the convergence of economies was adequate as things now stood. It was important to study economic policy as well as to have a study on monetary stability”.¹¹⁰ In order to reduce these regional disparities, at the

¹¹⁰ 1978 Jul 6 Th Archive (TNA). EMS: Bremen European Council record of conversation (after dinner meeting), (memorandum), Venue: No.10 Downing

Council Lynch insisted on the need to preserve the Common Agricultural Policy, which, in his opinion, was the only really positive aspect of regional policy, and to reinforce it in other areas. The Taoiseach requested the incorporation of some explicit mention to regional policies in the conclusions of the meeting.¹¹¹

The main achievements of the Irish representatives during the Bremen European Council were to include in the Conclusions of the Council that the envisaged common approach to EEC economic policies should be oriented to reduce regional disparities, and to add the expression “other less favoured regions”, besides “Mediterranean regions”, in reference to the actions intended to be undertaken in the framework of the Common Agricultural Policy.¹¹² This expression, according to the Taoiseach, was oriented to include measures to improve the structure of agriculture in West Ireland.¹¹³ The inclusion of “other less favoured regions” was presented by the press as a success of the Irish diplomacy, although there was general awareness that Germany did not feel comfortable with the

Street, PREM Source: 16/1634, reproduced in the Margaret Thatcher Foundation archive, available online, <https://www.margarethatcher.org/document/111541>

¹¹¹ 1978 Jul 6 Th Archive (European Council), EMS: Bremen European Council record of conversation (Session 1) [procès-verbal - official French text] (Declassified documents) Proces-Verbal, Venue: European Council Secretariat, Brussels, Source: European Council Archives, Justus Lipsius Building, Brussels, reproduced in the Margaret Thatcher Foundation archive, available online, <https://www.margarethatcher.org/document/111545>

¹¹² Office for Official Publications of the European Communities, "Conclusions of the Bremen European Council" Bulletin of the European Communities, n° 6. Luxembourg, 6-7 July 1978. No. 6/1978, p. 19.

¹¹³ Jack Lynch (Fianna Fáil), Dáil Éireann debate - Tuesday, 17 Oct 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-17/22/>).

idea of large transfers of resources as a part of the EMS agreement.¹¹⁴

The concrete amount demanded by the Irish government in exchange for EMS membership generated huge expectation and controversy within the Irish economic agents. Although there were different – and sometimes contradictory – statements by members of the cabinet with regard to the quantity requested by the Irish negotiators, the figure that circulated around after the Bremen European Council was £650 million. Although the members of the government did not make any official statement on this regard, opposition TDs asked in some occasions about this amount and the basis for its calculation. Opposition parties criticised the government for the lack of transparency on this issue.

Eventually, after a long debate in the Dáil on that topic and many requests of further information by the Fine Gael and the Labour Party, the 24 October 1978, answering to Parliamentary questions, Martin O’Donoghue, Minister for Economic Planning and Development, confirmed that the Irish proposal at the Bremen European Council was £650 million over a five-year period. This financial aid was requested to be mainly in form of grants, not loans. The justification for this demand of transfers was the deflationary effect of the EMS on the Irish economy, which would cause a slowdown in economic growth. In order to increase output and productivity, Ireland would need some financial aid during the

¹¹⁴ John Cooney, “Europe: built on money or not at all”, *The Irish Times*, 17 July 1978, p. 7.

transitional period.¹¹⁵ The inflow of funds for capital investment would enable the country to build up productive capacity and improve the rate of growth and productivity. Opposition TDs requested the government to clarify if the figure of £650 million was proposed for the scenario of Britain joining the EMS or for the opposite one. They also asked for further information on how the British decision on the EMS altered the request for transfers.¹¹⁶ However, the government did not provide further details.

In November 1978, the Irish government intensified the contacts with other European representatives in order to obtain the demanded transfers. At the beginning of November, the Tánaiste (Vice Prime Minister) and Finance Minister, George Colley, met the French Finance Minister, René Monory, and the German Economy and Finance Ministers, Otto Graf Lambsdorff and Hans Matthoefer.¹¹⁷ The objective of these meetings was to convince the European partners of the need for Ireland to soften the impact of entering the EMS. The German representatives, however, were very reluctant to accept large transfers of resources and they expressed more willingness to make concessions regarding minor technical aspects on the functioning of the system, such as the approval of a larger fluctuation band for the least developed countries. Germany also emphasized the need for the adoption of austerity measures to

¹¹⁵ Martin O'Donoghue (Fianna Fáil) Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed). (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>).

¹¹⁶ Michael O'Leary (Fine Gael) Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed). (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>).

¹¹⁷ Dick Walsh, "Colley faces tough talks in Bonn on EMS membership", *The Irish Times*, 6 November 1978, p. 7.

contain prices as a crucial aspect of the incorporation into the EMS.¹¹⁸ As John Cooney put it in an opinion article in *The Irish Times*, “The Irish beggar’s bowl will not go down well in Bonn”.¹¹⁹

In the Brussels European Council of December 1978, the Taoiseach reiterated the same request of £650 million. Lynch insisted on the particular “Irish economic situation”, since the Irish economy still remained “in the course of development”. According to Lynch, the specific problems of Ireland were the following: the lowest GNP per capita in the Community; the highest unemployment rate, close to 10% (which reflected the Irish demographic situation); 50% of population under 25; young people entering the labour market 3 times the average of the Community; and an economy very sensitive to external circumstances (over the 30% of GNP was exported). Due to the specific Irish problems, strongly expansionary measures would be required. However, the absence of Community financial support would impose deflationary policies. Consequently, Ireland requested 200 million EUA (£130 m) per year during 5 years if all member states, including the United Kingdom, participated in the system. If not all of them participated, the Irish needs would be considerably bigger. This aid was requested in form of cash transfers, not interest free loans.¹²⁰

¹¹⁸ “France, Germany revise EMS to win wider acceptance”, *The Irish Times*, 3 November 1978, p. 7; John Cooney, “EEC report rejects monetary aid for Ireland”, *The Irish Times*, 7 November 1978, p. 1.

¹¹⁹ John Cooney, “Colley’s Bonn visit is timely”, *The Irish Times*, 6 November 1978, p. 9.

¹²⁰ 1978 Dec 5 Tu Archive (TNA), EMS: Brussels European Council record of conversation (Session 2) (Memorandum), Venue: Brussels, Source: PREM

Ultimately, at the Brussels European Council, the Irish demands were not accepted. For this reason, Ireland requested an additional period to take a final decision on the adhesion to the EMS. The outcome of the Brussels negotiations was perceived as a big failure by Irish public opinion. The Irish government was offered loans for a maximum amount of £225 million a year over a five-year period starting in 1979. These loans would be repayable over a period of 15 years and would bear interest at the rates prevailing at the moment of taking the loans minus an interest subsidy of three per cent. There would be a moratorium on the repayment of the principal of either three or five years. This did not meet the Irish requests, since the demand of the government was that aid should take the form of grants, not soft loans. The total value of the interest subsidy was calculated to be around £45 million a year over the five years if all the loans were taken up. The total interest subsidy during these five years amounted for a total of £225 million, which was far from the original figure of £650 million.

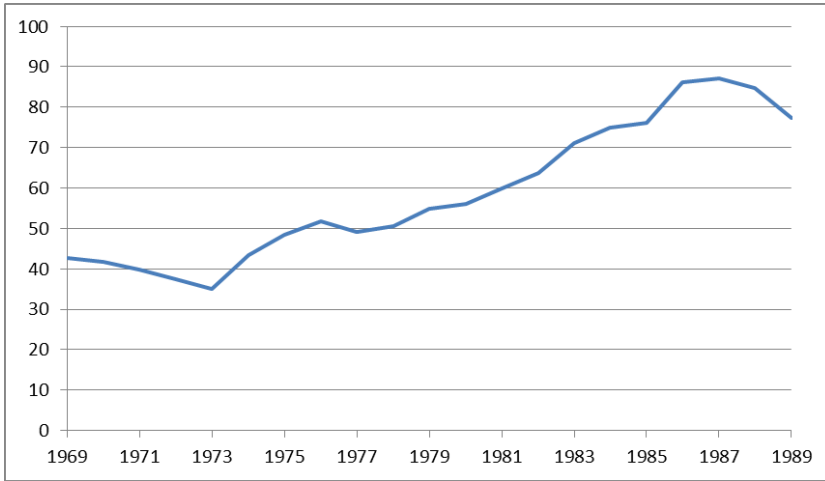
The Irish government did not give up and the 7 December 1978 the Taoiseach telephoned Chancellor Schmidt to discuss the possibilities that emerged after the Council. They arranged a meeting in Luxembourg for the 11 December, in which Irish officials from the Department of Finance and the Department of Economic Planning and Development (Dermot Nally, Maurice Horgan and Brendan McDonald) met representatives of the German government. The Taoiseach also spoke with President Giscard

d'Estaing, who agreed to facilitate informal contacts between Irish officials and French representatives. As a result of these bilateral meetings, the Irish government obtained additional grants of £70 million per year during the following two years, with additional £45 million per year for another three years.¹²¹ This figure was still far from the original requests of the government. However, since the other European leaders made it clear that they would not offer more than that, the Irish government decided to accept that agreement and supported the incorporation in the EMS on those terms.

The decision of the Irish government of accepting a much smaller amount of aid and join the system could be explainable if, by that time, Ireland had substantial difficulties to borrow and, thus, a small amount of lending had a crucial importance for the country. However, the level of debt to GDP and the government's debt yields do not seem to indicate that this could be the case (see figures 4.3, 4.4 and 4.5).

