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Conflicting authorities: states, currency markets and the ERM crisis of 1992–93

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Abstract. The concept of authority has recently received heightened attention in the international politics literature. Unfortunately, considerable confusion still exists regarding who possesses authority, how authority is constituted, how it erodes and how it differs from other means of generating compliance, most notably power. Drawing on work from international political economy and political theory, this article sets out to clarify some of the many ambiguities surrounding authority. It builds hypotheses regarding state/market authority relations and tests these hypotheses in the context of the Exchange Rate Mechanism (ERM) crisis of 1992–93. The article concludes that the ERM crisis did not represent a mere 'bump in the road' on the way to European Monetary Union, but rather the break-up of policy consensus in a dramatic way.

The evolution of European monetary cooperation also raises a series of broader theoretical puzzles about the changing historical interaction of political authority and economic markets, and how this interaction shapes the conditions under which societies are governed.

Kathleen McNamara
The Currency of Ideas

The argument put forward is that the impersonal forces of world markets, integrated over the postwar period more by private enterprise in finance, industry and trade than by the cooperative decision of governments, are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong.

Susan Strange
The Retreat of the State

Introduction

The concept of authority in international relations—who possesses it, how it is acquired, its influence on governance, and so on—has recently received heightened

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attention in the international politics literature.[1] In particular, students of international political economy and of European politics have found themselves drawn to the issue of authority for different—but not entirely unrelated—reasons. In the first instance, to try and understand the effects on international politics of what some contend to be the irreversible ascendancy of 'market power' relative to the power of states. In the latter, to understand the impact of ever deeper European Union integration—what John Ruggie argues is the development of the first postmodern form of political organization—and the fascinating questions of governance which evolving EU political structures engender.[2]

That these issues are not so disconnected from each other finds support in the way both Kathleen McNamara and Susan Strange draw on Karl Polanyi's notion that the relation of market authority to political authority shifts back and forth across time.[3] Strange, for instance, argues that a relatively recent shift to market authority can be seen in the way emergent transnational actors influence distributional outcomes across a host of issue areas previously the responsibility of states. McNamara argues ideational factors shaped European policymakers' responses to the growing structural power of global capital markets after the collapse of Bretton Woods, crucial to the story of European monetary integration.[4]

This article questions aspects of both these arguments. I begin by discussing Strange's account of authority. I argue Strange offers an underspecified notion of authority and frequently conflates authority with power. I then attempt to clear up the conceptual confusion surrounding authority. I specify how bearers of authority generate compliance and construct hypotheses regarding the causal implications of shifting state/market authority relations on monetary regimes. In doing so, I begin to fill the considerable theoretical gap that currently exists between politically naïve economic and overly state-centric political explanations of currency crises.

I then turn to McNamara's thesis that European Monetary Union (EMU) can be traced to the emergence of a neoliberal policy consensus among European officials since the collapse of the Snake.[5] Embedded in her thesis rests an important claim regarding state/market authority relations. Namely, that to improve their international economic position, European states abandoned domestic policy autonomy as a viable goal and ceded authority over monetary affairs to financial markets.[6] To test this claim, I enter the admittedly narrow and often arcane world of European

[1] See for instance A. Claire Cutler, 'Locating "Authority" in the Global Political Economy', *International Studies Quarterly*, 43:1 (1999), pp. 59–81; A. Claire Cutler, Virginia Haufler and Tony Porter (eds.), *Private Authority and International Affairs* (New York: SUNY Press, 1999); Richard A. Higgott, Geoffrey R.D. Underhill and Andreas Bieler, *Non-State Actors and Authority in the Global System* (London: Routledge, 2000); Ian Hurd, 'Legitimacy and Authority in International Politics', *International Organization,* 53:2 (1999), pp. 379–408; Ronnie D. Lipschutz, *After Authority: War, Peace, and Global Politics in the 21st Century* (New York: SUNY Press, 2000).

[2] John Gerard Ruggie, 'Territoriality and Beyond: Problematizing Modernity in International Relations', *International Organization,* 47:1 (1993), pp. 139–140.

[3] Karl Polany, *The Great Transformation* (New York: Octagon Books, 1944); Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996), p. 45; Kathleen R. McNamara, *The Currency of Ideas: Monetary Politics in the European Union* (Ithaca, NY: Cornell University Press, 1998), p.83.

[4] McNamara, *Currency of Ideas*; Strange, *Retreat of the State.*

[5] The 'Snake' operated as a managed pegged rate regime within the framework of Bretton Woods. Nine European countries implemented the regime in 1972 in response to currency instability provoked by the closing of the 'gold window' by the United States in 1971.

[6] McNamara, *Currency of Ideas*, p.10.

monetary politics. I apply the concept of authority developed in the first part of the article to the case of the Exchange Rate Mechanism (ERM) crisis of 1992–93. I argue the crisis occurred because of a lack of consensus among key European policy-makers over the objectives of monetary policy and the appropriate relation of state and market authority. I go on to argue the collapse of the ERM did not represent merely a bump in the road on the way to EMU, but signalled the breakdown of consensus in a dramatic way.[7] Britain, Denmark and Sweden's continued reluctance to join EMU and the euro's persistent weakness in the foreign exchange market suggest many state and market actors believe the European Union has yet to resolve these central concerns.

Finally, in the last section I pull up from the details of the ERM crisis to offer some thoughts on the lessons of the crisis for European monetary policy under conditions of monetary union. Specifically, I address some of the potential dangers for euro stability associated with events in Europe since the euro's introduction. I then discuss some of the significant theoretical implications suggested by these arguments for our understanding of state/market relations.

Distinguishing authority from power

Much attention in international political economy has focused on the myth or reality of the 'powerless state'.[8] As one of the earliest and most dogged analysts of state/market relations, Susan Strange helped shape both the empirical and the theoretical dimensions of this discussion. What remains consistent in her work is the claim that politics does not begin and end with politicians. She writes, 'I must protest that politics is larger than what politicians do, and that power can be exercised—and is every day being exercised—by non-state authorities as well as by governments.'[9] Unfortunately, while Strange usefully discusses how students of politics ought to think about non-state forms of power, she is not at all clear about how we ought to think about non-state forms of authority.

Strange defines power as 'the ability of a person or group of persons so to affect outcomes that their preferences take precedence over the preferences of others.'[10] But power is just one means by which actors generate compliance. Ian Hurd argues political theorists most often isolate three mechanisms of social control: coercion, self-interest and legitimacy.[11] Legitimacy, as Hurd uses the concept, stands for 'the normative belief by an actor that a rule or institution ought to be obeyed. It is a

[7] For instance, McNamara (*Currency of Ideas*, pp. 169–170) refers to the ERM crisis only to demonstrate the domestic policy constraint posed by mobile capital. Rawi Abdelal argues the EMS remained essentially intact following the crisis. Rawi Abdelal, 'The Politics of Monetary Leadership and Followership: Stability in the European Monetary System since the Currency Crisis of 1992', *Political Studies,* 46 (1998), 236–259.

[8] See for instance, Robert Boyer and Daniel Drache (eds.), *States Against Markets: The Limits of Globalization* (London: Routledge, 1996); Philip G. Cerney, 'The Dynamics of Financial Globalization: Technology, Market Structure, and Policy Response', *Policy Sciences,* 27 (1994), pp.319–42; Linda Weiss, 'Globalization and the Myth of the Powerless State', *New Left Review,* 225 (1997), 3–27; *Current History,* 96: 613 (1997), multiple articles.

[9] Strange, *Retreat of the State*, p.xiv.

[10] Ibid, p.17.

[11] Hurd, 'Legitimacy and Authority', p.379.

subjective quality, relational between actor and institution, and defined by the actor's perception of the institution.'[12] What Hurd defines as legitimacy can be classified as an aspect of authority; and, indeed, Hurd concludes to the extent that non-state actors possess 'legitimacy' they also possess 'authority.'[13] In contrast, particularly throughout *The Retreat of the State*, Strange uses power and authority interchangeably, sometimes casting her thesis in terms of a state/market balance of power and at other times contending 'authority in society and over economic transactions is legitimately exercised by agents other than states.'[14] This conceptual conflation generates much confusion because power and authority are, in fact, distinct concepts with very different causal properties.

