

JOURNAL OFFPRINT

South European Society & Politics

A FRANK CASS JOURNAL

ISSN 1360-8746



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Exchange Rate Rules and Economic Policy Choices: Lessons from the Spanish and Italian Experiences of the ERM

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Turbulence in international financial markets has led to renewed calls for fixed exchange rate arrangements in several parts of the world. Proponents of such arrangements often cite the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS), which from 1979 until 1993 tightly pegged the currencies of member states, as a model, arguing that it produced convergence toward sound economic policies while attributing its collapse in 1992–93 to exogenous factors (the rise in interest rates caused by German unification and some perverse incentives for currency investors entailed in the 1991 Maastricht Treaty). Taking issue with this view, this article argues that the ERM's crisis was at least partly attributable to the system's own rules of adjustment. The basis for this argument lies in an analysis of the policy strategies pursued by governments in two of the ERM's higher-inflation members (Italy and Spain) in the four-year period prior to the crisis. With the lifting of capital controls, ERM rules actually bolstered the ability of these two governments to sustain an unbalanced macroeconomic policy-mix (that is, a restrictive monetary stance without commensurate fiscal restriction) for an extended period of time, while at the same time they limited the room for expansion for governments that were committed to a more balanced policy course. The result was an acute dissociation of exchange rates from the 'fundamentals' of member economies that increased speculative pressures, eroded the system's credibility, and set the basis for the crisis. The experience of Spain and Italy in the ERM suggests that, in the absence of capital controls, fixed exchange rate systems that are premised too heavily on the pursuit of monetary orthodoxy in an anchor currency country, are likely to fail.

The author would like to thank the German Marshall Fund of the United States for research support contributing to this article.

South European Society & Politics, Vol.5, No.3 (Winter 2000) pp.1–32
PUBLISHED BY FRANK CASS, LONDON

The recent history of crises in international financial markets has presented policy-makers in both developed and developing countries with a largely unexpected challenge: that of reforming the institutional framework that governs the international financial system. An important dimension of this problem is the question of exchange rate arrangements. The collapse of the fixed exchange rate regime of Bretton Woods in the early 1970s led many economists to favour floating exchange rates as a mechanism for adjustment. The problems encountered with floating rates, however, subsequently convinced most European governments that the benefits of an external, fixed exchange rate anchor outweighed those of floating exchange rates. This led eventually to the creation of the European Monetary System (EMS), and to its Exchange Rate Mechanism (ERM), which from 1979 through early 1993, pegged the currencies of most EU member states to each other within narrow (4.5 per cent) fluctuation bands. While the EU has moved on to monetary union, the question of exchange rate arrangements between the Euro and other currencies remains a live one. In the meantime, governments in other regions of the world hit by turmoil in international markets have raised the prospect of emulating the European experience by establishing exchange-rate zones centred on a major currency. (The debate over the establishment of a Yen-zone in East Asia and that over the dollarization of Latin America economies provide two examples.)

In these ongoing policy debates about exchange rate arrangements within and outside Europe, the experience of the ERM remains a major point of reference. Indeed, the ERM is often mentioned as a model for states in other regions. This positive view of the ERM persists despite the fact that the mechanism effectively collapsed in August of 1993, when the fluctuation bands of those currencies that were able to remain in the system during the intense weeks of crisis of 1992 had to be expanded from 4.5 per cent to 30 per cent, turning the mechanism into little more than a very loose peg. The principal reason for this paradox is that most observers have attributed the system's collapse in the 1992/93 crisis to an unfortunate confluence of conjunctural factors that undermined what are thought to have been its otherwise benign dynamics.

Three major explanations are commonly offered to explain the ERM's collapse in 1992-93. First, the rise in German interest rates that followed German unification, which placed other ERM currencies under unprecedented pressure, is widely identified as the most important cause. Secondly, the stipulation of strict convergence criteria and deadlines for European Monetary Union (EMU) in the 1991 Maastricht Treaty is

thought to have offered currency investors specific targets to speculate against, thus unnerving international markets and setting in motion the dynamic of a self-fulfilling prophecy. Thirdly, the effect of the first two factors is thought to have been aggravated by the dismantling of capital controls, which augmented the magnitude of speculative capital flows and limited the ability of governments to curtail speculation against their currencies once the crisis took hold.