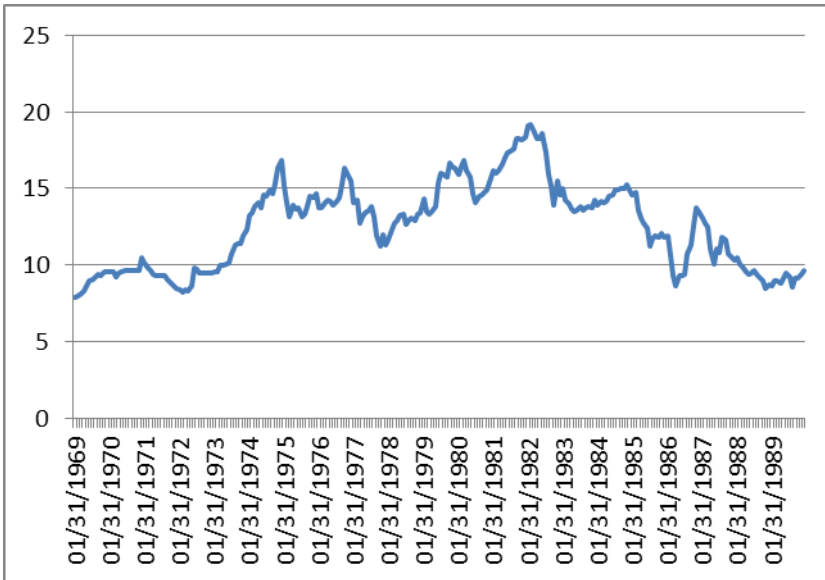
¹²¹ John Cooney, "Dublin-Bonn talks to on new EMS aid packages", *The Irish Times*, 13 December 1978, p. 4.

Figure 4.3: Ireland's Debt to GDP (%), 1969-89



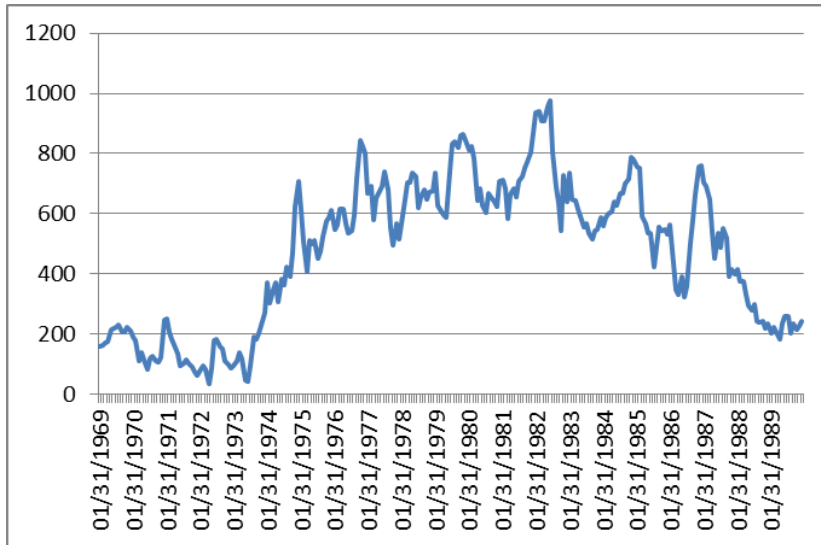
Source: International Monetary Fund

Figure 4.4: 10-year government bond yields (1969-90)



Source: Central Bank of Ireland

Figure 4.5: Ireland 10-year bond vs. German 10-year bond spread (basis points), 1969-89



Source: Central Bank of Ireland, Bundesbank

The Irish government's debt to GDP at that time was not particularly large, and similar to other countries, such as Italy, and, at that moment, the 10 year-government bond yields and the spread with the German bond were very similar to the Italian levels, which is consistent with the fact that Ireland and Italy had similar inflation levels (about 10-14% at the end of the 1970s). Therefore, the government's debt indicators do not seem to suggest a substantial problem of access to credit and, on the contrary, real interest rates were even negative in some years.

4.5 The domestic political debate

a) The debate about the begging bowl strategy and the sufficiency of transfers

Once it was confirmed that the amount of financial aid that Ireland was going to receive in exchange for EMS participation would be smaller than the amount requested, there was an intense debate in the Parliament about the convenience of joining the EMS under the agreed terms. The government claimed that the transfers obtained during the negotiations were enough to ensure a sustainable participation in the EMS. Opposition parties considered the amount attained insufficient and accused the government of having adopted a wrong bargaining strategy that resulted in a bad deal. The main reason for those parties to vote against the EMS, in particular for the Fine Gael, was not the expected negative consequences in terms of loss of competitiveness or impact on output and job destruction, but the meagre transfers obtained in exchange for membership.

Opposition was particularly critical towards the government bargaining strategy, and blamed this wrong approach to the negotiations with other European leaders for the inability to get a deal that met the Irish requests regarding transfers. Labour TD Frank Cluskey stated that the consequences of the government's mishandling of the negotiations were going to be severe. In his opinion, the initial mistake was made at Bremen, where the government enthusiastically accepted the proposals made there.

During the Bremen talks, the British Prime Minister Callaghan, suggested the Taoiseach to consider the possibility of working together to explore alternative options for the design of the system and to ensure safeguards for the weaker economies. However, the Taoiseach apparently dismissed Callaghan's offer in what Cluskey judged as a "display of nationalism and a break with the ancient enemy".¹²² Another criticism to the government was the decision of not meeting the Italian Prime Minister Giulio Andreotti during the visits that the Taoiseach paid to some European Prime Ministers before the Bremen Council. The purpose of those meetings was to explain the Irish request of transfers and obtain both empathy and support for that request. The Irish government received statements of support to the Irish position, but not firm commitments. Eventually, after the Bremen Council, when the press reported that there was a proposal to concede Ireland some transfers of resources, the response of the Italian government was that they "would support that suggestion but they should get the same treatment regarding their own circumstances"¹²³. To sum up, for the Labour Party, the strategy of bargaining individually with the strong currency countries instead of siding together with the United Kingdom and Italy, who had similar interests and requests during the negotiations, was a deeply mistaken strategy and the cause of the inability to achieve a better deal.

¹²² Frank Cluskey (Labour Party), Dáil Éireann debate - Thursday, 7 Dec 1978. European Council Meeting: Statement by Taoiseach (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-07/5/>).

¹²³ "Italians want EMS transfers", *The Irish Times*, 30 November 1978, p. 11.

The Fine Gael TDs also criticised the negotiation strategy of the government. Garret FitzGerald accused the government of not having a proper strategy and of “being content to go with the begging bowl looking for transfers”¹²⁴. He also claimed that negotiations were misconceived and compared the government strategy to his own experience during 1973 in the framework of the discussions on the EEC regional fund. In that occasion, FitzGerald started the contacts with the European leaders travelling to Rome to meet the Foreign Minister and the Minister for Special Investments for the Mezzogiorno. According to FitzGerald, the correct way to approach the negotiations was to agree first with the Italians “so that we and they would not trip over ourselves, each looking for more, and giving the others the excuse of saying that neither of us should get anything”.¹²⁵ Another mistake was not to provide information about the contents of the program of public investment allegedly to be financed with transfers from Ireland’s European partners. The government did not explain properly how the figure of £130 million per year was calculated, why these funds were necessary, or what the government intended to do with them. This poor bargaining strategy was the reason why, according to the Fine Gael, Ireland got so little.

According to the Labour party, this strategy of “chasing around Europe peddling our alleged poverty for a mere interest subsidy

¹²⁴ Garret FitzGerald (Fine Gael), Dáil Éireann debate - Thursday, 30 Nov 1978. European Monetary System: Statement by Taoiseach (Prime Minister) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-11-30/3/>).

¹²⁵ Garret FitzGerald (Fine Gael), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

subject to very stringent conditions” not only produced very little results, but also led to “severe national demoralization”. The government should “recover some of our pride in this situation. We should kick the begging bowl out of our negotiations, and we should also be acutely aware of the fact that in the past seven or eight years since we joined the EEC the attitude of Europe is that they have given massive transfers of agricultural subsidy and resources into Ireland in the past. Europe, on that basis, does not particularly feel that she owes us anything”.¹²⁶

Disregard of the design of the system was, according to opposition parties, another mistaken approach. Placing all the emphasis on transfers instead of on the general characteristics of the new monetary system resulted in a very small capacity of Ireland to influence the outcome of the negotiations, in particular the definition of the system. Labour TD Michael O’Leary underlined the fact that the real capacity of decision-making was in the hands of the German and French governments, something that became evident after the meeting of Chancellor Schmidt and President Giscard d’Estaing in Aachen. In that sense, the Irish government bargaining strategy was a fiasco. Not only it was unable to influence the design of the system, but also failed in obtaining “any real assurance that an adequate transfer of resources within the Community will accompany the monetary innovations”.¹²⁷

¹²⁶ Barry Desmond (Labour Party), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

¹²⁷ “Colley reports on EMS”, *The Irish Times*, 20 September 1978, p. 7.

The misconceived approach to the negotiations led to an amount of transfers that was, according to opposition, insufficient. The Fine Gael considered that an appropriate amount would be £600m per year. They justified that figure on the basis of the existing transfers in other federations of States. According to the Fine Gael, regional differences in the EEC were much bigger than in other federations, such as the United States. In those federations, poor regions received inflows of around 30% of their GNP. If Ireland was a member of one of those federations, the country could expect to receive an amount of more than the 30% of its GNP (because differences were bigger in the EEC). But, since a monetary union is far from a full federation, the amount required in this case should be calculated as one third of what would be in a full federation, this is, 10% of GNP. This proportion was established on the basis of a report presented by the government, which calculated the needs for a monetary union as ten times the present Community budget, and the needs for a full federation as 30 times that amount. Consequently, since the Irish GNP was £6.000 million, the amount of transfers required would be £600m per year.¹²⁸ Therefore, the initial figure of a total of £650m in five years proposed by the government was considered insufficient to counterbalance the negative effects of the EMS. The government responded to the Fine Gael calculations claiming that the EMS was not a monetary union. They also accused the Fine Gael of having the same begging attitudes for which they accused the government.

¹²⁸ Garret FitzGerald, Dáil Éireann debate - Thursday, 19 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-19/3/>).