The difficulty here is not Strange's alone. Claire Cutler notes that in the international political economy, 'the location and structure of legitimate authority are not obvious or self-evident.'[15] Nevertheless, particularly in *The Retreat of the State,* Strange illustrates both non-state sources of power and of authority without noting the considerable differences in how they produce social control. Organized crime and cartels, for example, utilize power to generate compliance through coercion, fear and intimidation. Actors comply with insurers, accountants and telecoms, in contrast, because they represent critical sources of 'expertise.' Econocrats generate compliance because they occupy legitimately constituted 'offices' and possess expert knowledge over specific issue areas.[16] As I explain next, the latter examples, 'expertise' and 'office', are constituent elements of legitimate authority. Compliance through coercion most certainly is not.

Authority and the authoritative in political theory

Exploration into the nature of authority has traditionally been considered the purview of political theorists. Theorists of international relations, satisfied by their reading of Hobbes that authority resides in and ends with the sovereign, most often find little need or opportunity to discuss the matter further. For Hobbes, the social contract ceded authority on all public matters within the collectivity to the sovereign. However, since the sovereign was not a party to the contract, he/she remained within the anarchical 'state of nature'; a place thereby defined by the fact that it was absent of authority.[17]

Authority is a much richer concept than is usually assumed by international relations scholars, however, with several competing typologies of authority present in the political theory literature.[18] Generally, theorists distinguish between those 'in' authority from those who represent 'an' authority where 'in' authority is defined as

12 Ibid, p.381.
13 Ibid
14 Strange, *Retreat of the State*, pp. 7,13.
15 A. Claire Cutler, 'Locating "Authority" ', p. 61.
16 Strange, *Retreat of the State*.
17 Thomas Hobbes, *Leviathan* (New York: Penguin Books, 1985 [1651]).
18 See for instance, Terrence Ball, 'Authority and Conceptual Change', in J. Roland Pennock and John W. Chapman (eds.), *Authority Revisited* (New York: New York University Press, 1987), pp. 39–58, and Richard E. Flathman, *The Practice of Political Authority: Authority and the Authoritative* (Chicago, IL: The University of Chicago Press, 1980).

'a property of rules and offices created by rules' and 'an' authority is 'based on, is possessed by virtue of, demonstrated knowledge, skill or expertise concerning a subject matter or activity'.[19] Authority is also most often considered interrelated with, but conceptually distinct from, power and other means of achieving compliance derivative of power such as coercion, persuasion, and influence. Hannah Arendt, for instance, argues,

> Since authority always demands obedience, it is commonly mistaken for some form of power or violence. Yet, authority precludes the use of external means of coercion; where force is used authority itself has failed. Authority, on the other hand, is incompatible with persuasion, which presupposes equality and works through a process of argumentation. Where arguments are used, authority is left in abeyance. Against the egalitarian order of persuasion stands the authoritarian order which is always hierarchical. If authority is to be defined at all, then, it must be in contradistinction to both coercion by force and persuasion through arguments.[20]

Authority is constructed through social practice where symbols of expertise, such as levels of education, membership in professional associations and titles of offices, mark the bearer as worthy of some degree of deference. Richard Friedman grounds the right to command and the duty to obey in a 'mutually recognized relationship'.[21] Within Friedman's framework, authority assumes an 'inherently perspectival' dimension forcing us to analyse authority within a relational context.[22] Importantly, while symbols of expertise or office mark actors as potential bearers of authority, they are insufficient to sustain authority. Authority must be constantly nurtured through personal performance.[23] While Carl Friedrich argues 'authority is a quality of communication, rather than of persons', he neglects the fact that specific individuals can augment or detract from the authority of an office.[24] Individuals defer to authority not only because the communication appears reasonable but also because they trust the agent issuing the command.[25] A significant implication of this notion of authority is that, contrary to the arguments of some writers, individuals suspend their own judgment when confronted with an authority, but they never surrender it.[26] The way they view authorities, their structure, influence, and other characteristics, significantly influence the extent to which actors are willing to extend or withdraw support.[27] Therefore, authority, defined here as the voluntary suspension

19 Peter M. Blau, 'Critical Remarks on Weber's Theory of Authority', *The American Political Science Review,* 57:2 (1963), pp. 16–17.

20 Hannah Arendt, 'What was Authority?' in Carl J. Friedrich (ed.), *Authority* (Cambridge, MA: Harvard University Press, 1958), p. 82.

21 Friedman quoted in Steven Lukes, 'Perspectives on Authority', in J. Roland Pennock and John W. Chapman (eds.), *Authority Revisited* (New York: New York University Press, 1987), p. 65.

22 Lukes, 'Perspectives', p. 60.

23 Flathman, *The Practice of Political Authority,* p. 100.

24 Carl J. Freidrich, 'Authority, Reason, and Discretion', in Carl J. Friedrich (ed.), *Authority*, (Cambridge, MA: Harvard University Press, 1958), p. 36.

25 This is what principally separates 'authority' from 'credibility'. Credible dictates are merely acts or statements that are—for whatever reason—believable. Credibility does not suggest in any way an obligation to comply on the part of an agent. Authoritative actions, in contrast, generate compliance regardless of their *prima facie* credibility. Authorities are considered authoritative because of their recognized expertise over a particular domain and/or the fact that they hold a legitimate office. That said, credible acts build an agent's reputation and therefore help to sustain authority. A steady stream of non-credible acts eventually erodes authority.

26 See, for example, Cutler, Haufler and Porter, *Private Authority.*

27 David Easton, 'The Perception of Authority and Political Change', in Carl J. Friedrich (ed.), *Authority* (Cambridge, MA: Harvard University Press, 1958), p. 173.

of individual judgment in response to a dictate, is subjective and conditional. It must be reinforced through appropriate acts of social conduct.

These diverse elements combine to create 'authoritative' relationships in two interrelated ways. Modifying terminology used by Richard Flathman, they first possess a 'formal' dimension.[28] In other words, they originate in an 'office' or 'organization' constituted by precise, recognized, rules, laws and procedures such as a central bank, treasury ministry, or an elite financial firm. Second, authoritative commands possess a 'substantive' dimension. Substantive authority results from the level of trust, respect and credibility afforded to the person, office or organization issuing the command.

By implication, the ability of actors to generate and sustain authority varies. An office may possess a certain baseline level of 'formal' authority due to its institutional position. For example, market actors, most of the time, view independent central banks as more authoritative on matters of monetary policy than politically motivated finance ministries. Similarly, government officials and investors tend to consider currency strategists at prestigious financial institutions, such as Goldman Sachs or Citigroup, to be more authoritative about exchange rates than their peers at small commercial banks.[29] In contrast, whether or not the actor or organization maintains 'substantive' authority is primarily a function of whether or not others believe their statements and actions to be truthful, credible and the like. Substantive authority is a product of the subject's judgment concerning the authority's prior history and reputation. For example, a foreign exchange economist will not long defer to the statements of a policymaker concerning monetary or fiscal policy if that official is known to be corrupt, incompetent, politically motivated or frequently misleading. Nor will a policymaker long accept the actions of the market—or any particular person or firm in the market—if the market exhibits what the policymaker judges to be irresponsible, irrational or malicious behaviour.

Authority and monetary regimes

Most people view monetary issues as highly esoteric and best left to the sound judgment of expert 'financiers' in governments and private firms. The realm of monetary policy, therefore, represents an ideal ground for investigating authority because of its unique dependence on communities of experts. I begin my investigation narrowly by theorizing how exchange rate regimes structure the choices that policymakers and market actors make when confronted with changing monetary conditions.[30] I then test these assumptions by analysing the ERM crisis of 1992–93.

John Ruggie argues 'the formation and transformation of international regimes may be said to represent a concrete manifestation of the internationalization of

[28] Flathman, *The Practice of Political Authority.*

[29] Author interviews with currency strategists at major investment banks in London and officials at HM Treasury and the Bank of England (January, November and December 1998).

