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MAKING COMMITMENTS: FRANCE AND ITALY IN THE EUROPEAN MONETARY SYSTEM, 1979–1985

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European monetary integration depends on commitments by member states of the European Community to sustain monetary policies consistent with stable exchange rates. These commitments in turn depend on the domestic political support that governments can muster for such policies. Two domestic political dimensions have been central to the development of the European Monetary System (EMS): the role of economic interest groups with preferences toward the policies associated with EMS membership, and the domestic implications of linking EMS commitments with the broader process of European integration. This chapter[1] analyzes the domestic politics of French and Italian policy toward the EMS from 1979 through the mid-1980s, during which the two countries' commitments to monetary integration gradually hardened.

EUROPEAN MONETARY integration (MI) has experienced dramatic twists and turns over the past twenty-five years. The "snake" of the 1970s was a general failure, and in the early 1980s the new European Monetary System (EMS) seemed little better.[2] In the late 1980s the EMS appeared to settle into something approaching a currency union, but appearances of stability were shattered by the currency crisis that began in September 1992. As of late 1993, the monetary future of Europe was still very much in question.

At the center of the problem were national governments' commitments to maintain fixed exchange rates with their European Community (EC) partners. The manifest weakness of such commitments on the part of several important EC members – especially France and Italy – in the 1970s and early 1980s led to great skepticism about the EMS, while the apparent hardening of those commitments in the late 1980s gave rise to equally (and, in the event, perhaps overly) great optimism.

This chapter elucidates the ways in which the French and Italian governments' commitments to a fixed exchange rate became increasingly credible

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[2] It is actually more accurate to speak of the Exchange Rate Mechanism (ERM) of the EMS, which is the agreement to bind currency values. The United Kingdom, for example, was a founding member of the EMS but only tied sterling to the ERM in October 1990. However, inasmuch as the two are closely linked in popular and scholarly discussion, I use the terms more or less interchangeably.

between 1979 and 1985. In this context, I argue for the central role of two factors within the domestic political arena. The first is the confluence of economic interests expected to favor or oppose a system of fixed exchange rates within the European Community. The second is the linkage between monetary integration (MI) and other EC policies, which might lead actors otherwise indifferent about currency developments per se or even hostile to the EMS on its merits to support MI in the interest of broader Community goals.

The first section evaluates a series of common explanations of EC members' decisions to commit to fixed exchange rates over the years, concluding that linkage politics is crucial to the process. The next section discusses both the political implications of the distributional impact of currency arrangements, and the logic of a linkage-based argument. The third section analyzes the domestic politics of French and Italian monetary policies between 1979 and 1985, tracing the operation of the distributional and linkage-related factors that helped the two countries' currency commitments acquire credibility. The final section explores the implications of these experiences for the future of European monetary integration.

CREDIBLE COMMITMENTS AND EUROPEAN MONETARY INTEGRATION

Monetary integration depends on commitments by EC member governments to particular exchange rates. This implies committing to similar national monetary policies, as currency values depend first and foremost on underlying national monetary conditions. These commitments were, on average, quite lacking in credibility in the 1970s, but gained increasing credibility over the 1980s.

The snake of the 1970s did hold together for Germany, Denmark, and the Benelux countries, but it was widely regarded as a failure. In the late 1980s the EMS and its exchange rate mechanism (ERM) had these countries as members, along with France, Italy, and Ireland, and it was widely regarded as a success. The crucial difference between the failed snake and the relatively successful mature EMS, then, was the adherence of France, Italy, and Ireland. For reasons of size, the French and Italian cases are central.

But this raises a major puzzle. The French and Italian governments had not been able to sustain fixed exchange rates during the 1970s. Nor had either government been able to commit itself to serious inflation reduction over this period. Indeed, bringing them into a German-dominated monetary union was a special challenge: both had run inflation substantially higher than German levels since the late 1960s. There was, therefore, little reason to believe that they would be able to implement the domestic policies necessary to sustain their EMS commitments in the 1980s – and yet they did.

Various solutions to this puzzle have been proposed.[3] The first is that the

[3] For a summary of some of these analytical perspectives, see Eichengreen and Frieden (1994, this volume). Other good surveys are Giavazzi and Giovannini (1989) and Fratianni and von Hagen (1992).

formal institutions of the EMS were more effective at sustaining cooperation among member states than those of the less formal snake because an exchange rate agreement requires a number of explicit provisions for consultation about parity changes, and the financing of payments deficits.

It is true that the EMS was a somewhat more developed institutional mechanism than the snake, and that the EMS made more money available to members than did the snake. Much of the difference, at least at the outset, was undoubtedly due to the fact that the snake was planned while the Bretton Woods system was still (barely) alive, which made more formal arrangements redundant. In any event, very short-term financing arrangements were extended from thirty to forty five days, and their capacity expanded from 6 billion to 14 billion European Currency Units (ecus). Medium-term financing ceilings were raised from 5.45 billion to 14.1 billion ecus, and five billion ecus in concessionary loans over a five-year period were made available to Ireland and Italy [van Ypersele (1985, pp. 61–64)]. Certainly the greater resources committed to the EMS made affiliation more attractive.

However, there is little evidence that these organizational factors were particularly important to the process. In fact, many of the new mechanisms were not part of the original EMS but evolved as (or after) it became credible. From the financial side, the money involved was not really substantial, and Italy did not even use its concessionary finance. Certainly there is no evidence that the evolution of French policy was at all related to the formal institutions of the EMS.[4]

A second explanation is that the exchange rate targets chosen in the EMS were more transparent than the monetary targets announced, and not met, by the French and Italian governments in their prior attempts to fight inflation. The idea here is that economic agents are more likely to be convinced by a government's commitment to a specific exchange rate, which the markets can observe, than by a general commitment to reduce inflation or even a specific commitment to a monetary target, which the markets cannot directly observe.

This, however, does not explain why the French and Italian governments were better able to commit to a fixed exchange rate in the late 1980s than in the 1970s. If transparency in and of itself increased a government's credibility, a government serious about reducing inflation would *always* use the exchange rate as such a signal. The fact that the signal sent by the French and Italian governments in the 1970s turned out to be untrustworthy, while it was far more reliable in the late 1980s, simply pushes the question back a step.