With respect to the type of aid, the Fine Gael stressed the need for grants, not loans. To Fine Gael TDs, one of the objectives of the government should be to reduce the levels of debt, in particular, foreign debt. The strategy of promoting growth through the expansion of government spending financed through foreign debt was causing negative effects to the Irish economy. Garret FitzGerald considered that the consumption boom originated by the government's policy was generating an inflation rate 3.5 times the German rate and damaged the position of the Irish economy in relation to a potential breakup with the sterling.¹²⁹ John Bruton pointed out the adverse consequences of foreign debt for the Irish economy. First, foreign debt reduced country's control on economic policy-making. Second, the government was not able to recoup the payment of interests through the income tax in the way it did on domestic debt. Third, it accelerated inflation in relation to other countries to which Ireland would link its currency.¹³⁰

The Labour Party members also insisted on the need for bigger transfers, although they did not suggest any specific amount. Labour TDs, in comparison to the Fianna Fáil and the Fine Gael, placed much more emphasis on the technical aspects of the system, and related the amount of financial resources requested to the specific conditions of the Irish participation. Irish industries, claimed the Labour Party, were not ready to deal with the

¹²⁹ Garrett Fitzgerald (Fine Gael). 19 Oct. 1978: Written answers. European Monetary System Motion (resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-19/41/>).

¹³⁰ John Bruton (Fine Gael), Dáil Éireann debate - Thursday, 14 Dec 1978. Adjournment of Dáil: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-14/31/>).

implications of joining the EMS. The reasons the Labour Party gave to vote against joining the EMS were the inability of the Taoiseach to read correctly the attitude of other EEC members on the issue of the transfers of resources, the scarce amount of resources obtained, the government failure in devising strategies to make the Irish participation in the EMS more sustainable, the government concealment of the consequences of breaking up the link with the sterling, and the significance of the problems the country would face as a result of the entrance into the EMS.¹³¹ Labour TDs demanded the government to “get down to the real issues of economic policy, taxation policy, budget policy and next year's public capital programme and run the country in a calmer, more responsible and undoubtedly more effective manner”.¹³²

Despite having made the decision of joining the EMS conditional to the transfers requested (£650 million in 5 years in form of grants), and having eventually received a much lower amount in the form of soft loans, Fianna Fáil TDs decided to vote joining the EMS anyway. The 13 December 1978, in the debate in the Dáil, the Taoiseach justified the adequacy of this smaller amount of aid and supported Ireland's EMS membership. The Taoiseach stated that the reason why Ireland had not received the transfers requested was not any “defect in the presentation of the Irish case” by the government, but “the inability to reconcile conflicting interests and

¹³¹ John Horgan (Labour Party), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/27/>).

¹³² Mr. Barry Desmond (Labour Party), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

approaches, heavily influenced by limitations on the domestic political capacity to agree to compromises”. According to Lynch, both Giscard d’Estaing and Schmidt made a huge effort to find an agreement that would enable Ireland to participate in the EMS.¹³³ Martin O’Donoghue, Minister for Economic Planning and Development, considered that the opposition stance of not joining the EMS on the grounds of the inadequacy of resources obtained was the same as claiming: “We are poorer than the rest of Europe and if we are to enjoy something akin to the same standards of public services as the rest of the EEC, without improving our own output and performance, this is the kind of money you will have to give us. That is the begging bowl”.¹³⁴ With respect to the final amount, £45 million, which was the value of the interest subsidy if all the soft loans offered were eventually taken, according to O’Donoghue it represented a substantially larger sum than the amounts which were forthcoming from the regional funds negotiated by the Fine Gael-Labour coalition government that ruled Ireland between 1973 and 1977. This amount would enable the government to finance investments, infrastructures and other facilities and, in the long term, would improve efficiency and reduce costs for the Irish firms. In relation to the increase in the levels of indebtedness produced by the fact that aid took the form of

¹³³ Mr. Jack Flynn (Fianna Fáil), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

¹³⁴ Martin O’Donoghue (Fianna Fáil), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

loans instead of grants, these loans did not commit the government to any increase in foreign debt above what the government desired.

Eventually, the Fianna Fáil justified the incorporation into the EMS claiming that it was an opportunity for Ireland not only to improve its economic situation, but also to make a contribution to the building a better Europe. O'Donoghue reminded the Dáil that, although they had been spending most of their time debating about the “precise details of loans, transfers or anything else”, ultimately the priority was the “possibility of creating a major new element in the construction of a European union, the possibility of a further major step forward along the path to European union. Surely that is an ambition that ought to be shared by many people here on both sides of the House”.¹³⁵

All this debate on the financial aid received in exchange for the Irish participation hid the technical aspects of the system and their specific implications for Ireland. Surprisingly, the Irish governments did not stress the importance of the precise features of the system, neither in the negotiations with other government nor in the domestic discussions in the Parliament. Opposition also focused on the insufficiency of transfers and the wrong bargaining strategy instead of the definition of the system and the implications for the Irish economy. A deeper analysis of the Irish government stance on these technical aspects shows important contradictions between the official stance of the members of the Cabinet (and their positions

¹³⁵ Professor O'Donoghue, Minister for Economic Planning and Development, Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

during the European Councils) and the options endorsed, in particular in relation to the future monetary relationship with the United Kingdom and the breakup with the sterling. Officially, the standpoint of the government was that the preferred option was to maintain the link with the sterling with both the United Kingdom and Ireland as members of the EMS. However, the position of the Irish government regarding the definition of intervention rules and the election of the narrow fluctuation band made more likely the British decision to stay out of the EMS and the breakup with the sterling.

b) The surprising absence of debate about symmetry

As previously explained, the Irish position in the European meetings was to give support to the EMS whatever the final design would be, provided that Ireland, as the least developed country of the EEC, received enough transfers to facilitate improvements in the economic structure and productivity and to fight the negative consequences produced by the expected loss of competitiveness. Surprisingly, the government did not make distinctions among the different designs to calculate the potential cost of membership in terms of loss of competitiveness, in spite of the fact that an asymmetrical system would probably impose a much bigger adjustment to the Irish economy. Besides, remarkably, during the negotiations the Irish leaders did not fight for a symmetrical system and accepted the German proposal of the parity grid as the basis to define intervention rules. The justification for this stance was based

on the anti-inflationary effects of the parity grid option, which was more favourable, from the Irish government point of view, to control inflation.¹³⁶ However, this choice clearly made less likely a positive British answer to the project. Consequently, the support to the option of the parity grid seems inconsistent with the desire that the British participated in the system.

The issue of symmetry had an almost negligible presence in the domestic debate. However, opposition TDs, in particular of the Labour Party, at some points of the discussion criticized the government's preference for the parity grid option, although eventually the concerns on the design of the system were not the main reason for their negative vote to the Irish incorporation to the EMS. At the Parliamentary debate held the 24 October 1978, Labour TD Michael O'Leary asked the government why it was not supporting the option of the basket of currencies, as other countries, like the United Kingdom, were doing. O'Leary highlighted the deflationary bias of the parity grid option and stressed the fact that the option of the basket of currencies would spread the cost of adjustment among strong and weak currencies, while the parity grid option placed all the burden of adjustment onto weak currencies. According to O'Leary, the differences between the two designs in terms of costs of adjustment also had a crucial importance for the main debate in the Irish framework, the amount of transfers that Ireland demanded to join the system. The financial aid required in

¹³⁶ Liam Lawlor (Fianna Fail), Dáil Éireann debate - Thursday, 19 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-19/3/>).

the case of a system with a deflationary bias would be bigger. For that reason, O’Leary considered unconceivable the Irish silence on that respect during the European meetings. He believed that the Irish government should have supported the British stance in favour of the basket of currencies option and requested the government to change position in that regard.¹³⁷ Labour TDs accused the Fianna Fáil cabinet of taking decisions on behalf of nationalistic reasons, not economic. The Taoiseach’s main motivation, according to them, was to demonstrate independence and detach from the United Kingdom, although in some matters, such as the defence of the currency basket, the best strategy for Ireland was to side together with the British.

Martin O’Donoghue, Minister for Economic Planning and Development, answered to this criticism on the issue of symmetry with a quite astonishing technical argument. According to O’Donoghue, in the case of a small country, since its currency would have a very small weight in the composition of the basket, there was no (or very little) advantage in the option of the basket of currencies. Bigger countries would benefit from the basket option, since the evolution of their currencies would have an impact on the value of the basket. To O’Donoghue “there is no benefit to us worth talking about from the use of a basket as against the parity grid system for calculating the point at which one has to intervene to

¹³⁷ Michael O’Leary (Labour Party), Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>).

support one's currency".¹³⁸ For the government, the Belgian compromise, this is, the definition of intervention rules on the basis of the parity grid and the use of the basket of currencies to create a divergence indicator, was a good option for the Irish interests and there was no reason to campaign in favour of the basket option.

This justification of this government's position was quite feeble. Although the Irish pound was not going to have a relevant weight in the ECU, in terms of the adjustment measures needed to reduce inflation rates to make the peg of the punt sustainable, there were big differences between a system that was expected to operate under the hegemony of the Deutsche mark and, thus, committed the government to maintain a fixed exchange rate with Germany, and a system based on the ECU, where Germany was expected to be obliged to intervene frequently to correct the probable appreciation of the mark with respect to the other currencies in the basket. The first system imposed a bigger reduction in inflation rates than the second and, thus, required harder austerity measures. Besides the cost of adjustment, the British government was much more likely to decide to join the system if the option endorsed was the basket of currencies instead of the parity grid and, if the Irish government preferred the United Kingdom to join the EMS in order to be able to maintain some relationship with the sterling, there were strong reasons for the Irish government to defend actively this option. Although the Irish government claimed that maintaining some link

¹³⁸ Martin O'Donoghue, Minister for Economic Planning and Development (Fianna Fail), Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>).

to the sterling was a priority, there were other countries, such as Italy, that insisted much more than Ireland on the need of having a monetary arrangement that included all EEC countries, this is, also including the United Kingdom.

c) The breakup of the peg to the sterling

For countries like Italy, the British decision on the EMS was very relevant, since the operation of the system would be very different if there was another big country with high inflation in it. But, for Ireland, it had huge consequences, due to its high trade dependence with respect to the United Kingdom and the one-to-one peg to the sterling. The Irish government insisted on the wish that the British joined the system and claimed that, even if this was not the case, it was a priority to maintain the peg to the sterling. Again, the official stance of the government and the concrete actions endorsed were contradictory. Even after the Irish decision of joining the EMS without the British (and in the narrow fluctuation band), the government kept on insisting that the peg to the sterling was going to be maintained, although it was evident that this was not going to be possible and, in fact, the government had already introduced exchange controls with the United Kingdom to get prepared for that circumstance.