[30] I adopt the traditional definition of regimes provided by Krasner as 'implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations' but also include the organizational structures embedded in the regime. Stephen D. Krasner, 'Structural Causes and Regime Consequences: Regimes as Autonomous Variables', in Stephen D. Krasner (ed.), *International Regimes* (Ithaca, NY: Cornell University Press, 1983), p. 2.

political authority'.[31] That said, the notion of regime authority is a derived notion. Because regimes do not possess wills or discretion, they do not possess authority directly.[32] Rather, they specify relationships of authority between those individuals and organizations bearing influence and expertise within specific issue areas and those subject to their dictates. In the context of currency regimes, this relationship can be most easily seen at its extremes. In a pure floating rate regime—where market mechanisms operate unencumbered—governments maintain authority over national monetary and fiscal policies. At the same time, market actors maintain authority for determining the rate of currency exchange believed to most appropriately reflect relative national monetary and fiscal conditions.[33] In a pure fixed rate regime—again where market mechanisms operate unencumbered—states possess authority to set central rates of exchange, but market actors then maintain authority to determine the domestic wage levels, interest rates, and so on, required to sustain those rates.

These 'pure' regimes rarely find expression in real world practice. Instead, we encounter currency regimes embodying different distributions of state/market authority such as managed floats, fixed but adjustable rates, crawling pegs and target zones.[34] In each case, what represents expertise, the boundaries of legitimate behaviour on the part of state and market actors, and, hence, appropriate authority relations, reflects a complex interplay of ideas and practices unique to the regime's historical juncture.[35] At the same time, the lines delineating domains of state and market authority are much more ambiguous and contestable. The 'rules' are less clear, open to a greater range of interpretation by both market actors and policymakers and hence less able to produce stable sets of expectations. Here, then, at the churning confluence of state and market authority, where the opinions of experts clash under complex and ambiguous economic and political conditions, lay the origins of currency crises. This becomes much clearer by investigating the evolution and crisis of the European Exchange Rate Mechanism (ERM).

Normative change and European monetary regimes

Much has been written about why the ERM crisis of 1992–93 occurred, but little has been said about how the crisis should be understood relative to the progress of European monetary politics more generally. I begin by challenging the notion that the ERM crisis represents merely one of several bumps along the rough road of

[31] John Gerard Ruggie, 'International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order', *International Organization*, 36:2 (1982), p. 380.

[32] Andreas Hasenclever, Peter Mayer, and Volker Rittberger argue the lack of agency in this sense is what distinguishes regimes from organizations. See Andreas Hasenclever, Peter Mayer, and Volker Rittberger, *Theories of International Regimes* (Cambridge: Cambridge University Press, 1997), p. 11.

[33] Defining an 'appropriate' exchange rate is not easy. One currency economist defines it as 'that rate which maintains internal and external stability'. A Bank of England official defines it as 'whatever the market says it is'. (Author interviews, January 1998).

[34] For a more detailed description of these regime types see Tony Latter, 'The Choice of Exchange Rate Regime', *Handbooks in Central Banking*, 2 (London: Centre For Central Banking Studies, 1996).

[35] See, for instance, Kenneth W. Dam, *The Rules of the Game: Reform and Evolution in the International Monetary System* (Chicago, IL: The University of Chicago Press, 1982) and Ronald I. McKinnon, 'The Rules of the Game: International Money in Historical Perspective', *Journal of Economic Literature*, 31 (1993), pp. 1–44.

European monetary integration that began with the demise of the Bretton Woods regime in the 1970s. I do so by investigating Kathleen McNamara's thesis in *The Currency of Ideas* that beginning in the mid-1970s, a neoliberal policy consensus—what she labels 'competitive liberalism'—came to replace the compromise of 'embedded liberalism' that sat at the heart of the Bretton Woods regime.[36] I test this thesis by first identifying the gaps in existing political and economic accounts of the ERM crisis and then recasting the crisis as a crisis of authority. What becomes sharply evident is the extent to which dissension, rather than consensus, among European policymakers regarding the objectives of national fiscal and monetary policies and the role of states and markets in economic life contributed to crisis in the ERM regime.

John Ruggie argues economic regimes embody a historically contingent fusion of power and social purpose. According to Ruggie, we may be able to understand a regime's form by understanding relations of interstate power, but not its content.[37] McNamara utilizes Ruggie's approach to regimes to argue a shift in power—from states to capital markets—and a shift in social purpose—from growth and full employment to low inflation—drove the progression towards EMU that began with the *de facto* collapse of the Snake in 1973. She writes, 'A neoliberal policy consensus that elevated the pursuit of low inflation over growth or employment took hold among political elites, eventually resulting in a downward convergence in inflation rates. This policy consensus redefined state interests in cooperation, underpinned stability in the EMS, and induced political leaders to accept the domestic policy adjustments needed to stay within the system'.[38] According to McNamara, the neoliberal policy consensus that took hold centred around a German version of pragmatic monetarism that delivered economic growth with relatively low inflation during the 'stagflation' years of the 1970s. Finally, she suggests this shift can best be understood as the abandonment by European leaders of the compromise of 'embedded liberalism' in place since Bretton Woods and the embrace of a 'competitive liberalism' defined as the willingness of states 'to rule out the use of monetary policy as a weapon against broader societal problems, such as unemployment or slow growth … and support for exchange rate stability and inflation control above all other macroeconomic goals.'[39]

McNamara is certainly correct that the growth of capital markets from the 1970s onward influenced the range of policies available to state policymakers confronted with slow growth and creeping unemployment. She is also correct that the substantial convergence evident in the fiscal and monetary policies of European governments during the 1970s and 1980s was in no small part due to policy emulation. However, by 1992, several European leaders and organizations were clearly unwilling to co-operate with each other or to subordinate their domestic policy to achieve stable exchange rates even when that meant contributing to crisis in the ERM. In short, the ERM crisis reveals the breakup of consensus in a dramatic way. McNamara overstates the extent to which European officials abandoned the goals of

[36] McNamara, *Currency of Ideas*. According to Ruggie ('International Regimes', p. 393), 'This was the essence of the embedded liberalism compromise: unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism'.

[37] Ruggie, 'International Regimes', p. 382.

[38] McNamara, *The Currency of Ideas*, p. 3.

[39] Ibid, p. 10.

embedded liberalism prior to 1992. She also understates the deep divisions regarding the balance of government activism and market autonomy that existed among European policymakers prior to, during (and since) the ERM crisis.

Economic and political explanations of the ERM crisis

Although much has been written about currency crises, we still know very little about why currency crises occur, how they progress and why they stop. One explanation might be that our knowledge of currency crises divides into the fields of economics and political science. This artificial division of labour—economists investigate how macroeconomic conditions influence market behaviour while political scientists investigate why governments change exchange rate policies—leaves significant theoretical blind spots in both fields. This becomes increasingly evident when we begin to explore difficult questions about the ERM crisis. For instance, why did the Danish Maastricht vote trigger the crisis? Why did the crisis begin in Scandinavia rather than in the EC? Why did investors attack currencies where economic fundamentals appeared robust and exchange rates appropriate? Why did Bundesbank policies prove the crucial determinant of who did and did not successfully defend their parities when speculation occurred?

Most economists agree that strains on the ERM system imposed by German reunification 'were exacerbated by inappropriate macroeconomic policy decisions that contributed to high inflation and budget deficits in some EMS countries—especially the United Kingdom and Italy'.[40] Economists dispute, however, the actual effects of Britain's entry rate, Italy's budget problems and France's interest rate policies on economic competitiveness and the sustainability of parities within the grid.[41] This lack of consensus among economists primarily results from disagreements about the causal influence of macroeconomic variables on exchange rates. As