The dominance of these explanations gives rise to the conclusion that the ERM's collapse in 1993 was due to an inopportune confluence of factors that had little to do with the system's own design. Yet, underlying all of these explanations is another factor that accounts for the system's vulnerability to the change in German policy, the stipulation of EMU deadlines, and the lifting of capital controls: namely, the persistence, and indeed intensification, of significant differences in the macroeconomic fundamentals of ERM member states in the period leading up to the crisis. This divergence is particularly significant because it contradicts the expectation that fixing exchange rates would force economic policies among member states to converge toward a path of macroeconomic orthodoxy, and that such convergence would intensify following the lifting of capital controls.

In this article, I argue that the persistence of significant divergence in the macro-economic fundamentals of ERM member states even after capital controls had been dismantled can be attributed to the functioning of the ERM itself and, in particular, to its rules of adjustment. These rules, which were meant to ensure the German Bundesbank's freedom of action within the system, and with it, a standard of economic orthodoxy in the exchange rate area, did constrain the policy options available to other participating governments. But they did so in a biased manner that allowed some governments to sustain a highly unorthodox policy mix for prolonged periods of time, in particular after the lifting of capital controls at the end of the 1980s. This policy behaviour, in turn, heightened the degree of speculative tension in the system and ultimately weakened the Bundesbank's own ability to set the monetary policy parameters within which other states operated. Thus, it was only after the system's effective suspension in 1993 that greater macroeconomic policy convergence (this time in compliance with EMU convergence criteria) was achieved.

The basis for my argument is an analysis of the economic policies pursued by two ERM member states (Spain and Italy) in the four-year period prior to the crisis. Spain's experience in the ERM following the

peseta's entry into the system in mid-1989, and that of Italy in the years prior to the crisis (1988–91) suggest that, while the system imposed constraints on policy-makers, it did not necessarily encourage governments to conform to a course of economic orthodoxy. Rules designed to protect the position of the Bundesbank within the system skewed the ability of other countries to import credibility from the system in a manner that lent itself to exploitation. They created the option for some governments to pursue a strategy of 'hitching on' to the system's exchange rate guarantee in order to sustain significant macroeconomic and balance-of-payments imbalances financed through capital inflows. Indeed, the Spanish and Italian experiences suggest that, in the medium term and with high capital mobility, ERM rules placed stronger constraints on governments committed to a course of macroeconomic balance than on those willing to pursue an unorthodox policy mix.

Although it is beyond the scope of this article to offer a full account of the ERM crisis of 1992–93, the analysis of the policies pursued by Spain and Italy in the years leading up to the crisis suggest that, even prior to the change in German fiscal policy at the start of the 1990s, the operation of the ERM itself contributed to the persistence of economic policy divergence and speculative tension in the system. The discussion follows in three parts. In the first section I discuss various explanations that have been offered for the ERM crisis of 1992–93, suggesting that the divergence of economic fundamentals among member states represents a critical underlying condition. In the second section, I discuss the significance of this divergence in the light of certain common assumptions about the ERM and the Bundesbank's role in it. I then go on to discuss the paradoxical experience of Spain after joining the ERM in June of 1989, and that of Italy in the period prior to the crisis. In the fourth section, I explain how ERM rules designed to protect the position of the Bundesbank, when coupled with capital liberalization, not only made the policy course followed by Spain and Italy possible, but in fact bolstered the ability of these two governments to maintain serious economic imbalances over an extended period of time. Lastly, I highlight some of the domestic political factors that led the Italian and Spanish governments to opt for such a course.

IMMEDIATE VERSUS UNDERLYING CAUSES OF THE ERM CRISIS

The European Monetary System (EMS) was created in 1979 with the aim

of establishing a 'zone of monetary stability' in Europe. After an initial period (up to the spring of 1983) during which parities had to be realigned several times, the system appeared to deliver on its promise, allowing for overall exchange rates stability with only minor parity realignments. In the late summer of 1992, however, the EMS entered a period of severe crisis, as massive speculation built in favor of the DM and against almost every other currency in the system. Both the pound and the lira were forced to withdraw, while other currencies, the Spanish peseta, Portuguese escudo, and eventually also the Irish punt, were kept in the system only through drastic devaluations and interest rate hikes. Continued instability thereafter forced several further devaluations and ended with the quasi-suspension of the system in August of 1993, when ERM fluctuation bands were expanded from 2.25 per cent around central rates to 15 per cent, allowing currencies to fluctuate by as much as 30 per cent in relation to each other. This signified the effective suspension of the system, as it would henceforth constitute little more than a very loose peg, 'almost indistinguishable from a free float'.¹