Before the decision of joining the EMS, the government position about a potential breakup with the sterling was much more favourable than the general stance of economic actors. As previously explained, sectorial associations and trade unions were

in favour of the preservation of the link to the sterling. On the other hand, the Fianna Fáil government, although reckoned the advantages of a fixed exchange rate with Ireland's main trade partner, also highlighted the disadvantages of being pegged to the sterling. During the months previous to the EMS incorporation, there were several statements made by members of the cabinet on the possibility of breaking up the peg. The general tone of those assertions was quite favourable to the end of the one-to-one exchange rate. For example, after the Bremen European Council, the Taoiseach affirmed that: "While tied to the sterling we have always held that we have the capacity to leave the sterling club if and when it suits us"¹³⁹. When discussing this possibility within the Cabinet, the Taoiseach presented such a decision as the dilemma between "an attempted break with the sterling to allow attachment with EMS and retention of the sterling connection with attendant risks of damaging fluctuations".¹⁴⁰ The Tánaiste and Finance Minister, George Colley, expressed similar opinions on the issue and presented the break with the sterling as a "strong" although not "uncomplicated" possibility.¹⁴¹

In the Parliament, Colley explained the government's opinion on the disadvantages of being pegged to the sterling. The Tánaiste acknowledged the advantages for a small and open economy of linking its currency to its major trade partner, since it provided an

¹³⁹ John Cooney and Dennis Kennedy, "Ireland backs new monetary plans despite British doubts", *The Irish Times*, 8 July 1978, p.5.

¹⁴⁰ Dick Walsh, "Lynch brings back the sterling dilemma for the Cabinet", *The Irish Times*, 10 July 1978, p.1.

¹⁴¹ Dick Walsh and Ken O'Brien, "sterling link may end with EEC plan", *The Irish Times*, 21 July 1978, p.1.

essential element of stability to a large share of its external trade. However, these advantages were attained only if the economic situation of the bigger country was satisfactory and the currency was stable. According to the Tánaiste, this was not the case of the United Kingdom in the 1970s. During this period, Ireland was unable to insulate from the adverse effects of the British economic and monetary policies, in particular, during the period of high inflation of 1973-76. This made imperative the review of the relationship with the sterling. The Tánaiste also described the advantages of joining the EMS without the British and breaking the link with the sterling which, according to Colley, were the following: First, Ireland would join a currency zone whose members were growing faster than the United Kingdom. Second, the link to a stronger currency would contribute to a reduction in inflation. Third, it could be expected an increase in the non-British foreign investment. Fourth, Ireland would benefit from the increased credit support and the additional Community aid obtained as a result of the negotiations on the new monetary arrangement. On the other hand, the Tánaiste also identified several inconveniences of breaking with the sterling. One of the most important disadvantages was that the United Kingdom accounted for almost 50% of the Irish external trade, almost 40% if agricultural goods were not included (they were insulated from exchange rate fluctuations through the operation of the Common Agricultural Policy). A potential appreciation of the sterling in relation to the Irish punt would produce a loss of competitiveness of the Irish exports to the United Kingdom, which would have adverse

consequence for output, employment and the balance of payments. Investment from British firms operating in Ireland and Irish firms whose exports concentrated on the British market would also be negatively affected. Additionally, Ireland would become a less attractive touristic destination for British visitors. Finally, the uncertainty created by the fluctuation of the exchange rate could impose the need to introduce exchange controls in order to restrain currency speculation.¹⁴²

Opposition TDs, in particular of the Labour Party, were much more reluctant to break the link with the sterling than the government. The main reasons were the potential loss of competitiveness of the Irish exports and the negative impact on output and employment. Labour TD Michael O’Leary highlighted that, although the Irish dependence with respect to the British market decreased since the incorporation to the EEC, the British market still represented a fundamental share of the Irish exports. He blamed the government of oversimplifying the consequences of such a decision.¹⁴³

Labour TDs also accused the government of being willing to break the link with the sterling for romantic and nationalistic reasons, even if this decision would have, according to them, an important cost in terms of loss of jobs. For example, James Tully, a Labour TD, stated that “*I have not any greater love for Britain than has any*

¹⁴² George Colley (Fianna Fáil), Dáil Éireann debate - Tuesday, 17 Oct 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-17/22/>).

¹⁴³ Michael O’Leary (Labour Party), Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>).

member of Fianna Fáil. I know what the British stand for and that from time to time they are doing well or doing badly, but they are our customer and they have taken about 46 per cent of the produce of Ireland. As long as that is the case we must take cognisance of what they do. It is nonsense for somebody to try to wave a tricolour and claim to be doing the patriotic thing, saying that we do not care what Britain does and we are not tied to the £ sterling. We may get a few cheers from people who say 'This is wonderful; at last we are going to get away from them and our punt and their £ will be entirely different'. That will be of very little use when the unemployment problem will grow. We could find ourselves in the position of being unable to compete at all, particularly if our punt were to go up, while we import produce from Britain".¹⁴⁴ Barry Desmond also mocked the government for the same reason and stated: "unfortunately, early on in the Bremen situation the Taoiseach and the Tánaiste were caught up with this republican euphoria of breaking the link with sterling [...]. After Partition and after the national language I suppose breaking the link with sterling would be about the greatest thing that the Taoiseach would like to go down in history on; he could comfortably retire on that".¹⁴⁵

In the voting procedure, the Labour Party emphasized its Europeanism and desire to favour "the closest possible links with Europe". However, they judged inconvenient the breakup with the

¹⁴⁴ James Tully (Labour Party), Dáil Éireann debate - Thursday, 19 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-19/3/>).

¹⁴⁵ Barry Desmond (Labour Party), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

sterling due to the close economic and monetary relationships with the United Kingdom. Consequently, if the British decided not to join the EMS, the best option for Ireland was, according to Labour TDs, to stay out and join later when the British did so. To the Labour Party, Ireland's best option was to try to strengthen the EEC regional and social fund, and considered that the Irish presidency of the Community during the second half of 1979 was a good opportunity to bring these issues into the agenda. Ireland could then benefit from aid within the Community without having to face the rigours of the EMS.¹⁴⁶

The Fine Gael was not so critical about the possibility of breaking up with the sterling, but their members highly criticised the lack of preparation of the government for that circumstance. Fine Gael TDs pointed out that ending the link with the sterling required the adoption of important measures regarding the control of the exchange rate, the introduction of exchange controls and conferring new powers to the Central Bank. They criticised the government for not having issued any piece of legislation in that direction and being totally unprepared for a potential break with the sterling.¹⁴⁷

Fine Gael leaders also criticized the inability of the government, once the British announced that they would not be participating in the EMS, to obtain more transfers on the reason of increasing

¹⁴⁶ Barry Desmond (Labour Party), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

¹⁴⁷ Richie Ryan (Fine Gael), Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>).

difficulties of adjustment to the EMS without the United Kingdom. According to them, joining the EMS while the United Kingdom stayed out would have negative consequences for many Irish industries. The government should take action and request EEC partners to provide enough resources to guarantee investments to make Irish products competitive again.¹⁴⁸

In response to those criticisms, the government stressed the fast depreciation of the sterling to the mark during the 1970s and its consequences on the Irish inflation rate. The government highlighted the anti-inflationary effects of the EMS and, therefore, its positive impact on output and employment. Pádraig Flynn, from the Fianna Fáil, asked rhetorically: “Must we be dragged up and down by Britain’s rate of inflation forever?”¹⁴⁹ For the Fianna Fáil cabinet, the anti-inflationary effect of the EMS was desirable and the key for the future prosperity of the Irish economy based on an increase in investment and an improvement of productivity.

The decision to enter the EMS within the narrow band ($\pm 2.25\%$), instead of the wider band allowed to non-Snake members ($\pm 6\%$), had important implications for the possibility of keeping the link to the sterling. Peter Barry, from the Fine Gael, highlighted the inconsistency of the government’s choice of the narrow band and, at the same time, the confirmation that the peg to the sterling would be

¹⁴⁸ Peter Barry (Fine Gael), Dáil Éireann debate - Tuesday, 17 Oct 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-17/22/>).

¹⁴⁹ Pádraig Flynn (Fianna Fáil), Dáil Éireann debate - Wednesday, 13 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-13/6/>).

maintained. With the narrow band, Ireland would be forced to break the peg to the sterling earlier than it would be with the wider band. Besides, the narrow band entailed a much bigger risk of speculative attacks and hence required the use of exchange controls.¹⁵⁰

The government's answer to the question of why they preferred the narrow band is quite astonishing. Martin O'Donoghue stated that the width of the fluctuation band would determine the probability of breaking up the link if both countries were in the EMS. Since the United Kingdom was not part of the agreement, the width of the band had nothing to do with the risk of having to break up with the sterling.¹⁵¹ Michael Woods also added that the peg to the sterling was going to be maintained thanks to the fact that Denis Healey, Chancellor of the Exchequer, gave his "personal assurance" to the Irish government that Britain had no intention to diverge from the Irish punt.¹⁵² To finish the debate, the Tánaiste concluded that the decision of joining the narrow band was the result of "the weighing up of the various issues involved and the balance of advantages and disadvantages, we are quite convinced that the narrower margins suit our interests much better than the wider margins would".¹⁵³ In

¹⁵⁰ Peter Barry (Fine Gael), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion

(<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

¹⁵¹ Martin O'Donoghue, Minister for Economic Planning and Development (Fianna Fáil), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

¹⁵² Michael Woods (Fianna Fáil), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

¹⁵³ George Colley (Fianna Fáil), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion

spite of these statements, it was quite obvious that the breakup would occur sooner in the narrow band, since the sterling pound (and thus the punt) would reach the limit of the fluctuation band with any of the EMS currencies sooner.