[40] Bryon Higgins, 'Was the ERM Crisis Inevitable?', *Economic Review*, Federal Reserve Bank of Kansas City, 78:4 (1993), p. 27. Literature explaining technical aspects of the crisis include: Renzo Avesani, Giampiero M. Gallo and Mark Salmon, 'On the Nature of Commitment in Flexible Target Zones and the Measurement of Credibility: The 1993 ERM Crisis', in Christian Bordes, Eric Girardin and Jacques Melitz (eds.), *European Currency Crises and After* (Manchester: Manchester University Press, 1995), pp. 106–130; Christian Bordes, Eric Girardin and Jacques Melitz (eds.), *European Currency Crises and After* (Manchester: Manchester University Press, 1995); David Cobham, 'Causes and Effects of the European Monetary Crisis of 1992–1993', *Journal of Common Market Studies,* 34:4 (1996), pp. 585–604; Barry Eichengreen and Charles Wyplosz, 'The Unstable EMS', *Brookings Papers on Economic Activity,* 1 (1993), pp. 51–143; Michele Fratianni and Michael J. Artis, 'The Lira and the Pound in the 1992 Currency Crisis: Fundamentals or Speculation?', *Open Economies Review,* 7 (1996), pp. 573–89; International Monetary Fund 'Recent Changes in the European Exchange Rate Mechanism', *World Economic Outlook,* October (1993), pp. 29–47; Christopher Johnson and Stefan Collignon (eds.), *The Monetary Economics of Europe: Causes of the EMS Crisis* (Rutherford: Fairleigh Dickinson University Press, 1994); Jacques Melitz, 'French Monetary Policy and Recent Speculative Attacks on the Franc', in David Cobham (ed.), *European Monetary Upheavals* (Manchester: Manchester University Press, 1994), pp. 61–77; Richard Portes, 'EMS and EMU After the Fall', *World Economy,* 16 (1993), pp. 1–15; Andrew K. Rose and Lars E.O. Svensson, 'European Exchange Rate Credibility Before the Fall', *European Economic Review,* 38 (1994), pp. 1185–1216 and John Williamson, 'EMS and EMU After the Fall: A Comment', *World Economy,* 16:3 (1993), pp. 377–379.

[41] See Eichengreen and Wyplosz, 'The Unstable EMS', and Eichengreen, Rose and Wyplosz, 'Exchange Market Mayhem'.

David Cobham confesses 'the last two decades have failed to produce good predictive models of the exchange rate'.[42] This is not surprising. According to recent surveys of UK and US-based currency traders, 'There is no consensus among traders on a wide range of important issues relating to fundamental value and the determinants of exchange rate movements'.[43] The troubling result for economists attempting to use macroeconomic models to predict or explain currency crises is that 'it would appear that exchange rates can be, and repeatedly are, severely strained and destabilized by speculative pressures even in the absence of clear imbalances in macroeconomic fundamentals'.[44]

Economists also disagree on why currency markets underwent such a radical change in expectations in the summer of 1992 that an apparently stable foreign exchange regime turned so quickly into a fragile one. Some economists argue macroeconomic conditions underwent a significant shift prior to 1992. Significant enough, anyway, to make existing ERM parities non-credible. Others argue the parities were credible and indefinitely sustainable.[45] Positions in this debate turn on whether one believes market actors simply react to existing macroeconomic conditions or whether market actors can alter macroeconomic conditions by co-ordinating their investment behaviour.[46] What they share, however, is an underdeveloped view of the role politics plays in fostering currency crises.

Political scientists view the causes of the ERM crisis primarily in political/organizational terms. Michael Smith and Wayne Sandholtz point to a bureaucratic division of labour between the German government (responsible for 'treaty making') and the Bundesbank (responsible for 'policymaking') and show how conflicts between the objectives of these organizations undermined intra- and intergovernmental co-operation during the crisis.[47] They argue, 'German and European institutional structures worked against two potential solutions to the crisis: realignment and reductions in German interest rates'.[48] In contrast, Mark Harmon and Dorothee Heisenberg place blame for the crisis in Britain and in Germany. Harmon and Heisenberg attribute the failure of Britain to maintain the value of sterling within the ERM to 'London's failure to conform to the policy strictures of EMS

[42] Cobham, 'Causes and Effects', p. 596. For a useful survey of the dominant exchange rate models and their performance, see Robert P. Flood and Mark P. Taylor, 'Exchange Rate Economics: What's Wrong with the Conventional Macro Approach?', in Jeffrey A. Frankel, Giampaolo Galli and Alberto Giovannini (eds.), *The Microstructure of Foreign Exchange Markets* (Chicago, IL: The University of Chicago Press, 1996), pp. 261–301.

[43] Yin-Wong Cheung, Menzie D. Chinn and Ian W. Marsh, 'How Do UK-Based Foreign Exchange Dealers Think Their Market Operates?' NBER Working Paper Series no.7524 (2000), p. 2. See also Yin-Wong Cheung and Menzie D. Chinn, 'Macroeconomic Implications of the Beliefs and Behavior of Foreign Exchange Traders', NBER Working Paper Series no.7417 (1999).

[44] Eichengreen, Rose and Wyplosz, 'Exchange Market Mayhem', p. 255.

[45] See for instance, Higgins, 'Was the ERM Crisis Inevitable?'; Maurice Obstfeld, *Models of Currency Crises with Self-Fulfilling Features*, NBER Working Paper Series no. 5285 (1995); Maurice Obstfeld, *The Logic of Currency Crises*, NBER Reprint no. 1908 (1994); Maurice Obstfeld, 'Rational and Self-Fulfilling Balance-of-Payments Crises', *American Economic Review,* 76:1 (1986), pp. 72–81; Eichengreen, Rose and Wyplosz, 'Exchange Market Mayhem'.

[46] See Robert P. Flood and Nancy P. Marion, 'Speculative Attacks: Fundamentals and Self-Fulfilling Prophecies', NBER Working Paper Series no.5789 (1996), for a good review of both positions.

[47] Michael Smith and Wayne Sandholtz, 'Institutions and Leadership: Germany, Maastricht, and the ERM Crisis', in Carolyn Rhodes and Sonia Mazey (eds.), *The State of the European Union: Building a European Polity,* vol. 3 (Boulder, CO: Lynne Reinner, 1995).

[48] Ibid., p. 245.

membership'.[49] As for German culpability, Harmon and Heisenberg point to Germany's failure to insist on realignment after unification, the maintenance of high interest rates that threatened EC economies, the lack of verbal support for Britain and general uncertainty regarding Germany's commitment to monetary union.[50] Like Smith and Sandholtz, David Cameron finds 'Germany was, at several critical moments, *unable* to exercise "structural leadership"' particularly in its inability to gain agreement to a general currency realignment prior to the Bath summit.[51] In response, Cameron offers what he describes as a 'regime-as-polity' approach to the crisis. For Cameron, any adequate explanation of the crisis must factor in the ERM's rules, norms and procedures as well as the interactions among its members through which governments institutionalized themselves in the regime.[52] As a result, 'by its decision to remain outside the ERM, Britain had voluntarily excluded itself from that "evolution of cooperation" '.[53] This led to a lack of support for Britain within the ERM when they most needed it.

Unfortunately, these authors provide a no more satisfying explanation of the crisis than do their economist counterparts. For example, the focus on the importance of norm compliance among the parties to a regime is highly suggestive. Yet, normative embeddedness itself cannot fully explain state behaviour during the crisis. Italy participated in the ERM from its beginning and linked its economic and security policies tightly to the EC. Italy possessed high regime embeddedness but left the ERM anyway. Italy's behaviour is problematic for norm compliance as an explanatory variable, at least as Cameron and Harmon and Heisenberg specify it.

Similarly, Smith and Sandholtz offer a rich account of the challenges faced by policymakers trying to convert monetary power in the ERM into institutional authority. But they do not clearly explain how Bundesbank authority—or variations in it—resulted in currency markets pressuring exchange rates at different levels of intensity and at different times. Nor do they specify the linkages between levels of institutional authority and the stability of exchange rates. This leaves them unable to trace how institutional infighting in Germany ultimately led to currency markets attacking currency values within the parity grid.

Independently, economic and political approaches to the ERM crisis cannot explain the significant policy variations exhibited by Britain, France and Italy during the crisis. Table 1 describes six areas of variation between countries, each one of which the economic or political science literatures find difficult to explain. For example, all three countries came under intense exchange rate pressure, but only Italy possessed clear competitiveness problems. Britain and Italy both left the regime but Italy was highly embedded in the regime's normative structure while Britain was not. All three received significant *material* support from the Bundesbank, but only France received clear *rhetorical* support. The causal influence of this variable goes mostly unexplained in both literatures.

[49] Mark D. Harmon and Dorothee Heisenberg 'Explaining the European Currency Crisis of September 1992', *German Politics and Society,* 29 (1993), p. 20.

[50] Ibid.