A third potential explanation of the greater success of monetary integration

[4] This conclusion is analogous to that drawn from a broader historical survey by Cohen (1994, this volume). If one defines institutions more broadly, as does Martin (1994, this volume), then the linkage argument developed below might be regarded as a special case of a broader institutional explanation. However, most of the literature that relies on institutional changes to explain the success of the EMS is referring, as is Cohen (1994, this volume), to the formal organizational mechanisms by which the system itself was governed.

in the 1980s than in the 1970s is that national preferences had converged.[5] Certainly if countries' desired inflation levels had been more similar in 1979 than in 1973, they would have been better able to sustain fixed exchange rates. However, to judge from inflation levels, there is little evidence for such preference convergence. French and Italian inflation rates were higher in the first three years of the EMS than in the first three years of the snake, and differed more from that of Germany. Perhaps politicians and voters *wanted* lower inflation, but they appeared unable to achieve it outside the EMS – which again pushes us back to the need to explain the success of the mechanism as it evolved between 1979 and 1985.

A fourth reason often given for the relative accomplishments of the 1980s is that the international economic environment was easier than in the 1970s, especially in the absence of oil price shocks. This confuses overall *levels* of inflation with *divergences* from German levels. If all EMS members had had lower inflation rates in the 1980s than in the 1970s, this would not necessarily have made fixed exchange rates easier to sustain, so long as national inflation rates differed substantially. For external economic conditions to explain the differential successes of the two decades, these conditions would have to have been asymmetric in such a way that the shocks to Germany were more inflationary than shocks to other EMS countries. Only if this had come to pass – and there is very little evidence that it did – would international conditions have made it easier for other EMS countries to sustain fixed rates against the deutschemark (DM).[6]

[5] Collins and Giavazzi (1993) present the strongest case for this argument, purporting to show a change in national attitudes toward inflation. However, their study does not in fact look at public *policy* preferences, but rather at the weight that household respondents accord inflation (as opposed to unemployment) in formulating their forecasts of general economic outcomes. This is several steps removed from public willingness to support the political measures necessary to reduce inflation, which is the actual shift asserted in the literature.

[6] Fratianni and von Hagen (1992) present one of the more systematic arguments for a combination of the third and fourth arguments (in other words, that national preferences and the international environment changed). They focus more on alleged changes in national preferences, as seen in changes in inflation rates in EMS and non-EMS countries, arguing that there is little evidence that the EMS itself had a significant inflation-reducing impact.

However, questions can be raised about the data they use. Fratianni and von Hagen include successful members of the snake (Benelux) in the EMS sample, but the inflation rates of these countries had already converged with that of Germany by the start of the EMS. Similarly, they include Austria and Switzerland in the non-EMS control group, although the Austrian and Swiss currencies formally or informally tracked the deutschemark for most of the period. Finally, they use average inflation rates weighted by GNP, even though each country is an equally valid observation.

Reworking the data accordingly, in 1977–1978 the average unweighted inflation rate for the eventual new EMS members (France, Italy, Ireland, and Denmark – including this last as it was only a nominal member of the snake) was 11.3 percent, 8.1 percent higher than in Germany. By 1987–1988 the average inflation rate for these four countries was 3.7 percent, just 2.9 percent higher than Germany's. In contrast, the non-EMS group (Australia, Canada, Finland, Greece, Japan, the United Kingdom, and the United States) had an average inflation rate of 9.5 percent in 1977–1978, which came down to 5.8 percent in 1987–1988, 5 percent higher than Germany's. This would appear an appreciable difference in convergence of inflation rates between the two groups.

Perhaps more important is that for my purposes it is not particularly important to show that the EMS was necessarily the only reason for inflation reduction; it is sufficient to show that the EMS required convergence with Germany monetary conditions. This was also the case with the snake, and raises once more the same question: why were these countries willing and able to reduce inflation sufficiently to stay in the EMS when they had been unwilling or unable to do so for the snake?

A fifth explanation for EMS success is that structural economic characteristics of member countries had changed over the course of the 1970s. The principal point here is that the welfare benefits of currency union rise as economies become more financially and commercially integrated, and the members of the EC became more integrated over the course of the 1970s.

There is much truth to this argument, and I have presented the case for it elsewhere [Frieden (1993)]. Levels of economic integration within the EC grew after the late 1960s, and as they grew, so did interest in monetary union. By the same token, those countries most strongly integrated into other EC economies (especially that of Germany) have been most enthusiastic about MI. However, the change in levels of economic integration between 1973–1975, when France and Italy fell out of the snake, and 1983–1985, when they acquired credibility within the EMS, was small. Indeed, a more relevant comparison might be the last years of the snake (1976–1978) and the first years of the EMS (1979–1983), over which time the economies in question changed hardly at all. It is, in any case, hard to believe that marginal changes in structural economic conditions could have such striking effects on national commitments to currency policies.

The final argument made for the success of the EMS in the 1980s rests on linkage politics. Many analysts believe that monetary integration succeeded to the extent that it was tied to other goals at the European level. Countries went along with MI because cooperation on the monetary front was essential to cooperation on other fronts that they valued highly.[7]

In the remainder of this chapter, I develop the argument that linkage between monetary integration and European integration more generally was central to the success of MI in the 1980s, and specifically to French and Italian exchange rate commitments between 1979 and 1985. However, the invocation of linkage politics is not without problems. As Alt and Eichengreen (1989) point out, such linkage effects hold only under certain conditions, having especially to do with different national valuations of the policies in question.[8] Such valuations can best be understood as a function of domestic political factors; I analyze the domestic circumstances in France and Italy that made linkage politics feasible.[9]

DISTRIBUTIONAL PREFERENCES AND LINKAGE POLITICS IN EUROPEAN MONETARY INTEGRATION

Linkage politics ups the benefits of initial and continuing cooperation because tying two issue areas together enables gains from political trades. A group that

[7] Garrett (1994, this volume), makes a variant of this argument. Martin (1994, this volume), presents an explicit linkage-based explanation of EMU in the Maastricht process that is analogous to mine but focuses on the ways in which linkages are made binding by institutional characteristics of the EC itself.