Most extant analyses of the events of 1992-93 attribute the ERM's crisis to the qualitative change in German economic policy that followed unification in 1990. The German government's decision to convert East German marks to West German marks at a 1 to 1 rate (up to a limit) and the rise in the German public deficit from 0.5 per cent of GDP in 1989 to 5 per cent in 1991 led the Bundesbank to raise interest rates in a step-by-step fashion over the course of 1991 and the first half of 1992. This made it extremely difficult for the other ERM members to maintain the interest rate differentials *vis-à-vis* the DM to which international currency markets had become accustomed. At the same time, Germany's ERM partners rejected German proposals for an upward realignment of the value of the DM, because they had staked the credibility of their anti-inflation policies on maintaining the existing parities of the system without realignments following the Basel-Nyborg Agreement of 1987. Given the deep recession and high unemployment rates characterizing most EMS economies at the time, the Bundesbank's unwillingness to cut rates at the end of the summer of 1992 produced a crisis of confidence in the system's weaker currencies that drove the speculative onslaught of September 1992, and forced repeated devaluations thereafter until the system's effective suspension in August of 1993.²

The second factor that is commonly cited to explain the rapid loss of stability in the system in early September of 1992 is the final removal of capital controls by several members of the ERM at the end of the 1980s.

Until the late 1980s, the ERM had functioned as a system encompassing two internal sub-regimes: one consisting of Germany and the Netherlands which allowed complete mobility of capital across their borders (with the Netherlands allowing the German Bundesbank to set its monetary policy in a very direct fashion), the other consisting of France, Italy, and Belgium which 'used capital controls to shield their domestic money markets from the effects of speculative crises', and exhibited greater divergence in inflation rates from Germany than the Netherlands (De Grauwe 1990: 162–6).³ Although there is some disagreement on this point (Bini Smaghi and Miccosi 1990; De Grauwe 1990), many economists believe that capital controls were critical to the ERM's success in maintaining stable exchange rates during the 1980s.⁴

Controls served to reconcile differing inflation rates in the ERM with exchange rate stability and, when governments cut inflation, reconciled different levels of seignorage revenue (due to different fiscal structures) with similar inflation rates (Eichengreen and Wyplosz 1993: 57–8; Portes 1990: 230–31; and Giavazzi and Giovannini 1989: 204). They thus allowed Germany's ERM partners a modicum of policy autonomy. They were also helpful in overcoming episodes of dollar weakness, which put extraneous pressure on intra-ERM parities (Giavazzi and Giovannini 1989: 197). By the end of the decade, however, almost all EMS members had abolished their capital controls in compliance with the Single European Act of 1986,⁵ and the combination of pegged exchange rates and high capital mobility is believed to have created the possibility of self-fulfilling speculative crises, as speculators knew that they could ultimately impose a currency depreciation on national central banks (Artus and Bourguinat 1994: 156; Eichengreen and Wyplosz 1993).

Thirdly, there is a widespread belief that the effects of capital liberalization were compounded by the Maastricht treaty. The Delors report of 1989 argued that, without greater monetary policy convergence, free capital movements would undermine exchange rate stability in Europe, and it advanced EMU as a vehicle for achieving greater policy convergence. The sponsors of the treaty thus expected that EMU would become 'an element of stability in the EMS, because it [made] convergence of monetary policies more credible' (Giovannini 1994: 186). Contrary to this expectation, however, the Maastricht treaty seemed to shake, rather than bolster, confidence in the ERM. Several authors have suggested that the convergence criteria spelled out in the treaty created perverse incentives that were likely to bring on a self-fulfilling speculative attack by providing 'a yardstick against which

countries' performance could be assessed' and 'a time limit to the occurrence of devaluations' (Spaventa 1993; Eichengreen and Wyplosz 1994). This is believed to have encouraged investors to speculate against a currency even in the absence of a deterioration in a country's economic performance.⁶ Other authors suggest that the problem lay not so much in the quantitative convergence targets but in the gradualist approach to EMU set out in the treaty (Giovannini 1994: 188; Gros and Steinherr 1994).