[51] David R. Cameron, 'British Exit, German Voice, French Loyalty: Defection, Domination, and Cooperation in the 1992–1993 ERM Crisis', manuscript prepared for the annual meeting of the American Political Science Association, Washington, DC (September 1993), p. 64 (emphasis in the original).

[52] Ibid., p. 68.

[53] Ibid., p. 69.

Table 1. *Cross-case variations in the ERM crisis : Britain, France, Italy.*

Question	Britain	France	Italy
1. *Did a clear macroeconomic imbalance exist?*	Unclear	No	Yes
2. *Was the government highly embedded in the regime?*	No	Yes	Yes
3. *Did the government receive material support from the Bundesbank?*	Yes	Yes	Yes
4. *Did the government receive rhetorical support from the Bundesbank?*	No	Yes	No
5. *Did the government devalue in the mechanism?*	No	No	Yes
6. *Did the government leave the exchange rate regime?*	Yes	No	Yes

Unable to deliver a complete explanation of the crisis, these accounts do, nonetheless, pose clear challenges to McNamara's thesis. They underscore the significant degree of normative and operational conflict within and between countries at the time of the ERM crisis and the unwillingness of many policymakers to subordinate domestic economic goals to European objectives. Successful policy emulation in relative good times, it appears, masked deep normative and operational tensions.

Conflicting authorities: states, markets and the ERM

Exchange rate regimes embody certain 'rules of the game', historically contingent norms reflecting the underlying economic ideas that structure state and market behaviour.[54] In many cases these rules are not explicitly codified but rather tacitly understood. In either case, state and market actors align exchange rate expectations and adopt roles based on their understanding of these rules. The ERM began in 1979 as a floating exchange rate regime designed to counter the volatility in financial markets experienced throughout the 1970s. However, between 1979 and 1992, the ERM gradually shifted from a floating currency rate regime into a quasi fixed-rate regime. With this shift in regime form came a shift in the policy tools available to state officials for maintaining exchange rate stability. In particular, the abandonment of capital controls so central to the earlier Bretton Woods regime required states to develop alternative methods for supporting exchange rates. EC legislation codified these methods, including (among others) when and how to use intramarginal intervention, interest rate adjustments and parity realignments.[55]

The ERM regime defined authority relations among state and market actors. Returning to the language introduced earlier, formal political authority arose through the development of specific organizations and decision-making mechanisms (such as the regular meetings of European` finance ministers and central bankers)

[54] The term 'rules of the game' is usually attributed to Keynes in reference to the working of the pre-war Gold Standard. See Dam, *The Rules of the Game.*
[55] McKinnon, 'Rules', p. 36–37.

through which European leaders discussed and implemented exchange rate policies. Formal market authority arose as states loosened financial market regulations, market actors developed norms and principles for processing foreign exchange transactions and market mechanisms gained recognition as efficient and legitimate means through which to distribute financial capital. Substantive political authority arose through the respect market actors afforded the technical expertise of bureaucrats, particularly central bankers, as well as the reputation some policymakers possessed for truthfulness and competence. Substantive market authority rested on the beliefs held by policymakers of market expertise, market behaviour (compliance with existing norms and principles) and the respect—or disrespect—political officials afforded firms, leaders of firms or the market generally. When robust, these authority relations generated predictable patterns of state and market behaviour. States adjusted interest rates and intervened in financial markets when necessary to support weak currencies. Markets—anticipating government behaviour—self-corrected when rates approached the upper or lower bounds of the parity grid.[56]

In the period from 1990–92, however, political authority weakened as members increasingly pursued domestic-oriented policy. Specifically, the failure to realign exchange rates after German reunification and the failure (of some governments) to adjust interest rates to support exchange rate parities violated two foundational regime 'rules' and resulted in 'a sort of creeping instability' as the bases for market expectations shifted.[57] In this uncertain policy environment, market actors sought a new focal point around which to align exchange rate expectations and accepted perceived variances in exchange rates only because they believed European monetary institutions would garner increased formal authority through ratification of the Maastricht Treaty. As one foreign exchange analyst said prophetically in May 1992, 'some dealers fear that if the Danes decide not to join the EMU (European Monetary Union or single currency), the whole project will start to fall apart, adding to uncertainty in the European Monetary System'.[58]

On 2 June, Denmark voted against the treaty by the narrow margin of 50.7 per cent to 49.3 per cent. The vote revealed the significant doubt present in the European populace regarding the Maastricht Treaty and left EC officials unable to issue guarantees that the Maastricht timetable would proceed as envisioned. The 'no' vote also caused foreign exchange traders to question whether state compliance to the convergence criteria required by Maastricht would continue.[59] In response, market actors began to pressure exchange rates in countries linked to, but outside of the ERM's domain of authority—notably Sweden and Finland. Market actors then began to pressure the exchange rates of countries within the regime, such as Britain and Italy. French President Francois Mitterrand scheduled a French referendum for

[56] For a theoretical discussion see Marcus Miller and Lei Zang, 'Choosing a Target Zone: Rules versus Discretion,' in Bordes, et al., *European Currency Crises.*

[57] *The Reuter Business Report*, 23 November 1992. In particular, as many commentators have pointed out, EC officials were unable to organize a general realignment of parities or achieve interest rate policy behaviour on the part of members—particularly Britain and Germany—that conformed to regime goals. In the period 1990–92, members maintained highly asymmetric policies with Germany pursuing a tight monetary and loose fiscal policy, Britain a tight fiscal and loose monetary policy and France both a tight fiscal and a tight monetary policy as part of its *franc fort* policy.

[58] *Financial Times*, 22 May 1992.

[59] This is readily apparent in the case of Italy. The *Financial Times* points out, 'Investors are afraid that Italy will not get its public accounts into order without the discipline of European economic convergence rules (4 July 1992)'. See also Avesani, Gallo and Salmon, 'On the Nature', p.106.

20 September, 1992 in hopes that a French 'yes' would restore the EC's formal authority, stabilize market expectations and subsequently stabilize parities. As Cameron explains, it 'appeared at first to be a masterful political gambit—a means by which France, and Mitterrand, could appear as the saviors of Maastricht by rallying a large vote in favor of the Treaty'.[60] However, by late August, three different surveys indicated support for the treaty in France at below 50 per cent.[61] This reinforced an emerging belief in currency markets that EC institutions possessed insufficient formal authority to ensure state compliance to the convergence criteria. Market actors shifted from interpreting assurances regarding convergence originating at the EC level to interpreting the words and actions of political authorities at the domestic level. In so doing, the substantive, rather than the formal, aspect of authority rose in importance.

Throughout the crisis, with little clear economic data to guide them, market actors sorted through conflicting statements and signals originating from an array of policymakers and 'offices' throughout the EC. When in conflict, as these signals often were, to determine who and what to believe, market actors relied upon their own subjective judgments about the reputation, office and expertise of the speaker. This can be envisioned schematically. At the time of the ERM crisis German organizations—particularly the Bundesbank—possessed significant 'formal' authority. The deutschemark was the anchor currency in the ERM and the Bundesbank could manage its considerable foreign exchange reserves and interest rate setting power at its own discretion.[62] In contrast, the central banks of Britain, France and Italy each possessed significantly less formal authority than the Bundesbank.[63] French policymakers, however, possessed considerable 'substantive' authority garnered through their long-standing *franc fort* monetary policy as did German policymakers with their anti-inflation tradition.[64] Italian officials possessed far less substantive authority because of general market suspicion regarding the commitment of Italian politicians to painful fiscal, institutional and constitutional reforms. British officials possessed perhaps the least substantive authority of all because of their notable absence from the ERM until 1990. Therefore, in terms of 'authoritativeness', market actors roughly perceived German officials as possessing the highest levels of authority followed in turn by France, Britain and Italy.

[60] Cameron, 'British Exit', p.18.

[61] According to Cameron, 'In the space of three days, from August 25 to August 28, 1992, three national surveys estimated the support for the Treaty at less than 50 percent. The BVA survey of August 25 estimated the 'yes' vote at 49 percent and the CSA survey of August 28 estimated the 'yes' vote at 47 percent ('British Exit', ftn. 28).'