[8] In addition, as pointed out in Eichengreen and Frieden (1994, this volume), the invocation of linkage politics simply pushes the credibility problem back one step: if linking two policy arenas raises the costs of defection in each, as it may under certain carefully specified conditions, what makes the link itself credible? I do not address this issue here, but take the tie between the EMS and European integration as given.

[9] A parallel argument is presented in Woolley (1992).

has a strong preference for a policy in one arena and a weak preference against a policy in another arena can compromise with another group that has a weak preference against the first policy and a strong preference for the second policy. In this way, each group gets what it cares about more in return for giving up what it cares about less. Without the linkage process, the two groups would oppose each other in the two arenas; with the arenas linked, exchange is possible.[10]

French and Italian commitments to fixed exchange rates, I argue, were made more credible by the link between MI and broader European integration. This redefined the domestic politics of monetary policy and the choices available to domestic groups in ways that made a previously unattainable outcome possible. To clarify this argument, I discuss the constellation of interests on both dimensions – monetary integration and broader European integration – and show how trade-offs along the two dimensions made domestic political agreement possible.

The first step is to specify preferences in the first issue area, monetary integration.[11] Tying the franc and the lira to the ERM implied a fixed and relatively appreciated exchange rate against the deutschemark. The real appreciation was a function of the fact that France and Italy had inflation substantially above that of Germany, and in any foreseeable circumstances inertial inflation would lead to a transitional real appreciation of their currencies after they were fixed in nominal terms.

Moving from floating to fixed exchange rates provides greater predictability in foreign trade and exchange. However, it makes it impossible for the government to alter exchange rates to affect domestic macroeconomic conditions and relative prices. The level of the exchange rate has straightforward relative price implications: an appreciated ("strong") currency raises the domestic price of nontradable goods and services relative to the domestic price of tradables.

On this basis we can project the positions of economic groups toward fixing the franc and the lira. A fixed exchange rate is favorable to those heavily involved in international trade and payments, especially major international banks and corporations. Exporters of goods or services for which nonprice dimensions (quality, reputation) are very important will also tend to favor exchange rate stability even if the currency's level imposes some cost disadvantage (within limits, of course). Nontradables producers, such as those in the public sector, are pulled both ways: a strong currency is good for them, while forgoing national monetary independence is undesirable inasmuch as they depend upon national economic conditions (and exchange rate stability is irrelevant to them).

[10] This is simply a somewhat special case of the common observation that while a median voter result is possible when policy is on one dimension, increasing the number of dimensions makes all outcomes unstable. Linkage politics can, in this sense, be regarded as a process by which a two-dimensional policy space is reduced to one dimension.

[11] I have written at some length about this general analytical problem in Frieden (1991). Here I summarize the implications for the French and Italian cases.

Producers of tradable goods that compete primarily on price, on the other hand, are hostile to both the strong currency and its being fixed. The principal groups in question are producers of standardized manufactures, for whom a real currency appreciation causes substantial difficulties in competing with imports and, where relevant, in maintaining export markets. The fixed exchange rate is of little value, especially inasmuch as these producers are oriented toward maintaining their domestic markets.[12] In the EC, farmers are essentially indifferent, as they are protected against EC exchange rate movements by complex arrangements that are part of the EC's Common Agricultural Policy.

Thus traditional import-competing manufacturing sectors are hostile to a strong fixed currency, internationally oriented firms are favorable, and nontradables producers are ambivalent. Translating this interest group perspective into partisan politics is difficult, as many of the economic sectors in question cut across traditional party lines. It is, however, possible to present a highly simplified picture of French and Italian party positions on the EMS. Generally speaking, in both countries, the Right was oriented toward a mix of international business and nontradables, the center (especially the Socialists) reflected nontradables and manufacturing, and the Left (especially the Communists) represented workers in traditional manufacturing.

In France, the Right was weakly favorable to a strong franc, the Socialists (PS) were weakly opposed, and the Communists (PCF) were strongly opposed.[13] In Italy, the Christian Democrats (DC) were ambivalent about a strong lira, the Socialists (PSI) were moderately opposed, and the Communists (PCI) were a bit more strongly opposed.

These positions on the exchange rate issue made movement toward MI difficult. In France neither Right nor Socialist governments were enthusiastic about a strong franc, while in Italy, neither Right-center nor broad national governments were so inclined. Indeed, only a fraction of the French Right (the Union pour la Démocratie Française) and Left (the Rocard faction of the PS) strongly favored MI, while in Italy only one tiny member of the center-Left coalition

[12] These categories are merely first approximations. Clearly the policy preferences of any firm or individual depend on a wide variety of considerations, and firms' preferences on exchange rates are far more nuanced than is allowed for here. Nonetheless, these divisions are good enough to serve as a starting point for analysis.

It should be also clarified that this abstract discussion ignores the obvious fact that what really matters to such groups is not international trade and payments generally, but trade and payments within the prospective monetary union. This refinement is, of course, crucial to the European case: a British firm say, whose market was primarily in the United States would be far less enthusiastic about European monetary unification than a British firm whose market was primarily in the EC. The discussion also glosses over many important details, such as the relative importance of competition on nonprice dimensions.

[13] In reality one portion of the Right (the UDF) was favorable to a strong franc, while another portion (the neo-Gaullist RDR) was ambivalent; meanwhile, the Socialists were similarly divided between those mildly favorable and those quite opposed. Here I ignore intragroup differences and simply take averages of the two parties.

(the Republican party) was a strong supporter of monetary integration. This made MI on its own merits unattainable in both countries.

The second step is to specify preferences along the second policy dimension, that is, toward European integration more generally. The relative placement of partisan camps on this dimension is amenable to analysis, but for the sake of brevity, here I simply assert such preferences.[14] In France, the PCF was hostile to the EC, while the PS and the Right were moderately favorable.[15] In Italy, all three major parties were strongly favorable to the EC; if anything, the DC was somewhat more ambivalent than the others.