Developments in the ERM were also affected by the treaty's troubled ratification process. Garrett (1994: 60) writes that, with the removal of capital controls, confidence in the EMS began to depend on the expectation 'that the EMS was only a stepping-stone to EMU'. This expectation was placed in serious doubt after the negative outcome of the Danish referendum on the European Union Treaty in June 1992. Eichengreen and Wyplosz (1993: 87-9) show that Italy, France, Ireland, Denmark, and Sweden (which, though not a member, shadowed the ERM) saw their forward exchange rates drop out of their ERM bands after the Danish referendum, and well before the September crisis.⁷ The relationship between the ratification process and the crisis is also highlighted by the manner in which speculation gained momentum during the week-and-a-half prior to the French referendum, ending with the withdrawal of the pound and the lira on 16 September, just four days before the referendum was due to take place. Many accounts in the financial press thus interpreted the crisis as a loss-of-nerves by currency dealers in the face of polls that suggested a likely rejection of the treaty in France.

There was thus a confluence of catalytic factors behind the onset of the ERM crisis. Yet, as important as these factors may be in explaining the timing of the crisis, the system's vulnerability to such unfavorable circumstances had much deeper causes.⁸ Foremost among these was the persistence of serious divergence in the macroeconomic and current account 'fundamentals' of member countries. This divergence, which is summarized in Table 1, included significant differences in inflation and interest rates, as well as public deficits and public debt ratios. It also included very serious divergence in unemployment and current account trends, neither of which were directly addressed by the Maastricht criteria.⁹

Most economists agree that, whether or not there was a self-fulfilling element in the speculative attacks of 1992-93, the ERM crisis represented a market adjustments to the discrepancies in these variables.¹⁰

TABLE 1:
ECONOMIC FUNDAMENTALS OF MAJOR ERM ECONOMIES, 1991

	Inflation	Long-term interest	Public Deficit/GDP	Public Debt over GDP
Germany	3.5	8.5	2.8	41.7
France	3.1	9.2	2.1	47.1
Netherlands	3.9	8.7	3.3	79.6
Belgium	3.2	9.3	8.3	134.4
Italy	6.4	13.0	10.2	103.5
Spain	5.9	12.8	4.4	46.0
UK	5.9	9.9	2.1	34.4

Sources: Adapted from *The Spanish Economy: Monthly Report*, Oct. 1992, p.63, and Gros and Steinherr (1994: 291).

Such a conclusion is supported by the fact that the three currencies that fared worst during the crisis (the pound, the lira, and the peseta) were precisely those with the highest inflation differentials *vis-à-vis* the rest of the ERM. These currencies were also widely considered by financial analysts to be overvalued before the crisis. Although the speculative attacks against the French franc and the Danish krone – the two currencies that offered the best performance in terms of fundamentals – illustrate the non-fundamental-related element of currency speculation during the crisis, the overall adjustments that took place in the central ECU parities of ERM currencies from September 1992 to the end of 1993 clearly reveal the importance of macro-economic fundamentals and competitiveness variables. The Belgian franc, the French franc, the Deutschmark, and the Dutch guilder all appreciated in relation to the ECU (by 4.2, 3.9, 5.7, and 6 per cent respectively), while the lira, the peseta, and the pound all depreciated (by 18, 17, and 5 per cent respectively). Lastly, the importance of economic fundamentals is also manifested by the fact that the overall depreciation experienced by the peseta, the lira, and the pound from September 1992 to August 1993 was far more closely related to current account trends than it was to the immediate fate of each currency in September 1992. Thus, the Spanish peseta (which remained in the system) and the Italian lira (which was forced out) both experienced a depreciation of just under 22 per cent from September 1992 through July 1993, while the British pound (which was also forced out in September 1992) only depreciated by 10.8 per cent over the same period (De Grauwe and Tullio 1994: 192).