[62] Heidemarie C. Sherman and Fred R. Kaen, 'The Behaviour and Thinking of the Bundesbank', in David Cobham (ed.), *European Monetary Upheavals* (Manchester: Manchester University Press, 1994), p. 84.

[63] Peter Hall, *Governing the Economy (*New York: Oxford University Press, 1986) argues that the Bank of England possessed considerable policy autonomy 'although its independence (was) not as constitutionally entrenched as that of the Deutsche Bundesbank (p.248)'. And John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca, NY: Cornell University Press, 1992) contends, 'While the Bundesbank enjoys a substantial margin of independence, the Banque de France is clearly subordinated to the government in the conduct of monetary policy … (and) the Italian government possesses a number of means to influence the course of monetary policy' (p.49–50, 56).

[64] See Portes, 'EMS and EMU', p. 5–6. The Bank of France also received deep respect from markets. A senior currency economist at an investment bank in London characterized the Bank of France as 'masterful' at intervention (Author interview, January 1998).

As the ERM regime came under pressure, state and market actors challenged each other's authority along both substantive and formal dimensions. Spain and Ireland reinstituted capital controls altering the rules and procedures of their domestic currency markets. France introduced credit facilities that helped to insulate French commercial banks from the high interest rates used to punish market speculation. Both policymakers and market authorities (primarily traders and currency economists at the major investment banks in London) sparred with each other in the press concerning whether or not 'irrational' markets or misplaced state policies were to blame for the crisis.[65] Exchanges often resembled juvenile name calling. They nonetheless served to alter perceptions of expertise and legitimacy crucial for sustaining (or eroding) authority. In short, ERM rule violations combined with the Danish 'no' vote to break down the formal and substantive authority of EC institutions. As this occurred, policymakers and market actors attempted to locate new sources of authority around which to align policy and investment expectations. How evaluations of authority lead to variations in domestic policy outcomes—Britain and Italy leaving the ERM while France did not—becomes clearer by briefly looking at specific state-level cases.

Britain

When sterling came under pressure in August and September 1992, Britain implemented measures to defend the pound's parity. It intervened in currency markets spending the equivalent of \$1.28 bn of reserves in August and \$15 bn of reserves on 16 September alone.[66] Britain made verbal commitments to defend the currency and several senior-level officials announced their intention to remain in the ERM at whatever cost.[67] Finally, it structured policies in such a way as to make defection from the ERM costly in hopes of making these commitments credible from the viewpoint of the market.[68] Early on, these strategies supported sterling. Christopher May, the head of foreign exchange for Union Bank of Switzerland, acknowledged, 'We had told our customers that the Bank of England is in the market and is solid'.[69] Yet, Britain left the ERM on 17 September after two years of relative stability in the mechanism. How do we account for this substantial change in policy?

[65] During the crisis, governmental authorities attempted to erode the 'substantive' authority of the markets by projecting their behaviour as 'irrational', 'criminal', the work of 'teenage scribblers' in 'white socks'. See for instance, *The Reuter European Community Report*, 16 September 1992 and *The Reuter European Community Report*, 24 September 1992. In response, market actors argued that they were responding rationally in response to poor government policy. See for instance, *Financial Times*, 17 September 1992 and the *Christian Science Monitor*, 30 September 1992.

[66] *The Reuter European Community Report*, 2 September 1992.

[67] For example, on 11 July, British Chancellor of the Exchequer Norman Lamont said, 'The ERM is not an optional extra, an add-on to be jettisoned at the first hint of trouble. It is and will remain at the very centre of our macroeconomic strategy' (*Financial Times*, 11 July 1992). See also *Financial Times*, 29 August 1992; *Financial Times*, 11 September 1992.

[68] On 3 September Britain borrowed 10 bn European Currency Units (ECUs) to enhance its foreign currency reserves.

[69] *Institutional Investor*, December 1992.

First, as Cameron argues, Britain could not call on any more assistance from its EC colleagues than what ERM statutes required. An Irish official explains, 'there was so little real sympathy for the British after all these years of the kind of tack they had taken. They were on their own.'[70] Second, Britain clearly signalled its intention to pursue domestic-oriented monetary policy by not raising interest rates until 16 September even though market actors were demanding it. Neil Mckinnon, chief economist at Yamaichi International in London, reflecting widespread market sentiment during the summer, said, 'There is a mismatch between rhetoric and action. We have recently seen the Bank of Italy raise rates as a consequence of being in the ERM. The market wants to know whether the British are prepared to do the same.'[71] Third, when in conflict, markets downgraded statements made by Chancellor Norman Lamont and Prime Minister John Major in support of sterling and responded to statements made by Helmut Schlesinger, Hans Tietmeyer and other Bundesbank officials implying the need for devaluation. Markets responded to Bundesbank authority rather than British authority throughout the crisis.[72]

Currency market intervention only works if markets believe the intervention signals a concern about exchange rates great enough to lead to significant policy change. In the case of Britain, because of its checquered history in the EMS, the institutional position of the Bank of England, the lack of respect afforded Chancellor Lamont by market actors, and domestic constraints, Britain could not sustain the parity without unequivocal and public German support.[73] Britain needed to 'borrow authority' from the Bundesbank more than it needed to borrow reserves. As one analyst put it, 'the tensions are going to persist until the Bundesbank makes it clear that it's happy with the present structure of exchange rates'.[74] Unfortunately for Britain, the Bundesbank refused to provide such support for sterling because they believed Britain had entered the ERM at too high a rate, had not defended the rate properly and had refused to accept responsibility for its failure to hold the pound's value. As a result, unable to augment its formal and substantive authority, and hemorrhaging reserves, Britain abandoned the ERM on 17 September.

[70] Ibid., October 1992. Philip Stephens, *Politics and the Pound: The Tories, the Economy and Europe* (London: Macmillan, 1996) also contends, 'When the crisis hit in 1992 Britain had no real allies' (p. 260).

[71] *Financial Times*, 14 July 1992.

[72] Notable comments include those by Reimut Jochimsen, Helmut Schlesinger and others. See for instance, *The Reuter Business Report*, 26 August 1992.

[73] The market attached little weight to Lamont's strident statements in defence of the pound. Lamont was known to have previously disagreed with Britain's ERM policy and to be highly sensitive to political currents (Author interviews with currency strategists, January 1998). Additionally, interest rates represented a significant domestic constraint imposed on British policymakers during the crisis. Most credit issued in Britain—mortgages, credit cards, etc.—are variable rate instruments tied to the British base rate. Consequently, any increase in the British base rate rapidly shifts to the British public in terms of higher interest payments. Many homeowners experienced negative equity during this time period due to Britain's recession and it was believed that increased mortgage payments linked to higher interest rates would push many into bankruptcy.

[74] *The Reuter European Community Report*, 20 September 1992. The concept of linking a currency to the authority of another central bank finds theoretical elaboration in the rules versus discretion literature in economics. See for instance, Alberto Giovannini, 'Bretton Woods and its Precursors: Rules versus Discretion in the History of International Monetary Regimes', in Michael D. Bordo and Barry Eichengreen (eds.), *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (Chicago, IL: University of Chicago Press, 1993), pp. 109–147.

Philip Stephens argues, 'The failure to hold sterling's ERM central rate of DM2.95 robbed the Prime Minister of the authority of his office, just as devaluation had undermined Harold Wilson in 1967. After his enforced departure the following year, Lamont would charge that the government now behaved as if "in office but not in power." '[75] In fact, British officials began to lose authority prior to floating sterling. Eroding government authority produced currency crisis, not the other way around. Furthermore, little evidence suggests British officials viewed market behaviour as fundamentally irrational or illegitimate, as French officials later came to do. British policymakers never embraced regime norms. Many Bank of England and Treasury officials were proponents of a floating currency and viewed a market-led devaluation as permissible, even advantageous, for its domestic economy.[76] As a result, Britain decided to leave the ERM.