This implies that in both countries there was broad agreement on European integration, despite the disagreement on MI. Both Right and Socialist governments in France were generally pro-EC, as were all conceivable Italian governments. Linking the exchange rate issue to European integration more generally, then, created a new political reality, for a country's inability to join MI implied moving away from the EC.[16]

For political actors, the choice had been on two dimensions: pro- or anti-EC, pro- or anti-strong currency. Linkage collapsed these two dimensions into one: either pro-EC and pro-strong currency, or anti-EC and anti-strong currency. The result was to change the set of likely outcomes. In Italy all major parties were more intensely pro-EC than they were anti-EMS. In France, most of the PS and most of the Right were similarly positioned, while the PCF and a portion of the PS were both anti-EMS and anti-EC (or were more strongly anti-EMS than they were pro-EC).

This stylized discussion is meant simply to illustrate the operation of linkage politics, and its potential application to the French and Italian experiences. I have no illusions that this treatment represents the nuanced nature of the two countries' political debates over the issue between 1979 and 1985. However, I hope that it does help provide a framework in which these debates can be examined.

[14] Such preferences could be derived more systematically with reference to particular groups' or parties' positions relative to national and EC median voters. If, for example, the national median voter is to the right of the EC median voter, the national Left will be favorable to European integration, which will push the country toward its preferred policies. On the other hand, if the national median voter is to the left of the EC median voter, the national Left will be hostile to European integration. I believe that this – rather than political culture or other ideological considerations – explains why in the early 1980s Italian Communists were pro-EC while French Communists and leftist Socialists were anti-EC. However to avoid introducing another controversial set of assertions I restrain myself to observing this partisan placement.

[15] Again, I ignore intraparty divisions (the leftist Socialists and the Gaullists were more hostile to the EC) and take party means.

[16] In this sense, I assume that the linkage was credible, that is, that nonparticipation in MI implied less than full membership in the EC. I do not explore how or why this linkage was made credible, which, of course, is an important question.

FROM SKEPTICISM TO SUCCESS: FRANCE AND ITALY, 1978–1985

Despite the general failure of the snake in the 1970s, discussion of European monetary union began to gather new momentum in October 1977, when Roy Jenkins, the president of the European Commission, made a prominent public appeal for MI. In April 1978, the French President, Valéry Giscard d'Estaing, and the German chancellor, Helmut Schmidt, proposed a new European Monetary System, which was approved by the European Council in December 1978 and went into effect in March 1979. At that time all EC members except the United Kingdom affiliated with the exchange rate mechanism of the EMS, which allowed a 2.25 percent band among currencies (6 percent for the lira).[17]

The prevailing opinion at the time was that French and Italian inflation rates were too high and intractable to allow the ERM to operate as planned. Indeed, in the first four years of its operation, there were seven realignments of EMS currency values. During this period, deutschemark revaluations and lira and franc devaluations reduced the nominal DM value of the two problem currencies by 27 and 25 percent, respectively – hardly a sign of commitment to fixed rates. But over the following four years, between April 1983 and January 1987, there were only four more realignments, and the lira and franc were brought down only 13 and 9 percent against the deutschemark, respectively. Indeed, after 1983, exchange rate variability within the EMS declined substantially, while monetary policies converged on virtually every dimension.[18] It is generally agreed that the decisive turning point in the evolution of the EMS came between 1981 and 1985, when the French and Italian governments changed course to bring their inflation rates in line with the EC average.[19]

This turning point was in large part made possible by the linkage of the EMS to European integration more generally. The system was launched personally by the French president and German chancellor, and its founding documents explicitly tied monetary stability to broader European integration. There had not been any sense that the snake was essential to the EC, to which in fact two non-EC members (Norway and Sweden) affiliated. Neither national politicians nor Community leaders had staked much political capital on the snake. The EMS was different, and its success was publicly related to other aspects of European integration, in ways that implied that a country not in the ERM would become a second-tier member of the Community.

[17] Ludlow (1982) is especially detailed on the negotiations and early operation of the EMS; see also Ypersele (1985, pp. 71–95) and Ungerer (1983). Outstanding surveys of the EMS experience more generally are Fratianni and von Hagen (1992) and Giavazzi and Giovannini (1989).

[18] Relative parity changes are calculated from exchange rate data in International Monetary Fund (1988, pp. 20–34).

[19] See, e.g., International Monetary Fund (1988, p. 48).

Linking MI with EC integration affected the domestic political lineup in many member nations. This was especially the case during the early 1980s, when beset by stagnation and unemployment, many Europeans began to look upon an intensification of economic integration as the last best hope for the region.[20] As the pace of European integration quickened, MI came to be seen as a near-essential component of a broader trend. The process was particularly striking in France and Italy.

France, 1981–1983

François Mitterrand and the PS took power in May-June 1981.[21] In the two years since the EMS had begun operation, with French inflation still well above German levels, the franc had appreciated about 12 percent against the deutschemark in real terms, putting serious competitive pressure on French manufacturers.[22] As French prices continued to rise and the trade balance to deteriorate, the government (represented at Brussels by the finance and economy minister, Jacques Delors) negotiated an October 1981 EMS realignment in which the franc and lira were devalued by 3 percent and the deutschemark and Dutch florin were revalued by 5.5 percent. The devaluation proved inadequate in the face of continued French inflation, and in June 1982 another realignment raised the deutschemark and florin by 4.25 percent and lowered the franc by 5.75 percent (the lira was devalued by 2.75 percent). This second realignment gave rise to serious disputes within the French government.

President Mitterrand's government was headed by Prime Minister Pierre Mauroy, and included four ministers from the Communist party. The Communists were unenthusiastic about European integration and hostile to austerity (*rigueur* in French economic policy parlance). The Socialist-Communist differences were especially important because they implicated the trade unions. The largely pro-Communist Confédération Générale du Travail (CGT) was most adamant in its resistance to austerity, even at the expense of French membership in the EC (toward which it had been indifferent or opposed). Inasmuch as the economic policies necessary to control inflation affected real wages, the CGT and the PCF were recalcitrant at best, obstructionist at worst [Kesselman (1980; 1985)].

The PS was divided in several factions, running roughly from right to left as

[20] For one among many possible interpretations of this trend, see Katseli (1989, pp. 186–195).