The government's attitude with regard to the breakup with the sterling is quite scheming. Publicly, after joining the EMS, the members of the cabinet kept on insisting that the link with the sterling was going to be maintained. For example, on the 12 March 1979, the day before the launching of the EMS, Martin O'Donoghue, Minister for Economic Planning and Development, claimed that the sterling link was going to remain "intact".¹⁵⁴ When the EMS started operating, the Taoiseach stated that "there was no question at this stage of a break in the parity between the Irish and UK currencies", although he accepted that "if the British £ floated beyond the EMS fluctuation limits of the punt, it would be good-bye to the sterling".¹⁵⁵ In spite of this insistence from the government, both in the Parliament and in public discourses on the maintenance of the peg to the sterling, it was obvious that it could not be preserved for long. In fact, the breakup took place just a couple of weeks after these declarations, the 30 March 1979. When this eventually occurred, the government claimed that it took them "by surprise" and issued a statement explaining that: "As previously indicated it has been the government's policy to maintain the one-for-one no-margins parity between the Irish pound and sterling as

(<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

¹⁵⁴ Ken O'Brien, "Sterling link to remain", *The Irish Times*, 12 March 1979, p.7.

¹⁵⁵ John Cooney, "Lynch does not foresee early sterling break", *The Irish Times*, 14 March 1979, p.1.

long as this was feasible in the light of our obligations under the EMS”. However, “as movements of sterling have brought the Irish pound to its upper intervention limit within the EMS, maintenance of the one-for-one parity with sterling would bring it beyond that limit and, in accordance with our EMS obligations, it has been discontinued”.¹⁵⁶

Before joining the EMS, in spite of the public statements asserting that the peg to the sterling would be maintained, in the Dáil, the Fianna Fáil TDs tried to convince other parties of the advantages of breaking up with the sterling. Besides, the 28 November 1978, when it was already clear that Ireland was going to join the EMS and the United Kingdom was going to stay out, the Exchange Control (Continuance and Amendment) Act was passed and included the possibility of applying exchange controls to monetary transactions with the United Kingdom. This represented the end of free movement of capitals between the two countries.¹⁵⁷ Moreover, the option of the narrow band forced an earlier breakup of the one-to-one exchange rate than the option of the wider band. In conclusion, despite the insistence on the preservation of the link, the government supported the advantages of ending the link with the sterling, prepared legislation for that circumstance and joined the EMS with the option that forced an earlier breakup.

¹⁵⁶ Dick Walsh, “Cabinet takes philosophical view of parity break”, *The Irish Times*, 31 March 1979, p 14.

¹⁵⁷ Exchange Control (Continuance and Amendment) Bill 1978 (Bill 33 of 1978) (<http://www.irishstatutebook.ie/eli/1978/act/24/enacted/en/html>).

d) Implications of the break with the sterling for the future relationship with Northern Ireland

The breakup of the peg to the sterling and the introduction of capital controls with the United Kingdom had important implications for the future economic and political relationship with Northern Ireland. In the Dáil, this issue generated more controversy than the breakup itself. Again, there were substantial differences between politicians' and economic and social actors' preoccupations. In the Parliament, the impact for Northern Ireland relations was the main concern regarding the breakup with the sterling, while, in the case of trade unions and sectorial associations, this was not a relevant argument, while the consequences for the competitiveness of the Irish products and its impact on output and employment was the most important argument to maintain the peg.

In the political debate, there were two perspectives on how a breakup with the sterling would affect the relationship between the Republic of Ireland and the Ulster. The first viewpoint assumed that joining the EMS and breaking up with the sterling would distance Northern Ireland from the South even more, and would reduce the likelihood of the reunification of the island. The second standpoint claimed that joining the EMS and improving economic conditions, as well as social services, at a moment in which there was a perception of decline of the British economy, could convince pragmatists in the Ulster that their best option was a union with the

Republic.¹⁵⁸ The government supported the second approach, and was quite convinced that the improvement of the living standards in the Republic would be a strong driving force for the reunification of the island. The incorporation to the EMS, together with the transfers of resources that were expected to be obtained in exchange for the Irish participation, could contribute to this improvement in economic conditions. According to the Fianna Fáil, one of the most vital benefits of the EMS would be its contribution to the process of reunification.¹⁵⁹

For the Fine Gael, the implications of a breakup with the sterling for the relationship with Northern Ireland should be a priority when making a decision on the EMS. To this party, this should be a decisive factor when considering the possibility of finishing the link to the sterling. For example, according to Barry, “We must ensure that any decisions we arrive at do not set back by as much as one day the possibility of reunification”¹⁶⁰. John Bruton also stressed how important this aspect was for his party: “In the event of our departing from sterling this will mean that the Irish punt will not be

¹⁵⁸ Dáil Éireann debate - Tuesday, 24 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-24/26/>); Dáil Éireann debate - Wednesday, 25 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-25/9/>).

¹⁵⁹ Martin O'Donoghue (Fianna Fáil), Dáil Éireann debate - Wednesday, 25 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-25/9/>); Jack Lynch (Fianna Fáil), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

¹⁶⁰ Peter Barry (Fine Gael), Dáil Éireann debate - Tuesday, 17 Oct 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-17/22/>).

capable of being used in Northern Ireland. If one wants to go to the North one will have to buy sterling at a different rate of exchange. Economic transactions between the North and the South will be interfered with. [...]Most of us are in politics to bring about reconciliation in this island. We all want to see that although we all have a different way of going about it. We in Fine Gael have a different approach to the problem than some people on the other side”.¹⁶¹ The Fine Gael did not share the Fianna Fáil approach to the issue of the impact of a breakup with the sterling on the Ulster and was very worried about making a decision that could negatively affect the reunification.

The Labour Party also expressed concerns about the implications of the breakup with the sterling for trade and economic relationships with Northern Ireland, although their opinions were not as dramatic as those of the members of the Fine Gael. During the political debate, Labour TDs placed more emphasis on the consequences of the breakup on output and employment than on the impact on the Ulster.

The government’s response to Fine Gael’s concerns about creating a new border with Northern Ireland was to reject the idea that Ireland was forced to give up the possibility of choosing the exchange rate in order to maintain the existing circumstances in the North. For Martin O’Donoghue, Minister for Economic Planning and Development, the fastest way to promote the Irish unity was to

¹⁶¹ John Bruton (Fine Gael), Dáil Éireann debate - Wednesday, 18 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-18/3/>).

demonstrate that “an independent Irish monetary system is part of a set of economic arrangements which are accompanied by a faster rate of progress in the economic area than would be experienced as part of a sterling system”.¹⁶² The Taoiseach, in his intervention about the EMS in the Dáil the 21 December 1978, also insisted on the fact that, although Northern Ireland would not participate in the exchange rate mechanism, the government placed attention to the relations with the North and the “progress towards the national objective of the coming together of all the people of Ireland”.¹⁶³ For the Taoiseach, Irish membership would expand cross-border trade and economic cooperation and would promote progress towards the national objective of reunification. Economic benefits of EMS membership would also improve the perception on the Irish levels of economic development and living standards.

Although there was a high degree of uncertainty about the eventual consequences of breaking up with the sterling for the relationship between the two sides of the border and there were opposed stances about how the EMS could affect the relations with the Ulster, it is clear that nationalistic aspirations of reunification played an important role in the debate and the decision making process. Both for the Fine Gael and the Fianna Fáil, the relationship with the Ulster and the reunification of the island was a political priority, in spite of having divergent opinions on how to achieve it. Both parties

¹⁶² Martin O'Donoghue (Fianna Fáil), Dáil Éireann debate - Wednesday, 25 Oct 1978. European Monetary System: Motion (Resumed) (<https://www.oireachtas.ie/en/debates/debate/dail/1978-10-25/9/>)

¹⁶³ Jack Lynch (Fianna Fáil), Dáil Éireann debate - Thursday, 21 Dec 1978. European Monetary System: Motion (<https://www.oireachtas.ie/en/debates/debate/dail/1978-12-21/6/>).

placed much more attention to the consequences of the breakup of the peg to the sterling for Northern Ireland than they did to the impact on competitiveness or, in general, the economic effects. The belief that the EMS was going to improve the economic conditions of the Republic and this would foster reunification was a quite uncertain bet. However, according to the *Irish Times* journalist Paul Tansey, “with the prize of a united Ireland as the incentive, Fianna Fáil may well have a go”.¹⁶⁴ This political discussion about the implications of ending the link to the sterling centred mainly in the possibilities of reunification was very detached from the main concerns of economic agents, which were worried about the consequences of the breakup for Irish competitiveness, trade, output and employment, but did not express preoccupation for the implication for the Ulster.

4.6 The Irish experience with the EMS

The Irish government expected the EMS to encourage Irish economic performance, as well as to contribute to the improvement in the living conditions in comparison to the United Kingdom. The aim of this section is to assess to what extent the Irish government predictions on the EMS effects were fulfilled and what were the short-term effects of EMS membership. I will show that the Irish experience during the first years of the EMS were very different to

¹⁶⁴ Paul Tansey, “North is at core of EMS decision”, *The Irish Times*, 26 October 1978, p. 12.