Italy

A similar argument explains Italy's policy behaviour during the crisis.[77] Italy failed to reform its domestic policies and institutions fully prior to the Danish 'no' vote in June. As formal EC authority eroded and markets sought political and economic assurances for continued convergence at the domestic level, market actors called both formal and substantive Italian authority into question.[78] As in the case of Britain, market actors questioned the Bundesbank's commitment to defending the lira. Although the Bundesbank defended the lira in September and linked a small interest rate cut to Italian devaluation on 14 September, market actors generally perceived Bundesbank unwillingness to incur the real cost of sustaining the lira within the parity grid. The Bundesbank's attitude became increasingly evident in late August when 'conflicting reports on the absence of support for the lira by the Bundesbank triggered uncertainty over whether the German authorities had deliberately decided to stay on the sidelines'.[79] Currency dealers and Italian officials

75 Stephens, *Politics*, p.257. See also John Major, *The Autobiography* (New York: HarperCollins, 1999) who writes, 'It had been a very traumatic day that would change the perception of the government: we were never again to enjoy the same confidence as before Black Wednesday' (pp. 334–5).

76 According to a senior financial affairs correspondent at the *Financial Times*, career officials within the Treasury were never happy with Britain's participation in the ERM and preferred a floating rate regime. He indicates that 'the commitment to the intellectual underpinnings of the ERM were weak' (Author interview, January 1998). This is lent support by Philip Stephens who argues that Treasury officials never built institutional or personal alliances or allegiances with other finance ministries (*Politics*, p. 260).

77 One notable difference between Italy's situation and that of Britain, however, concerns competitiveness. Whereas it is unclear to what extent Britain had lost competitiveness by 1992, Italy's economy was clearly under strain. Eichengreen and Wyplosz argue that Italy was 'the only EMS country that shows unambiguous evidence of deteriorating international competitiveness' ('The Unstable EMS', p. 65).

78 According to the *Financial Times*, 'Since the ratification of Maastricht now appears in doubt, the markets suspect that Italy's politicians may not be willing to undertake the tough measures needed, under the convergence criteria of the treaty, to bring the economy into line with the rest of the EC' (*Financial Times*, 4 August 1992).

79 *Financial Times*, 29 August 1992.

interpreted these comments as their British counterparts did: Italy could not count on linking the value of the lira to the authority of the Bundesbank.[80]

Italy did pursue the devaluation option, agreeing to devalue within the mechanism by 7 per cent against the deutschemark on the weekend of 12/13 September. They preferred to devalue within a general realignment because their participation in the ERM had previously sustained the lira's value.[81] Unfortunately, they received little support for a general realignment from other members of the ERM and were forced to pursue devaluation alone.[82] According to one dealer, 'The lira was suffering from a lack of confidence in Italy'.[83] Confirming fears held by British officials that no single devaluation within the grid would prove sufficient to stem speculation, the lira was back on its ERM floor within two days of devaluation.[84] Italian officials considered an additional devaluation but were frustrated at the lack of support for the lira shown by ERM members and cognizant of the fact that they did not possess the authority upon which to anchor the exchange rate. They also recognized that the lira had been overvalued and that a market-led devaluation was justified on economic grounds. Therefore, Italy, like Britain, exited the ERM and allowed the lira to float.

France

In contrast to both Britain and Italy, France did not devalue. They remained in the ERM through three rounds of speculative attack that occurred prior to the widening of parity bands to 15 per cent on 1 August, 1993.[85] Three factors contributed to French success in defending the value of the franc during the first two attacks. A breakdown in the third factor ultimately led to the widening of the parity bands during the third attack.

First, because of its long-standing commitment to the ERM and to the anti-inflationary stance associated with its *franc fort* policy, France possessed more overall authority than did either Britain or Italy.[86] Market actors clearly recognized France as the driving force behind closer monetary union and its commitment to the

[80] Eichengreen and Wyplosz argue that the Bundesbank had long been a supporter of the coronation theory whereby those ERM members that maintained proven convergence credentials received full Bundesbank support while those without such credentials only received marginal support. They place Italy in the latter group and conclude, 'thus it is logical that the Bundesbank would have devoted its scarce resources to other currencies first' ('The Unstable EMS', p.112).

[81] Eichengreen and Wyplosz show that markets remained consistently suspicious of Italy's underlying economic fundamentals. While the spot rate for the lira remained within the band up to 14 September, one year forward exchange rates had regularly fallen below the lower parity band since 1987 ('The Unstable EMS', p.88).

[82] Martino Delfini, an exchange rate analyst based in Milan explained it this way, 'The fact that it's just Italy devaluing makes me think we're being used as a sacrificial goat for the whole of Europe' (*The Guardian*, 14 September 1992).

[83] *The Reuter Business Report*, 15 September 1992.

[84] Major, *The Autobiography*, p. 331.

[85] The first attack occurred in September 1992, following the pound's and lira's exit from the ERM. The second attack occurred in early December and January 1993. The final attack began in July 1993 and culminated in the widening of parity bands on 1 August 1993.

[86] A senior currency economist at an investment bank in London notes 'Smart dealers didn't challenge them, only stupid ones did' (Author interview, January 1998).

ERM never came into question. One market analyst argued late in 1992, 'People really don't understand what is behind French economic policy. The authorities are just not going to give in.'[87] Second, on economic grounds—a lower inflation rate than Germany and a stronger economy—the franc's position within the parity grid remained strong and many in the market acknowledged this fact.[88] Therefore, in contrast to Britain and Italy, many investors viewed speculation on the franc as misplaced thus impeding market co-ordination. Third, during the first and second attacks France received critical and unambiguous material and *rhetorical* support from the Bundesbank, support not extended to either Britain or Italy.[89]

During the first speculative attacks in September, several senior Bundesbank officials made notable public statements in support of the franc. [90] Schlesinger's comments in particular stood 'in contrast to the ambiguous comments he reportedly made about sterling'.[91] Market actors noted the difference immediately and aligned expectations accordingly.[92] Furthermore, for the first time in ERM history, the Bundesbank intervened on behalf of the franc before the currency hit its ERM floor. Once again, the situation was different from that of the pound and the lira where Germany intervened but did so with obvious reluctance.

A similar scenario unfolded during the second attack in December and January. In early January, the franc received support through a small cut in the German repurchase rate from 8.76 per cent to 8.6 per cent. Although not economically significant, the rate cut—like the intramarginal intervention earlier—sent a powerful signal to financial markets concerning the Bundesbank's resolve to support the franc.[93] In fact, it was not until 10 July that the Bank of France again intervened in the market in support of the franc. However, in those five months, the market changed its impression of the German/French relationship.

The first hint of changing market sentiment appeared in late November. The *Financial Times* reported that the market was impressed by the performance of the franc during the September crisis but had begun to worry about the strength of the deutschemark.[94] This view intensified during the spring and summer of 1993. The ratification of the Maastricht Treaty by Denmark in May convinced one currency economist that the deutschemark would soon be one of the weakest of the major

[87] *The Reuter European Community Report*, 27 November 1992.

[88] Said one currency strategist, 'There is no obvious case for a franc devaluation, and the strength of the French economy makes me think that there is even some reason to expect a revaluation' (*Financial Times*, 22 September 1992). By November, markets forecasted that the French could even lower interest rates without undermining the franc. Said Joanne Perez, an economist at Banque Indosuez in Paris, 'A cut in rates would confirm that France is part of the hard core of the exchange rate mechanism and would be interpreted as a show of strength' (*Financial Times*, 10 November 1992). See also Melitz, 'French Monetary Policy'.

[89] Bertie Ahern, Irish Finance Minister, publicly claimed that smaller countries were at a disadvantage in defending their parities because they could not rely on Bundesbank support whereas France was able to get a 'separate deal' in support of the franc (*Financial Times*, 2 February 1993).

[90] *Financial Times*, 19 September 1992.

[91] *Financial Times*, 22 September 1992.

[92] Ruth Lea, chief economist for Mitsubishi Bank in London acknowledged, 'The Germans were now making the kinds of positive comments in support of the franc that were noticeably not forthcoming when the lira and the pound came under pressure last week' (*Inter Press Service*, 23 September 1992).

[93] Thomas Meyer of Goldman Sachs in Frankfurt commented, 'I think the move was designed to help the French franc. This move is primarily directed at the foreign exchange market' (*The Reuter Business Report*, 7 January 1993).