This brings us to the question of why an exchange rate regime that is so often viewed as an institutional mechanism for convergence toward macroeconomic orthodoxy failed to bring about such an outcome. In what follows, I will suggest that ERM membership served as a vehicle for convergence toward policies of macroeconomic rigour only when certain conditions were met in the domestic political economies of all member states. In the absence of these conditions, ERM rules actually tended to support rather than limit policy divergence, an effect which, contrary to expectations, increased with the liberalization of capital flows. In developing this point it will be helpful to start by reviewing some of the ways in which ERM membership was commonly conceptualized by political observers.

THE ERM AND NATIONAL ECONOMIC POLICY CONVERGENCE

The degree of divergence reflected in Table 1 challenges much conventional wisdom about the room for policy variation across national economies in a world of high capital mobility. It also conflicts with the way in which the ERM has been commonly conceptualized by political scientists. Although some economists have noted that fixed exchange rate systems may encourage countries to pursue an unbalanced policy-mix (see for example Walters 1986; Tornell and Velasco 1995), ERM membership was widely understood to represent an external commitment that governments used to impose macroeconomic orthodoxy at home (e.g., Notermans 1993: 153; Goodman 1992: 195–7; Kurzer 1991; Russo and Tullio 1988; Fischer 1988a).¹¹ It was regarded as a relatively easy way for weaker-currency governments to impose stabilization policies for two reasons: (1) because it allowed them, in essence, to defer monetary policy authority to the German Bundesbank and thus to extricate monetary policy decisions from domestic political pressures and (2) because it simultaneously allowed them to import the credibility of the Bundesbank, thus reducing the interest rate cost of deflation (Eichengreen and Frieden 1994: 6).¹² These beliefs about the ERM led to the widespread presumption that governments entered the system *in order to* embark on a course of monetary and fiscal orthodoxy.

It was this expectation that also underlay the creation of the EMS in the late 1970s. The question of whether convergence in economic policy parameters could follow or would have to precede the pegging of exchange rates was one of the fundamental issues considered by the system's architects. In the literature on the EMS, this debate is commonly

referred to as one between 'economists', who argued that convergence in economic parameters had to precede the pegging of exchange rates, and 'monetarists', who argued that pegging exchange rates could serve as the vehicle for policy convergence.¹³ In the late 1970s, American economists tended to take the first position, arguing that currency pegging in the absence of policy convergence was bound to fail. European officials, however, pushed forth on the idea that currency arrangements could come first, because they believed that the EMS would itself produce the convergence in economic policies that the American critics considered a prerequisite.¹⁴ Writing at the time of the ERM's launching, Jacques van Ypersele, chief of cabinet of the Belgian prime minister, explained that by adhering to the new currency scheme, participating countries 'compel themselves to aim at greater convergence, through domestic measures, of the fundamentals of their economies. This factor', he added, constituted the 'disciplinary element in the system'.¹⁵ Monetary policy convergence was thus expected to lead to convergence in other 'fundamentals', most notably fiscal deficits and interest rates.¹⁶ And it was expected that these effects would be reinforced by the liberalization of capital controls (De Grauwe 1990).¹⁷

A decade after its creation, however, the EMS appeared to thrive in the face of the persisting discrepancies in these variables captured in Table 1. Capital liberalization in the late 1980s, moreover, did not diminish the divergence in economic parameters among ERM countries, but rather appeared to aggravate it (Giavazzi and Spaventa 1990).¹⁸ These developments were not lost on EU policy-makers, who sought to create a definitive set of incentives for convergence in the EMU convergence criteria. Yet, as already noted, the strategy backfired as the treaty's convergence criteria and deadlines brought the persisting divergence in fundamentals within the ERM into sharp focus, setting the stage for the system's crisis and almost derailing the move toward EMU itself. What then explains the persisting policy divergence in the pegged exchange rate area?

To be sure, a complete answer to this question requires a comprehensive analysis of the economic policies pursued by each of the countries in the system. However, an analysis of the policies pursued by just two member states (Spain and Italy) is enough to reveal that the persistence of discrepancies in policy outcomes underlying the ERM crisis was at least partly the result of the skewed manner in which the system itself shaped the policy options of participating governments. While ERM membership did require that member states maintain a particular interest rate stance to keep their currencies in the system, this

requirement did not exhaust the possibilities for policy divergence. For governments that did not place a high priority on minimizing their domestic interest rate levels, the system also entailed an opportunity to exploit the high interest rate bias of the ERM's key adjustment mechanism: the bilateral parity-grid.