[21] The literature on these years is enormous. Most of the discussion below is drawn from detailed journalistic accounts of the experience, which will be cited as used. More general analyses of the period can be found in Sachs and Wyplosz (1986), McCarthy (1990), Cameron (1992), and Friend (1989). Macroeconomic data are taken, except where otherwise noted, from Sachs and Wyplosz (1986). Among the many edited volumes on the experience, the following contain particularly useful discussions of economic policy: Ambler (1985); Machin and Wright (1985); and Ross, Hoffmann, and Malzacher (1987).

[22] Real bilateral exchange rate calcuated from Wood (1988).

follows. The group led by Michel Rocard was economically liberal and strongly pro-European. Mitterrand's faction was more tied to his personality than to any particular policy stance. The group around Mauroy tended toward standard social democracy – friendly to economic liberalism but committed to traditional socialist goals; Mauroy generally had the support of the Marseilles-based federation led by Gaston Deferre. Finally, the CERES faction led by Jean-Pierre Chevènement was a stronghold of nationalistic and economic policy views similar to those of the Communists [Bell and Criddle (1988); Hanley (1986)]. Mitterrand and his followers dominated the PS, largely by means of a series of tactical alliances with other factions.

In the labor movement, the Socialists' principal allies were the Confédération Française Démocratique du Travail (CFDT) and the Fédération de l'Education Nationale (FEN). The former was a general labor federation that explicitly competed with the CGT; the latter was a teachers' association. There was a Socialist presence in the CGT, but it was a minority of the confederation. A third major labor federation, Force Ouvrière, (FO), was not partisan, although it tended to combine hostility toward the organized Left with general militancy over wage issues [Adam (1983); Mouriaux (1985)].

There were important sociological differences among these parties and labor unions. The Communist party was, as elsewhere in Europe, heavily oriented toward blue-collar workers in traditional industries. The Socialist party was essentially middle class, dominated by managers, professionals, and white-collar workers. The PS membership relative to the population at large in 1973, for example, had a heavy overrepresentation of upper managers (11 percent of the party and 6 percent of the labor force), and of teachers (17 percent of the party and 3 percent of the labor force); workers were underrepresented (19 percent of the PS and 37 percent of the labor force) [Hardouin (1978)]. Of the 169 PS deputies elected in 1981, to take another example, fully 47 percent were teachers; another 22 percent were professionals, and 20 percent were upper managers and senior civil servants.[23]

The trade unions differed quite a bit in their composition. The CGT was especially strong in traditional manufacturing industries. Table 1 shows how much heavier was the industrial bent of the CGT than that of the CFDT and FO: three-fifths of those who voted for CGT in 1979 were in industry, compared to less than half of those who voted for CFDT or FO.

The CGT's industrial orientation is indicated by other measures as well. CGT votes in union elections in 1981 were 32 percent of total votes. In such industries as metalworking, pulp and paper, and chemicals, the CGT vote was between 45 and 51 percent of the total, while in finance and services, the CGT

[23] Bell and Criddle (1988, p. 203). Hanley (1986, pp. 177–197), has a useful compilation of his own survey of the PS and that of Cayrol, which address both the party's social composition and the differences among the factions.

TABLE 1 FRANCE: SECTORAL COMPOSITION OF VOTES FOR THREE MAJOR LABOR FEDERATIONS AND FOR ALL FEDERATIONS, 1979 (PERCENT)

	CGT	CFDT	FO	All Federations
Industry	59.7	49.1	45.3	50.5
Trade	23.8	24.1	26.9	23.8
Agriculture	2.6	5.2	4.7	3.5
Various	9.7	13.6	14.7	11.7
Management	4.2	8.0	8.4	10.4

Source: Adam (1983, p. 164).
Notes: N = 3.3 million for CGT, 1.8 million for CFDT, 1.36 million for FO, and 7.79 million for All Federations. All Federations includes a number of smaller labor unions; percentages do not total 100 because of roundings.

vote was between 10 and 22 percent of the total.[24] Within the public sector, the CGT dominated the steel, chemical, and auto firms, but had little strength in high-technology and financial firms [Mouriaux (1985, pp. 201–202)]. In the 1979 union elections, the CGT received 50 percent of the votes of industrial workers, 30 percent of the votes of agricultural workers, and 33 percent of the votes of other workers.[25]

The CFDT, like the PS, tended to be more oriented toward services and high-technology firms than the CGT. Table 2 shows how some of these differences played out in union elections in several important French firms. While the CGT overwhelmed the CFDT within Renault and led in Michelin, for example, the CFDT dominated such financial firms as the Banque National de Paris and the insurance company Assurances Générales de France. The CFDT and an autonomous union swamped the CGT in IBM-France.

The general pattern within the labor movement, then, was that the CFDT was concentrated in nontradables (service) sectors and competitive high-technology firms, while the CGT was prominent among producers of tradables, especially those most affected by competition from imports. This division was mirrored to some extent by that between the Socialist and Communist parties. In this context, recall the expected policy differences among uncompetitive tradables sectors, competitive internationally oriented firms, and nontradables producers. The first are expected to be especially hostile to a strong currency, the second favorable, and the third ambivalent.

These sectoral divisions were exacerbated by the economic trends of the early 1980s. As the franc appreciated in real terms against other EMS currencies, domestic relative prices moved against tradables and in favor of the nontradables (and cross-border investing) segments of the French economy. In 1981–1982 the prices of industrial products rose 19.5 percent, while prices of private services rose 28.3 percent and those of public services rose 34.8 percent.

[24] Groux and Mouriaux (1992, p. 103).
[25] Adam (1983, p. 164). The elections in question were the *élections prud'homales*.

TABLE 2 FRANCE: CGT AND CFDT STRENGTH IN SELECTED FIRMS, 1979–1981 (PERCENT OF VOTERS)

Firm and Date of Vote	Votes for CGT	Votes for CFDT
Renault, 1981	61.2	16.6
Michelin, 1980	46.1	43.8
Banque Nationale de Paris, 1980	25.1	30.0
Assurances Générales de France, 1980	22.4	50.1
IBM-France, 1979	12.4	56.2

Source: Hervé Hamon and Patrick Rotman, 1982, *La deuxième gauche* (Ramsay, Paris), 423–427.
Notes: The elections in question were for enterprise commissions. In the case of IBM-France, votes for the CFDT include votes for an autonomous union.