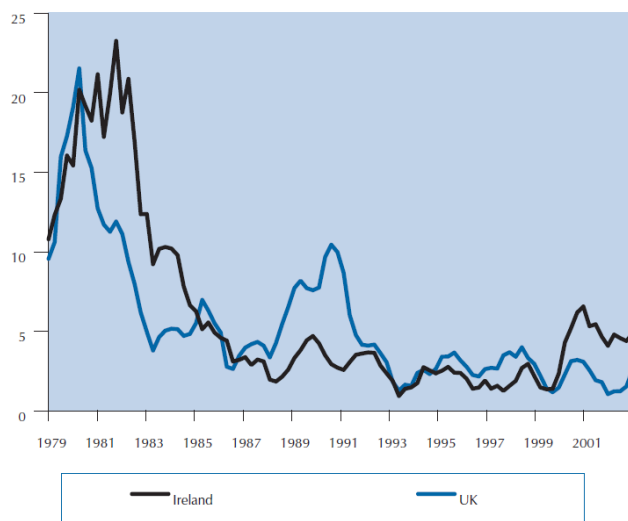
what the government anticipated, and this forced the adoption of severe adjustment measures and triggered a government crisis.

Before joining the EMS, there was a consensus on the idea that, in the event of a break of the one-to-one peg, the Irish currency would appreciate against the sterling. In fact, in October 1978, when the likelihood of the breakup of the sterling increased as a result of the evolution of the EMS negotiations, there were several episodes of speculative pressures.¹⁶⁵ As a result of stockbrokers' concern about the potential consequences of breaking up the link, the London Stock Exchange created a special committee to study the relationship between the Dublin and London stock markets.¹⁶⁶ However, the evolution of the exchange rate of the Irish punt with respect to the sterling after the breakup did not meet the expectations created. During the period 1979-83, Ireland had a higher inflation rate than the United Kingdom and the Irish punt depreciated against the sterling (see figures 4.6 and 4.7). This evolution was the result of the improvement of the British balance of payments thanks to the exports of North Sea oil, the shift in the British monetary policies during Thatcher's government, the increase in the cost of the Irish imports due to the rise in oil prices in 1979, and the inability of the Irish government to control budget deficits during the first years of the 1980s due to political tensions.

¹⁶⁵ Paul Tansey and Ken O'Brien, "British speculators gamble millions on Irish sterling break", *The Irish Times*, 24 October 1978, p.1; Ken O'Brien, "British money pours into stock market", *The Irish Times*, 25 October 1978, p. 1; Ken O'Brien, "UK speculation in Irish shares continues", *The Irish Times*, 25 October 1978, p.14.

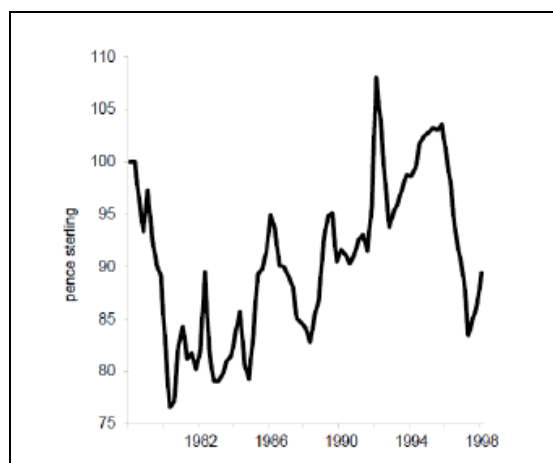
¹⁶⁶ Sebastian Taylor, "Committee to watch pound/punt problems", *The Irish Times*, 26th October 1978, p. 14.

Figure 4.6: Inflation rate in Ireland and in the United Kingdom, 1979-2002



Source: KELLY, J., 2003. "The Irish Pound: From Origins to EMU," *Quarterly Bulletin Articles*, Central Bank of Ireland, pages 89-115, March.

Figure 4.7: Sterling pound-Irish pound exchange rate (pence sterling per Irish pound)



Source: HONOHAN (2015), "Currency choices in Ireland past and present", Presentation by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at Queen's University, Belfast, 31 March 2015.

In fact, as a consequence of these differentials in inflation that Ireland maintained, not only with respect to the United Kingdom but also to other EMS countries, the Irish government was forced to devalue the punt often during the first stage of the operation of the EMS (see table 4.2). However, the frequent realignments did not compensate entirely differentials in inflation (Giavazzi and Giovannini, 1989), leading to an appreciation of the real effective exchange rate of the Irish pound and a deterioration of the Irish balance of payments.

Table 4.2: Irish pounds per German mark

	Irish pounds per German mark
13/03/1979	3,788854705
24/09/1979	3,714572267
05/10/1981	3,520903605
14/06/1982	3,377351481
21/03/1983	3,089213394

Source: NYBERG, P., UNGERER, H. and EVENS, O. (1983), "The European Monetary System: The Experience, 1979-1982", International Monetary Fund.

By 1985-86, the situation of the Irish pound was unsustainable. In spite of the progressive reduction in inflation rates, large budget deficits and the increase in external borrowing put interest rates under pressure and the country risked a financial crisis. Unemployment rose to a record level of 17.4% (Park, 2003). The government faced the dilemma of leaving the EMS and devalue against the sterling in order to stimulate competitiveness and fight the high level of unemployment, or maintain the punt in the EMS and implement austerity measures. The cabinet, formed by a

coalition of the Fine Gael and the Labour Party split on this matter and the Labour Party obstructed any attempt to impose fiscal discipline, leading to a government crisis. Eventually, the Labour Party left the government triggering general election in 1987. The Fianna Fáil won the election and the new Prime Minister, Charles Haughey, started an austerity program with the parliamentary support of the Fine Gael. Macroeconomic stability measures were imposed with the purpose of consolidating the position of the punt in the EMS. Thus, the expected positive effects of the EMS on the Irish economic performance and the reduction of the Irish inflation rates below the British rates were only attained after the adoption of severe austerity measures and reforms.

4.7 Conclusions

The breakup of the one-to-one peg to the sterling pound was a transcendental outcome of the Irish decision of joining the EMS. However, the government placed very small attention to the economic consequences of such a decision and, instead, concentrated all the efforts in obtaining financial aid from European partners in compensation for joining the system. The amount requested was independent from the design of the system and the British participation in it, although the potential impact for Ireland would be different in each case. Besides, the government disregarded technical aspects related to the definition of the system. In the Dáil, the debate on EMS also concentrated on the amount of transfers obtained by the government in the negotiation and the

bargaining strategy, while the economic consequences of joining the EMS and breaking up with the sterling had much smaller presence. Regarding this last issue, the debate was focused on the implications for the Ulster. This political approach to the issue of the EMS did not reflect the worries of the majority of the economic agents, for whom the potential economic impact of a breakup with the sterling in terms of competitiveness of the Irish products was the most important concern and the main reason to oppose the EMS. Sectorial associations and trade unions had different stances on EMS membership, but there was the unanimous will to maintain the link with the sterling, since trade relations with the United Kingdom were considered essential for all of them.

Regarding the British incorporation into the EMS and possibility of breaking up with the sterling, the government had a contradictory stance. The members of the cabinet stated in the Dáil and in public discourses that they preferred the United Kingdom to take part of the EMS and that one of the priorities was not to break the peg to the sterling or, at least, preserve it as much as possible. However, the options endorsed regarding the definition of the system and their own participation in it were the opposed to those that could have facilitated these objectives. First, with respect to the definition of intervention rules, the government did not support a symmetrical system and the basket of currencies and defended the parity grid instead, which had a much bigger deflationary bias. Taking into account that the British government was much more likely to join the system if the option endorsed was the currency basket, if the Irish government wished the British participation in the EMS, there

were strong incentives to defend a system based on the ECU, which, for Ireland, not only reduced the cost of pegging to EMS currencies due to a smaller deflationary impact, but also could contribute to convince the United Kingdom to join. Second, the decision of not opting for the wider band, and not even actively support that possibility during the negotiations, is also inconsistent with the announced will of maintaining the link to the sterling as much as possible. The wider band would have allowed the Irish government to keep the link with the sterling for longer time than the narrow band, since, in this last case, the probability of the sterling reaching the limit of the band with any EMS currency was much higher (although, eventually, even in the wider band, at some point Ireland would have been forced to break up the peg). The wider band not only allowed Ireland to preserve the link with the sterling for longer, which was coherent with the will of most economic actors, but also reduced the risk of speculative attacks (a big concern for bankers and industrial producers) and decreased the cost of the system in terms of intervention obligation. The Cabinet's justification for both options, the parity grid and the narrow band, were very weak from an economic point of view, or directly based on false assumptions.

The decisions endorsed by the Irish cabinet show a clear incongruity between the government statements, which uttered that the preservation of the peg to the sterling was a priority and that the breakup was not going to occur, and the decisions ultimately endorsed, this is, joining the EMS without the United Kingdom and opting for the narrow band, which made the breakup unavoidable.

The Fianna Fáil, and to some extent the Fine Gael, was much more favourable to end the link to the sterling than most economic agents (agrarian associations, trade unions and the industrial and banking sectors). The political debate on the link to the sterling was concentrated on political and nationalistic aspects, mainly the impact for the future relationship with the Ulster and the possibilities of reunification, instead of the economic consequences of the decision, which were the reason why economic agents did not want the breakup to occur. The Fianna Fáil members were quite convince that the EMS and the breakup with the sterling, which, according to them would improve the economic prospects and living conditions in Ireland, while the British would experiment a decline, would be a driving force of the reunification for Ireland. This idea led policymakers to be much more favourable to the end of the link to the sterling than the majority of economic agents. The EMS provided an excuse to carry out this decision.

Therefore, for the Irish government the decision of joining the EMS was mainly motivated by political reasons, as they expected the EMS, and the financial aid obtained, to be determinant in the development of the country and the detachment from the United Kingdom, which was, according to the Irish government, a crucial factor to encourage reunification. The debate about transfers hid the implications that the decision of joining the EMS entailed for the Irish economy, not only due to the breakup with the sterling, but also in terms of austerity measures, which were eventually implemented in the mid-1980s.