[94] *Financial Times*, 21 November 1992.

currencies.[95] By June, many observers speculated Germany could lose its status as the anchor currency of the ERM.[96] Perhaps the most damaging event occurred in late June when French Finance Minister Edmond Alphandéry seemed to indicate he was summoning senior Bundesbank officials, including Waigel and Schlesinger, to Paris to discuss German interest rates. German officials, angry at receiving what they took to be an order to come to what was a regularly scheduled meeting, quickly cancelled.

These facts support David Andrews' contention that by early 1993, the French—sensing German weakness—desired to replace the deutschemark with the franc as the anchor currency of the ERM.[97] Unfortunately for the French, they seriously misinterpreted how market actors understood the French/German relationship. Although the deutschemark weakened in early 1993, market actors never seriously questioned German authority within the ERM.[98] In its bid to assume a more dominant role in the ERM at the expense of Germany, France only served to weaken the bond that held them together, a bond that had supported the franc for a year. Market actors began to look again for a clear signal of Bundesbank commitment to the franc and that meant significant German interest rate cuts. Said Kim Schoenholtz of Salomon Brothers in London at the end of July, 'The state of the exchange rate mechanism depends on the Bundesbank.'[99] Market actors therefore interpreted the Bundesbank's refusal to lower its key discount rate on 29 July—after signalling its likelihood to do so—as a clear indication of Bundesbank unwillingness to extend further support to the franc.[100] The French/German relationship had gone sour with the Bundesbank increasingly making decisions 'regardless of what the German government or any other government wants'.[101]

With the franc no longer supported by German authority, market pressure increased.[102] To stem speculation while preserving the institutional structure of the ERM, parity bands were widened to 15 per cent on 1 August. The move, viewed by Dutch Finance Minister Wim Kok to be 'the worst but one option', transformed the ERM from a quasi-fixed rate regime back into what it had been a decade earlier: a

[95] *Financial Times*, 21 May 1993.

[96] Avinash Persaud, currency economist for UBS said, 'The D-Mark is slowly losing its anchor status in the ERM' (*Financial Times*, 17 June 1993). See also, *Financial Times*, 21 June 1993 and David M. Andrews, 'European Monetary Diplomacy and the Rolling Crisis of 1992–1993', in Carolyn Rhodes and Sonia Mazey (eds.), *The State of the European Union: Building a European Polity,* vol. 3 (Boulder, CO: Lynne Reinner, 1995), pp. 159–176, who provides additional citations.

[97] Andrews, 'European Monetary Diplomacy', p. 160.

[98] Sherman and Kaen ('The Behaviour', p. 83) argue, 'the special status of the Bundesbank as "the bank that rules Europe" was not really challenged. This status is confirmed daily by the financial markets which keep the DM strong relative to other European currencies despite the fact that Germany's rate of inflation and its budget deficit (as related to GNP) are higher than in a number of other European countries'.

[99] *The Christian Science Monitor*, 28 July 1993.

[100] Joachim Fels, economist for Goldman Sachs in Frankfurt said about a German rate cut, 'It's not so important what the economic data say—this is mostly a political decision' (*The Christian Science Monitor*, 28 July 1993).

[101] *The Christian Science Monitor*, 2 August 1993.

[102] One French official said, 'We have to ask what has changed, and wonder why the preservation of the ERM no longer appears to be a high Bundesbank priority' (*The Christian Science Monitor*, 2 August 1993). Smith and Sandholtz ('Institutions') also place considerable emphasis on the Bundesbank stressing its commitment to autonomy and inflation fighting legitimacy over that of its ERM commitments.

managed floating-rate regime.[103] It also significantly reshaped the 'rules of the game' guiding state and market actor behaviour leaving both policymakers and market actors tentative as they slowly began to reconstruct their relationship.[104]

Conclusion

Exchange rate regimes institutionalize norms of behaviour around which state and market actors base expectations. They also specify the distribution of formal authority over the production, exchange and management of money allotted to state and market actors. State and market authority relations are historically contingent and vary in their attributes across both time and place. Short-term exchange rates depend not only on the relative conditions of national economies, but on how state and market actors come to understand each other's current and likely future behaviour. The Danish 'no' vote on the Maastricht Treaty destabilized expectations by destabilizing interstate and state and market actor authority relations. Contrary to McNamara's thesis that by 1992 European leaders had arrived at a deep consensus regarding the normative and operational foundations of 'competitive liberalism', national policy behaviour suggests policy emulation may have arisen more from pragmatic impulses than from ideological consensus. Before and during the crisis, prominent European leaders clearly placed national policy autonomy and domestic oriented objectives before their commitments to the ERM. Significant divisions remained (and still remain) across Europe regarding the scope of European institutions relative to domestic institutions, the appropriate distribution of state and market actor authority and the goals and prerogatives of monetary organizations.

Almost ten years after the ERM crisis began, many of the same tensions which provoked currency crisis then remain evident now, even though Europe has since proceeded with EMU. This is most apparent in the reluctance of Britain, Denmark and Sweden to join in EMU. While they may agree with the policy aspirations of 'competitive liberalism' they appear not to agree with its operational prescriptions. Indications of lingering normative disagreements are evident in former German Finance Minister Oskar Lafontaine calling for an activist European Central Bank (ECB) and the occasional French call for a political counterweight to ECB authority.[105] The issue of ECB activism appeared again in the aftermath of the terror attacks on New York and Washington, DC last September when the ECB followed the US Federal Reserve in cutting interest rates after previously indicating they would not do so.[106] While the ECB has prided itself on not having an 'activist' monetary policy, market actors indicated the rate cut 'shows that the ECB is a very active bank and that the central banks stand ready to help the economy'.[107] Political conflict can be seen in the wrangling between France and Germany over the initial

103 *Financial Times*, 2 August 1993.
104 Said one currency dealer, 'It's a whole new game. A lot of us have never had to deal with this sort of floating currency' (*The Reuter European Community Report*, 2 August 1993).
105 See, for instance, *Agence France-Press*, 15 September 2000.
106 See, for instance, *AFX News*, 17 September 2001.
107 Ibid.

choice to head the ECB. And the decision not to publish the complete minutes of ECB meetings suggests to some an attempt to mask internal dissension.[108]

The ERM crisis offers important lessons for exchange rate management under conditions of monetary union. Most of all, it suggests governments should pay close attention to how they manage their formal and substantive authority because authority relations have a significant influence on exchange rate relations even in a floating rate environment. So far, Europe has performed below market actor expectations on both dimensions resulting in a significantly weaker euro than anticipated. Italian Treasury Minister Amato acknowledged the core of the problem in 1999 when he remarked, 'The euro is a currency for which 11 countries speak and this may have created confusion in the markets'.[109] A strong euro will only emerge when EU institutions first possess clear relations of formal authority and then build enough substantive authority to anchor market actor expectations. This will not occur, however, until European officials resolve the disagreements described above.

More generally, the argument developed here addresses a question that sits at the heart of international political economy: why the interactions of states and markets sometimes (but not always) lead to monetary crisis? This is a question of utmost relevance particularly in light of instability in financial markets across the 1990s. In a speech delivered in August 1999, US Federal Reserve Chairman Alan Greenspan noted, 'That episode of investor fright (Asia's financial crisis) has largely dissipated. But left unanswered is the question of why such episodes erupt in the first place.'[110] That we do not yet know has much to do with disciplinary barriers that inhibit theorizing about the way policymaker and market actor understandings of economic and political conditions (and each other's behaviour) translate into investment and policy outcomes. The state/market relationship is frequently viewed through the lens of structural or relational power.[111] But this analysis suggests a more fruitful approach is to view state and market actors as engaged in interdependent authority relations. Monetary regimes institutionalize relations between communities of experts where one's office and recognized expertise influence the direction of monetary policy and market action. By distinguishing relations of power from relations of authority we uncover the deep interdependencies that exist between state and market actors, and open up rich avenues of research beyond those concerned with the power, or lack thereof, of the state.

[108] Author interviews with currency strategists at major investment banks in London (January, November and December 1998).

[109] FT Asia Intelligence Wire, 19 July 1999.

[110] *Reuters*, 27 August 1999.

[111] See for instance Thomas C. Lawton, James N. Rosenau and Amy C. Verdun (eds.), *Strange Power: Shaping the Parameters of International Relations and International Political Economy* (Aldershot, UK: Ashgate, 2000).