This put serious pressure on tradables producers [Fonteneau and Muet (1985, p. 319)]. Indeed, between 1980 and 1983, employment in tradable sectors declined 7 percent. Meanwhile, employment in construction, trade, and services held steady, while that in energy, transport, telecommunications, and finance rose 5 percent.[26] It is not surprising that manufacturers demanded further devaluations.

This cleavage was an important component of French debates over the EMS, which largely became couched in terms of austerity (*rigueur*) and commitment to a fixed exchange rate within the EMS, versus reflation, devaluation, and abandoning the EMS.[27] The Communists and the CGT, along with the CERES faction within the PS, opposed austerity and advocated devaluing the franc and leaving the EMS. The CFDT and the Rocard and Mauroy factions of the PS were pro-European and thus in favor of maintaining EMS commitments, even at the expense of austerity. Mitterrand and his supporters within the PS were in the middle, and they were crucial to the ultimate disposition of the issue.

After the June 1982 realignment, it was clear that the government faced a distinct choice. The franc continued to appreciate in real terms, and after October 1982, it came under constant attack on foreign exchange markets. Battle lines were drawn between EMS partisans and opponents. In March 1983 the issue came to a head in a period that has been called "ten days that shook Mitterrand" [Bauchard (1986, p. 139)]. France had to devalue to avoid running out of reserves in a matter of days, and this devaluation had either to take place within the ambit of the EMS or to represent a definitive break with the monetary union.

At the political level, the Socialists were in trouble. The Left did poorly in the March 6 first round of the municipal elections. Concerned that austerity had

[26] These are the figures given, and the aggregations (tradable, nontradable, and "sheltered") used, in Sachs and Wyplosz (1986, p. 275).

[27] For the account that follows, in addition to the general works cited already, I have relied primarily on a series of detailed narratives, by well-informed journalists, of the early Mitterrand years: Favier and Martin-Roland (1990); Bauchard (1986); July (1986); and Nay (1988).

alienated the government's constituents, Mitterrand leaned toward taking France out of the EMS.[28] However, the message of the second round of municipal elections held on March 13 was conflicting. The Left did badly, but the losses were less severe than anticipated and, perhaps more important, the PCF suffered a major setback.

Mitterrand apparently read the election results as an indication that the economic nationalism espoused by the PCF would not succeed in shoring up the Socialists' political base. The municipal elections, in other words, led Mitterrand to conclude that while popular discontent with austerity was widespread, anti-EC sentiment was limited.[29] This apparently pushed him toward keeping France inside the EMS and reconfirming Mauroy in office. At the same time, he increased the hold of the Mitterrand and Mauroy factions on the cabinet, removed several leftist Socialists from office, and appointed Jacques Delors as a super minister in charge of Economics, Finance, and Budget. A series of new economic policy measures were announced, from tax increases and budget cuts to a tightening of exchange controls.

Austerity was the order of the day. Inflation was more than halved, from 12.6 to 6 percent, between 1982 and 1985, and the current account was in surplus by the latter year; but meanwhile unemployment rose from 8.1 to 10.1 percent, and GDP growth stagnated. Nevertheless, the new ERM parities held for more than three years, until the readjustment of April 1986. By then, French commitment to the EMS was credible, and Jacques Delors, as president of the European Commission, was leading the charge to accelerate the process of monetary integration.

Two features of the French experience are worth highlighting. First, there were clear differences, as expected, in the EMS preferences of various sectors of the economy. Import-competing tradables producers, represented especially in the labor movement by the CGT and the PCF, were the strongest opponents of a strong franc. Internationally integrated firms and nontradables sectors, represented especially by the CFDT and segments of the PS, were more enthusiastic about monetary union despite its association with austerity.

Second, the link between the exchange rate and France's relations with its EC and EMS partners was explicit. It was clear by mid-1982 that commitment

[28] On this period, see Favier and Martin-Roland (1990, pp. 465–493) and Bauchard (1986, pp. 139–154). Both books, especially the former, are based on extensive interviews with participants both at the time and after the fact.

[29] In the meantime, there is some evidence that many in the business community – including the largely Socialist executives of many newly nationalized French multinational banks and corporations – were pressing strongly for a deepening of French commitment to the EC, which implied staying in the ERM. On this point, see Green (1993). Another argument advanced [by Goodman (1992, p. 136)] is that an internal French government report indicated that the costs of a devaluation would be greater than the costs of conforming to the fixed rate. Without being able to evaluate the evidence fully, I find the report's alleged conclusions, and the likelihood that its arguments were crucial in influencing Mitterrand, quite questionable.

to the EMS required major changes in policy so that French macroeconomic conditions would converge with those of Germany; it was also clear that the EMS commitment was of paramount importance to broadening French participation in the EC. The linkage between MI and European integration was crucial in leading the Socialist government to abandon its economic policies and commit itself to austerity.

Italy, 1980–1985

The decisions that bound monetary policy to the EMS were less striking in Italy than in France. Italian credibility on this score developed gradually between 1981 and 1986, but several important turning points can be identified. In most instances we observe the sorts of divisions familiar from the French case, and a link between these debates and general attitudes to the EC.

There were two defining characteristics of Italian macroeconomic problems after 1973. The first was a high level of budget deficits, a substantial portion of which was monetized. In fact, in 1975 the central bank committed itself to buy all unsold Treasury securities, thereby ensuring that budget deficits would translate automatically into money creation.

The second feature of Italian macroeconomic conditions was that inflation had taken on something of an inertial character. In 1975 the unions and businesses had negotiated a tight wage indexation scheme, the *scala mobile,* and defense of this arrangement had become a rallying cry for labor. Both the explicit commitment of the central bank to monetize a portion of the budget deficit and extensive wage indexation led to a strong inflationary tendency, which made a fixed exchange rate nearly impossible. Both would have to be altered for Italy to abide by its EMS commitments.