To sum up, the Irish decision to join the EMS cannot be explained on the ground of the traditional literature on interest groups. From the perspective of the benefits of fixed exchange rate agreements, there were strong incentives to try to keep some kind of relationship with the sterling, perhaps not necessarily the one-to-one peg, but at least the EMS fluctuation band. The size of compensations obtained in exchange for EMS membership seems to be enough to justify the government's decision, since the final amount conceded was far from the government's request. For the Irish government, EMS membership was part of a nationalistic project leaning to the total split with the United Kingdom, not only politically, but also economically, and eventually the reunification of the island. EMS membership without the United Kingdom created a situation that made the breakup with the sterling unavoidable. EMS benefits and transfers obtained were expected to foster economic growth faster than the British rates. According to the government, the improvement of the living standards in the Republic, compared to the British standards would encourage the reunification of the island, since North Irish citizens would have strong incentives to reclaim the annexation to Ireland. The first years of the EMS membership refuted these aspirations. Ireland's inflation rate was higher than the British and most of other EMS countries, the Irish punt was devalued in several occasions and unemployment skyrocketed. This poor economic performance forced the government to impose severe austerity measures during the 1980s.

CONCLUSIONS

The European Monetary System is frequently considered the predecessor of the European Monetary Union, and the ECU the ancestor of the euro. The current crisis of the euro has revealed the inability of the European Monetary Union to deal with asymmetrical crisis. Actually, the possibility of this kind of shocks was not anticipated, or was simply assumed that would be automatically corrected through movements of capital and labour. There were simply no provisions on how to deal with this kind of situations. The shortcomings in the design of the Monetary Union, which have become noticeable with the current crisis, call for a reassessment of the whole process of European monetary integration.

Although the EMS is considered the starting point of European monetary integration, the analysis of the negotiations leading to its launching shows however that at the time when the new system was conceived there was not any intention or expectation that it would eventually lead to a monetary union. On the contrary, the design of the EMS and the decision of high inflation countries to join it were motivated by the specific problems of the 1970s and the difficulties that emerged in the framework of the generalization of floating exchange rates. In order to understand the EMS design and eventual functioning, it is necessary to contextualize the system in the particular historical period in which it was devised and it operated.

The negotiation of the EMS was highly conditioned by the experience of the Snake, the system inherited from Bretton Woods. High inflation countries (France, United Kingdom, Italy and Ireland) were constrained to leave the arrangement and experienced very high levels of inflation and volatility of their currencies during the second half of the 1970s. The poor economic performance during this period casted doubts about the sustainability of floating exchange rates and triggered the need to find a new approach to monetary cooperation within the European framework.

The main source of tensions during the Snake was the perception of high inflation countries' governments that the system operated under the hegemony of the Deutsche mark and placed all the burden of adjustment onto weak currency countries. Therefore, at EMS discussions, symmetry became the main conflicting issue. High inflation countries demanded a new monetary agreement that eliminated the asymmetry of the previous system, while Germany feared that a symmetrical system would entail the loss of its monetary autonomy.

Traditionally, the concept of symmetry has been used as a binary category and monetary systems have been classified as symmetrical or asymmetrical. I propose here to use the concept of "degree of symmetry" in order to compare different systems or alternative designs of a system, and rank them as more or less symmetrical than others. In the case of the EMS, the concept of degree of symmetry is useful to assess the costs and benefits for the participants. For high inflation countries, the cost of adjustment

associated to the participation in the monetary agreement depended on how asymmetrical the system was, this is, how much they had to reduce their differential of inflation with respect to other participants with low inflation, mainly Germany. For low inflation countries, mainly Germany, the more symmetrical the system was the higher the risk of suffering inflationary tensions due to the loss of autonomy of money supply (as a result, for example, of being constrained to intervene to correct the expected appreciation of the mark). When assessing the symmetry of a monetary arrangement it is also important to take into consideration that the notion of symmetry itself has changed throughout time. Since the 1990s, with the generalization of systems of fixed exchange rates as anti-inflationary mechanisms, asymmetrical systems have been frequently interpreted as tools to keep inflation under control. However, in the framework of the operation of the Bretton Woods system (an asymmetrical system), when some European leaders complained about its asymmetry, they were not referring to an alleged deflationary bias of the system, but to the privileges that it granted to the dollar (this was for instance the case of France), or to the inflationary pressures that the United States transmitted to the rest of countries of the system (the case of Germany).

The concept of symmetry of a monetary agreement is connected to the nature of the system as an anti-inflationary tool or as a mechanism to stabilize exchange rates. This leads to the question of why is the system asymmetrical. Countries might join a fixed exchange rate agreement to fight inflation. In this case, the system should be asymmetrical, and the main reason for it is the desire of

countries of imposing themselves discipline. On the other hand, if the main objective of the system is to stabilize exchange rates, it does not need to be asymmetrical. Moreover, for high inflation countries, a symmetrical system achieves that objective with lower costs. In that case, if there is asymmetry, it would be the result of the different bargaining capacity of the countries in the negotiation, allowing the most powerful countries to impose their preferred option. It is sometimes difficult to separate the two objectives because they are interconnected, but to explain the causes of the asymmetry it is a crucial distinction.

The European Monetary System has been frequently interpreted as an anti-inflationary instrument which contributed to the disinflation process of the 1980s. However, the analysis of the negotiations shows clearly that the governments of high inflation countries wanted a more symmetrical system, which is the option that theoretically has smaller anti-inflationary effects, and complained about the deflationary bias of the design eventually approved. The examination of their stances denotes that their main objective was to stabilize exchange rates. Governments were also concerned by high inflation rates, but expected to decrease them through a reduction in the volatility of the currency. At that moment, some economists, in particular Italian, were revisiting the relationship between inflation and currency depreciation, and claimed that the depreciation of their currencies in international markets was triggering inflationary tensions due to the increase in the cost of imports. In the historical context of the oil shocks, many countries perceived that the short-

term volatility of their currencies had a remarkable incidence on the level of inflation.

To sum up, the particular economic circumstances of the 1970s, the desire of stabilizing exchange rates after the awful experience of floating rates during the 1970s, and the expected outcomes of the new system in terms of costs and benefits, which were determined by the degree of symmetry of the system, are crucial elements to explain the negotiations of the EMS and the final design approved in the Brussels European Council. The EMS design was not conceived as the starting point of a monetary union, but responded to the dreadful records of the period of floating exchange rates, and was motivated by the perception that currency volatility was aggravating inflation and having negative consequences on trade and investment in the case of high inflation countries, and the opinion that an excessive appreciation of the mark was reducing export competitiveness in the case of Germany. These judgements were determinant to convince European countries of the need to return to fixed pegs.

The main actors during the discussion on the EMS design were Germany and France. The discussions consisted mainly in the attempts of those countries that had been forced to leave the Snake, mainly France, to create a new system more symmetrical than the Snake, and the efforts of Germany to ensure the participation of high inflation countries without making concessions on symmetry. All countries had a similar objective, the stabilization of exchange rates, but disagreed on the design of the system, since it would

define the cost of each country to attain this objective. The degree of symmetry of the system would determine the cost of joining for each participant.

In order to analyse the bargaining process, I propose a combined approach, following the traditional economic approach based on macroeconomic magnitudes and the standard political economy approach grounded on interest groups, but adding to the analysis the countries' institutional design, this is, the specific institutional architecture behind the economic policy of each country, checking its effects on the outcome of the negotiations. I have examined the negotiations at the European level and at the national level, among domestic actors.

The examination of the negotiations and of the final design of the EMS leads to the conclusion that non-Snake countries failed in their attempts to introduce features to make the EMS more symmetrical than the Snake. Actually, the final design was almost identical to the Snake concerning symmetry. This does not mean that the final design was asymmetrical. In fact, from a strict point of view of the definition, it was symmetrical, but it ended up working asymmetrically. Coming back to the idea of degrees of symmetry, an analysis of the alternative proposals to define the new system allows saying that the alternative options to design the system, mainly the use of the basket of currencies to define intervention rules and the creation of a multilateral institution to manage credit facilities, would have entailed a more (although not necessarily totally) symmetrical operation of the EMS.

Germany managed to block all proposals which would have imposed a more symmetrical operation of the EMS (the use of the ECU to define intervention rules and the creation of a European Monetary Fund), leading to a system that was, in terms of symmetry, very similar to the Snake. On the other hand, German leaders accepted making concessions in other aspects, such as fluctuation bands, the possibility of realignments or the extension of credit facilities (which remained being bilateral credit lines among central banks), in order to grant the adhesion of non-Snake countries to the system. The German capacity to impose its stance in the aspects German negotiators deemed crucial, this is, anything that could have an impact in Germany's monetary autonomy, reveals the bigger bargaining power of this country.

Germany's bargaining power has been traditionally attributed to the fact that Germany was the largest surplus country and, therefore, controlled credit mechanisms. Even if this is a relevant factor, negotiations cannot be fully understood without making reference to the particular institutional architecture of each country and the tensions among domestic actors, as well as the particular political and macroeconomic circumstances. I have resorted to a combined approach of macroeconomic situation, groups of interest and institutional design to analyse the domestic debates and the stances of each country in the negotiations.

In the case of Germany, the analysis of the stances of the domestic actors reveals tensions between the German Federal government and the central bank. The role of the Bundesbank is crucial to

understand the position of the government during the negotiations. The Bundesbank did not participate directly in the negotiations, but was able to set decisively the framework of the bargaining process through the definition of the elements in which German officials were allowed to make concessions and those which were non-negotiable. The Bundesbank could do this on behalf of its high degree of legal and actual independence and the reputation it enjoyed in the German society. The Bundesbank was even able to obtain a “secret” assurance from the government that it would be allowed to “violate” the agreement if considered that monetary stability was under threat.