The first major step in reorienting monetary policy was taken in 1981, when the governor of the Banca d'Italia indicated that he would no longer be guided by the 1975 commitment to purchase unsold Treasury securities.[30] This shift in policy, known as the "divorce" of the central bank from the Treasury, was strengthened in 1982 by the implementation of a new, compulsory commercial bank reserve system, and strengthened further in 1983 when administrative controls on credit were eliminated.

Almost immediately after the "divorce" Italian real interest rates shot up from well below German levels to well above them. Real interest rates in Italy went from an average of –1.5 percent between 1977 and 1981 to an average of 3.8 percent between 1982 and 1986. Meanwhile, the share of the public debt held by the central bank declined from 23.7 percent in 1981 to 16.6 percent in 1984 [Tabellini (1988)].

[30] The "divorce" is one of the few aspects of Italian economic policy in this period on which there is a substantial literature. See, e.g., Goodman (1992); Tabellini (1987); Salvemini (1983); Addis (1987); and Epstein and Schor (1989).

Restrictive monetary policy was not enough: inflation's inertial component had to be reduced, which required an assault on the *scala mobile.* Attempts to renegotiate the index were frustrated by the opposition of the Communists, and the Communist-oriented labor federation, CGIL. The Socialists and the Christian Democrats, along with the labor federations associated with them, the CISL and UIL, were willing to reduce indexation. Finally, in February 1984, Socialist Bettino Craxi, the new prime minister, simply decreed a reduction in the *scala mobile.* The CGIL and the PCI were outraged, and collected signatures for a national vote on the *scala mobile* [Lange (1986)].

The campaign leading up to the June 9, 1985 referendum was divisive. The costs of austerity were counterposed to the benefits of being in step with Italy's partners in the EMS and the EC. In the event, the no votes prevailed (with 54.3 percent of the total), and the decree loosening the *scala mobile* stood. This was the second crucial set of changes necessary to bring Italian inflation down and make it possible for the country to keep the lira within the ERM.

Domestic political divisions over the EMS and EMS-related issues, such as the *scala mobile,* date back to the original debate over Italian entry into the agreement. Bargaining over these issues took place against the backdrop of important political changes in the country. In 1976, the PCI gave its tacit support to the coalition government led by the Christian Democrats. In early 1978 the CGIL announced a significant moderation of its overall strategy.[31]

Nonetheless, both the PCI and the CGIL were ambivalent about the EMS. In 1978 the Communists voted against the law authorizing Italian accession to the exchange rate agreement, arguing that a delay of at least six months was advisable to avoid too severe a shock to employment and wages. The Socialists abstained, and the bill passed.[32] As discussed above, the PCI and the CGIL similarly fought against the reform of the *scala mobile.*

Some insight into the reason for these divisions is provided by a look at the socioeconomic differences among the major labor federations. The membership breakdown in Table 3 indicates that the Communist-dominated CGIL was more

TABLE 3 ITALY: NONAGRICULTURAL MEMBERSHIP IN THE CGIL, CISL, AND UIL BY SECTORS, 1983 (PERCENT OF MEMBERS)

	CGIL	CISL	UIL
Industry	59.4	45.6	44.8
Services	40.6	54.4	55.2
Private	18.4	16.8	21.8
Public	22.2	37.6	33.4

Source: Calculated from Baglioni, Santi, and Squarzon (1985, p. 196).

[31] On this so-called EUR line see Lange, Ross, and Vannicelli (1982, pp. 165–180).

[32] For two informed discussions of Italian accession see Spaventa (1980) and Andreotti (1981, pp. 284–289).

heavily represented in traditional industries, while the Socialist-oriented CISL and the more independent UIL had larger shares of their memberships in services. Expressed differently, in 1983, CGIL members constituted 55 percent of Italy's unionized industrial workers, with CISL members accounting for 29 percent and UIL members for 16 percent; 48 percent of the country's organized workers in private services, with CISL members accounting for 31 percent and UIL members for 21 percent; and 36 percent of union members in public services, with CISL members accounting for 43 percent and UIL members for 21 percent.[33]

Although quantitative data are not available, impressionistic evidence indicates that the Communist-Socialist social composition mirrored that of their unions, and was therefore similar to that of France. In both instances, the French generalization held for Italy: the Socialists were more representative of those in services and high-technology industries, while the Communists were concentrated in traditional import-competing manufacturing. This, again, helps explain why the PCI was more inclined toward devaluations, with the PSI more favorable to the EMS.

The link between European issues and the EMS was rarely drawn as explicitly in Italy as in France, perhaps because no single decision ever became the focus of popular attention. However, the presence of the link is evident from the beginning of the story. Indeed, when the arrangement was being negotiated in 1978, Prime Minister Giulio Andreotti originally announced that Italy would not participate. Only after substantial pressure was brought to bear on Andreotti by the French and Germans, did the government change its position. On the stick side, both Giscard and Schmidt made it clear that they would regard Italy's non adhesion as a blow to Italy's Europeanist credentials. On the carrot side, they permitted the lira a much wider (12 percent) band of fluctuation and incorporated financial assistance to Italy into the EMS agreement.

Andreotti swung toward EMS entry as the implications for Italian relations with its EC partners became clear. The issue was also tied up with DC-PCI relations at a time when many of Italy's allies were uneasy about the role of the Communists in the government. Extracts from Andreotti's diary for December 1978 are instructive. While still undecided, he noted in frustration: "If we do not adhere immediately it will be said that the Communists are not 'Europeans' and that the government is their slave." Once Andreotti decided to enter the EMS, he named as the most important considerations "the guarantees of Schmidt and Giscard and the need to safeguard our European prestige" [Andreotti (1981, pp. 287–288)].

Indeed, the tie between the EMS and other European policy issues served to mitigate the Communists' opposition. Unlike their French counterparts the PCI and the CGIL were generally Europeanist. The PCI regarded its relations with

[33] Baglioni, Santi, and Squarzon (1985, pp. 194–196). Figures exclude retirees.

Chancellor Schmidt, and the German Social Democrats more generally, as crucial to their future as a serious political force, and Schmidt regarded the EMS as a major personal achievement on his part. According to one major PCI leader, "Chancellor Schmidt put a great deal of pressure on both the Italian government and the PCI. In fact, Schmidt called [PCI leader Enrico] Berlinguer to try to get a reassurance that the PCI would not cause a government crisis over the EMS, and Berlinguer gave him that reassurance."[34] In other words, general Communist commitment to the EC, and the specific importance of the EMS for European integration, softened the PCI and CGIL concern about the exchange rate agreement.

There is little doubt among informed observers that the "foreign link" (*vincolo estero*) was crucial to the ability of the government to achieve austerity measures in the early and mid-1980s. A former central bank president put it succinctly: "With a weak government, the external link is a crucial anchor. In this context, a fixed exchange rate is the firmest guarantee of monetary stability when the authorities do not have the ability to impose a responsible monetary policy for *political* reasons."[35] Another Bank of Italy official was even more explicit:

> In the absence of specific *government* commitments to *macroeconomic* policy, we took the EMS as the foundation stone of our policy. The central element responsible for the changes was the desire of the political system and of public opinion for European integration. This is a reflection of the lack of confidence on the part of public opinion in the quality of our own political leaders. This has been exploited by the Bank of Italy. The external constraint was not enough to induce discipline on a full range of policies – fiscal policy is a clear exception – but on monetary issues it did have an effect.[36]

As this last informant indicated, one interesting aspect of the Italian case is the relationship between monetary and fiscal policy. During the 1980s, monetary policy conformed increasingly to the requirements of Italy's EMS commitments. This imposed severe costs on the manufacturing sector, and especially on labor within it. However, although many manufacturing jobs were lost because of the real appreciation of the lira the government picked up a great deal of the slack by running an expansionary fiscal policy. Put somewhat differently, the costs borne by manufacturing were counterbalanced by benefits that accrued to the nontradables sectors, especially those connected to public spending. In fact, over the course of the 1980s, employment in manufacturing declined more than 10 percent, and manufacturing investment was stagnant in real terms. Meanwhile, employment in services rose 27 percent, while investment in nonresidential services grew 5 percent a year in real terms [Confindustria (1992); Rey

[34] Interview, Giorgio Napolitano, Rome, July 21, 1992.
[35] Interview, Guido Carli, Rome, July 21, 1992.
[36] Interview, Fabrizio Saccomanni, Rome, July 16, 1992.

(1992, p. 52)]. Eventually, of course, the government's fiscal deficits became large enough to pose economic and political problems for it.

In this light, it is not surprising that adjustment to the EMS was most painful to the PCI's constituencies among industrial workers, while supporters of the DC and the PSI in the public sector were sheltered from the impact of the country's tight monetary policy. It is with this in mind that the man principally responsible for the PCI's economic policies at the time is somewhat bitter about the experience:

> Sectors tied to international competition hoped that the EMS and the single market would serve as a whip against the less competitive, more inefficient sectors, which they saw as a ball and chain around their legs. The most international sectors had to restructure, and had to demand a change in Italian policies.
>
> There is a broad national consensus in favor of European integration, and waving this flag one can ask for sacrifices. In 1984 the reduction of labor costs seemed key. We had indexation that other countries did not have. The inflation issue was crucial, and certainly there was a link to the exchange rate.
>
> The principal costs of this policy were paid by industrial workers. The public sector did well; management did well. But traditional industrial workers were sacrificed.[37]

The Italian experience, then, is one in which the redefinition of austerity and wage restraint as interconnected with the country's European commitments led to the adoption of policies that would probably not otherwise have been accepted. The PCI and the CGIL were forced to support a set of monetary initiatives about which they were very wary, largely because more ardent opposition would have called into question their long standing commitment to European integration. The linkage drawn between the EMS-based austerity measures and Italy's role in Europe allowed the government to change course in a way that had been impossible for over a decade.

IMPLICATIONS AND CONCLUSIONS

This discussion of the early years of the EMS leads to several conclusions about the reasons for the course of European monetary integration after 1978. Three features of the process deserve to be highlighted. First, the ERM required credible national commitments to austerity measures needed to bring high-inflation countries in line with German macroeconomic conditions. Second, these national commitments depended in large part on the response of various groups to the expected economic effects of the transitional real appreciation that would occur if the EMS commitment were honored. Third, a major component of the domestic political support for the EMS commitment was the linkage of European monetary union with other aspects of European integration: inasmuch as a nation's inability to conform to EMS constraints compromised its ability to be a

[37] Interview, Giorgio Napolitano, Rome, July 21, 1992.

full participant in other aspects of the EC, more domestic actors were drawn toward support for the measures required to fix the exchange rate.

It is reasonable to believe that the factors that affected the development of the EMS in the early 1980s will continue to influence the course of European monetary integration. Especially in the aftermath of the currency crisis of 1992–1993, real questions exist about the potential for future monetary integration. Future MI will involve further sacrifices of national policy autonomy, and there is every reason to believe that the forces that operated in the domestic politics of European monetary integration in France and Italy in the early 1980s will continue to operate there and elsewhere in the 1990s.

This implies that the prospects for further MI will depend on factors important to the development of the EMS. Domestic support for MI is essential, and this chapter has emphasized the importance of the link between currency union and other EC agenda items to cement this domestic support. This link was called into question when the ratification of the Maastricht treaty ran into difficulties. Among the results of the ensuing attempt to salvage the Treaty was a separation of economic and monetary unification from more controversial aspects of European integration (such as social programs and foreign policy). Although this might be desirable, the analysis presented tends to indicate that it is precisely the *linkage* among various policies that has been crucial to their adoption. If each component of the EC agenda were taken separately, it might be possible for opponents to prevail on every vote. With European integration taken as a package, the prospects for success are higher.[38]

MI is still closely tied to other aspects of European integration. Whether this linkage is sufficient to bring about a change in national monetary politics large enough to allow the process of monetary integration to go forward in a way that incorporates the entire present (and future) Community, or whether domestic political lineups will force consideration of alternatives to full-fledged MI, will be largely a function of developments in the domestic politics of monetary policy within EC member states.

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[38] This is the conclusion drawn by Martin (1994, this volume).

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