The Bundesbank capacity to veto an agreement that did not fulfil its conditions improved the bargaining power of the German government. In the case of a breakup of the negotiations, the Bundesbank, as the most reluctant actor to the EMS, would assume the political cost of not reaching an agreement. Moreover, the inability of the Federal government to accept an agreement that did not fulfil the Bundesbank’s restrictions convinced other European governments to bargain only those aspects that the Bundesbank would accept. This advantage of the German government resulted in an agreement that was particularly beneficial for the German interests, which allowed Germany to stabilize exchange rates at a minimum cost in terms of loss of monetary autonomy or inflationary pressures, and led to a fast increase in the competitiveness of the German exports.

Other central banks, for example the Banque de France, were not able to carry out this role because during the negotiations they worked under the orders of the French government. The Bundesbank's independence was an exception in Europe in the 1970s and was the outcome of the particular German political situation after the Second World War. Germany's central bank independence has been credited for the good performance in terms of inflation rates. However, EMS negotiations point out that the consequences of the Bundesbank independence went far beyond the control of inflation. The Bundesbank's capacity to influence exchange rate decisions (which, from a strict point of view, are a responsibility of governments) led to a design of the EMS that was particularly beneficial for Germany. The significance of the Bundesbank and of the German bargaining power continued during the process of construction of the European Monetary Union, demanding, for example, a high independence for the European Central Bank. To conclude, institutional architecture of monetary policy and central bank independence have been important in terms of macroeconomic results in inflation, but are also crucial to understand the political process leading to the European Monetary Union.

Other inflation countries, in particular Italy and Ireland, had a minor role in the negotiations and did not influence the final design. As the final agreement did not satisfy their requests, Ireland and Italy decided not to sign the agreement on the EMS immediately after the Brussels European Council and asked for a period of reflection before taking a final decision. In both countries, the issue was

largely discussed at the Parliaments during this additional period. Eventually, both governments decided that their countries would join the EMS. Domestic debates in these two countries were totally different and the reasons that explain the governments' decision to join the system were motivated by different factors. These factors had more to do with domestic debates than with the advantages and disadvantages of the new monetary arrangement. The examples of Italy and Ireland show that, beyond the macroeconomic situation and the preferences of interest groups, domestic political and economic institutions and national debates can be crucial to understand countries' exchange rate decisions.

The main reason for the Italian government not to join the EMS immediately was the fact that the new system did not meet the requisites it considered indispensable: a symmetrical system with a balanced distribution of the burden of adjustment and the creation of mechanisms of economic and financial cooperation. A system with those characteristics would have had a wide acceptance among Italian political parties and social groups, but the final design approved in the Brussels European Council generated conflicting opinions on the convenience of joining. The analysis of the debate on the EMS in Italy leads to the conclusion that this discussion went far beyond the specific decision on the exchange rate. There were other elements that weighted considerably in the EMS debate, in particular related to institutional reforms affecting issues that were accelerating inflation during the second half of the 1970s. These were the reform of the *scala mobile* (the system of wage indexation)

and the reform of the relationship of the Treasury and the Banca d'Italia.

This internal discussion on the EMS mixed up with other lively academic and political debates taking place in Italy in the second half of the 70s. Poor inflation records and high volatility of the lira during the period of floating exchange rates opened the debate about the management of monetary policy. The main domestic factor that was accelerating cost-push inflation, namely the system of wage indexation, and the monetization of the deficit, resulting from the obligation of the Banca d'Italia to purchase unsold Treasury bonds, had a central role in this discussion. Progressively, a new academic and political elite supporting the need for a shift in the traditional approaches to the use of monetary instruments and institutional reforms started consolidating. However, the reforms proposed by this group of economists and politicians lacked enough political and social support to be implemented. This elite used the EMS not only as a justification to launch the debate on these unpopular reforms, but also as a mechanism to enforce decisions that otherwise would not have been applied. The EMS also contributed to bind these reforms and secure their preservation, since the cost of revoking them was that Italy would be constrained to leave the monetary agreement.

The Italian adhesion to the EMS illustrates the use of exchange rate agreements to impose other reforms. It is easier for policy-makers to take actions on monetary policy or the exchange rate than on fiscal or income policies, since the latter have immediate and

evident effects for the population, while the former are less evident to non-experts. In Italy, the decision of joining the EMS did not only affect the exchange rate policy, but also imposed other institutional reforms that affected many areas of economic policy.

The case of Ireland is very different to any other EEC country. The reason for the Irish government not to adhere immediately to the EMS was that the amount of financial aid awarded by the rest of EEC countries in exchange for the Irish participation in the system was well below the Irish demands. The Irish government was the only one among high inflation countries that did not request a symmetrical system, and even supported the German proposal of a parity grid. The only demand of the Irish government during the negotiations was financial aid in exchange for EMS membership. These requests were not conditioned to a particular design of the system or to the British participation, aspects which conditioned clearly the costs of joining for Ireland.

The stance of the Irish government and the political discussion on EMS, focused on the issue of the financial transfers, was however very far from the worries of Irish economic and social groups. Agricultural associations, business groups, banking associations and trade unions showed big concern about the implications of joining the EMS for the future relationship of the Irish punt and the sterling pound, which, at that moment, had a one-to-one peg. Although interest groups expressed different opinions on EMS membership and the amount of transfers that the government should request, they unanimously expressed their will of keeping the fixed peg to

the sterling. The Irish government, although stressed that Ireland would not break the link with the sterling, supported and approved options that made this breakup more likely.

The analysis of the position of the Irish government shows a contradiction between the official statements guaranteeing the maintenance of the peg to the sterling and the decisions endorsed by the government. There are two decisions particularly difficult to justify, since they were not only against the Irish interests in terms of the cost of participation in the new system, but they also made it more probable to break the link to the sterling. The first was the support to the parity grid, which reduced the probabilities that the British government decided to join the system, and the second was the election of the narrow fluctuation band for the punt, which would trigger the breakup earlier than with the wide band. The decisions taken seem to indicate that the will of the Irish government was actually to break up with the sterling, against the preferences of most Irish economic agents. The government's stance during the negotiations cannot be explained without taking into consideration the nationalistic objectives of breaking with the United Kingdom, also in monetary matters. The debate in the Parliament reveals that the government was convinced that Ireland's adhesion to the EMS, together with the aid received, would encourage a fast economic growth in Ireland, quickly improving Irish living standards. This, together with the perception of British decline (enhanced by the fact that the United Kingdom stayed out of the EMS), would be a factor that would trigger the Irish reunification because it was hoped that pragmatists of the Ulster

would become convinced that the reunification of the island was their best option. The first years of operation of a system whose design was not particularly beneficial for Ireland refuted these nationalistic aspirations.

Summing up, the decision of high inflation countries of joining the EMS cannot be explained on the grounds of traditional approaches based on the optimization of monetary instruments to control inflation or on the preferences of interest groups. The Italian and Irish debates show that behind exchange rate decisions there were very different motivations and factors, not only economic. Particular domestic conditions are essential to explain the choices of those countries.

To conclude, the design of the European Monetary System was not conceived as the starting point of a process leading to a Monetary Union. On the contrary, it was the response to the 1970s short-term problems, and was therefore heavily influenced by the particular circumstances of the period, as it was the case of the previous system, the Snake, the starting point of the negotiations. At that time, in the framework of large differentials in inflation and, more generally, divergent macroeconomic fundamentals among the participant members, adjustability was a crucial element of the EMS. This adjustability was achieved through realignments and capital controls that, although not very clearly defined in the agreement, were a fundamental aspect of the new system.

However, the EMS suffered a drastic alteration in its functioning as a result of a factor that was not strictly linked to the monetary agreement: the advancement in the process of European integration and the signature of the Single Act in 1986, which involved the progressive elimination of capital controls. In this new framework of free movements of capital, countries were not able to use capital controls anymore and, therefore, were not able to prevent speculative attacks when realignments were expected. Consequently, countries were forced to abandon realignments and use more intensively interest rates in order to support the pegs. So, the system lost its adjustability and became more rigid. Initially, after the liberalization of capital movements, the system operated smoothly, in part thanks to its credibility, as it was seen as a part of the general process of European integration. However, an asymmetrical shock (the German reunification) triggered tensions and credibility problems, leading to a major crisis.

The response of European countries to the collapse of the EMS in 1992 was not a reconsideration of the monetary system or of the global project of European monetary integration, but the artificial preservation of the same system with wider fluctuation bands of 15%. With such fluctuation bands, the EMS was not a fixed exchange rate system anymore. In fact, a discussion started about if such a system should be considered a fixed but adjustable exchange rate or an intervened floating exchange rate. This period of wider fluctuation bands allowed countries to respond to the asymmetrical shock of the German reunification. However, after this period,

countries decided to advance towards the monetary union straightforwardly.

With the euro, countries again attained credibility by means of reducing the adjustability of the system. During the first years of the euro system there were not big tensions, in part due to the credibility it enjoyed, which led to a reduction in the risk premium of sovereign bonds and, in general, of interest rates in Southern Europe, and a fast increase in the availability of credit. However, when a new asymmetrical shock hit (the 2008 financial crisis), tensions emerged again and many countries suffered again problems of credibility (among many other problems). However, the strategy of gaining credibility by giving up some adjustability is now exhausted, since the euro is the most rigid option (a monetary union without an exit clause).

The result is a monetary union which imposes severe adjustments to countries that cannot leave the system, although in some cases they would be probably better off if they had never joined. The adjustment is not symmetrical, a fact which raises again the same debate that centred EMS construction. The entire burden of adjustment falls onto “weak” countries, those suffering the biggest tensions (bank runs, increase in the premium of risks and problems of competitiveness, among others). The issue of asymmetry of the shocks and asymmetry of the adjustment remains an essential discussion since the creation of the EMS.

European monetary integration illustrates the importance of the historical approach to economic facts. If the European Monetary Union is analysed only from an economic perspective and merely examining the final result, it is difficult to understand how it was possible that European countries, in spite of their big differences, tied themselves together in a monetary union without an exit clause and without the necessary flexibility in prices and wages or fiscal integration. However, if it is analysed as a historical process that started in the 1970s and is the outcome of path dependence and the particular historical circumstances of each period, a better understanding of how European countries reached the current situation is undoubtedly attained.

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