Two kinds of policy strategies appear to have been available to governments within the ERM after the lifting of capital controls and for as long as the credibility of the system as a whole was not questioned. The conventional option was that of using the system as an external monetary policy anchor, while fitting fiscal policy to this monetary constraint. This option required weak currency countries to keep their interest rates *high enough* to maintain their currencies within their fluctuation band. The strategic objective of such a policy course within the ERM was that of bolstering a government's credibility in international currency markets, in order to minimize the level of interest rates necessary to thwart currency speculation. Over time, the increased credibility afforded to governments pursuing such a course would allow a currency to rise closer to the centre of its band and to reduce the interest rate differential (or risk premium) required for currency stability. This is the manner in which the system's architects envisioned that 'imported credibility' would work.

The experience of countries within the ERM, however, also illustrates a second option: one of imposing a very tight monetary stance without a commensurate restriction in fiscal policy, allowing interest rates to rise to levels well above those necessary to keep a currency just within its fluctuation band. The fact that Germany itself was able to embark on such a course after 1990 can be understood in terms of the unrivalled credibility that the German government enjoyed in international markets and in terms of the DM's role as the anchor of the system. Yet in the case of higher inflation ERM member states, such a policy course might have been expected to produce an immediate crisis of confidence in the markets. In practice, however, the currency guarantee conferred by the ERM appears to have allowed such governments to exploit their interest rate differentials with other ERM member states so as to attract large short-term capital inflows and thus to finance a worsening current account deficit for an extended period of time.

THE ERM'S SOUTHERN PARADOX

The clearest example of the second option is offered by the policies

pursued by the government of Spain, one of the ERM's newcomers in the late 1980s. The course of Spanish economic policy following the peseta's entry into the system in June of 1989 directly challenges two of the premises of the EMS' architects. These were: (1) that membership would force countries to converge toward a course of domestic macroeconomic balance (that is, that monetary constraint would also act as a hard constraint on fiscal policy), and (2) that failure to embark on such a balanced course would place downward pressure on the standing of a country's currency within the system. Contrary to these assumptions, Spanish policy following entry into the ERM was characterized by the combination of a very tight monetary policy stance without a commensurate tightening of fiscal policy.

The result of this unorthodox policy mix for the Spanish economy was a rapid worsening of the current account balance, from a deficit of \$3.1 billion in 1988 to \$11.6 billion in 1989, and on to \$23.9 billion in 1992.¹⁹ In spite of this rapid deterioration in the current account, however, the Spanish peseta continued to appreciate sharply and almost continuously from the moment it entered the system until the 1992 crisis. It became the strongest currency in the system (closest to its upper limit) immediately after entering the system in July 1989, and it maintained this position through May of 1992, when it was surpassed only by the Portuguese escudo.²⁰ Thereafter, the peseta continued to hold its place up until the devaluation of the Italian lira on 14 September 1992, after which it fell precipitously from the highest to the lowest position within the system.

The basic traits of the Spanish paradox – persistent nominal currency appreciation in the face of a deteriorating current account balance – could be discerned even before entry into the ERM. Spain's accession to the EC in 1986 produced a strong foreign investment-driven demand boom. Long-term capital inflows, responding principally to favourable profit opportunities and an undervalued stock market, resulted in gradual appreciation of the peseta while an unfavourable EC accession treaty produced a rapid deterioration in the trade balance. This appreciation was strong enough to allow Spanish authorities to shadow the ERM during the two years preceding its entry.

Membership in the ERM, however, gave an entirely new twist to this dynamic. The peseta's entry at what was originally considered a relatively high rate of 65 pesetas to the DM was followed by a massive influx of short-term capital that immediately pushed it up against the upper limit of its six per cent fluctuation band.²¹ Driving this rush was the high

interest rate differential between Spain and its ERM partners (in particular a 6.7 per cent differential *vis-à-vis* German short-term rates). Coupled with a rebound in Spanish inflation during the late 1980s, this nominal appreciation of the peseta made for a real appreciation of approximately 30 per cent and produced a very sharp deterioration of the Spanish trade balance. Yet, in a remarkable case of imported Bundesbank credibility, this deterioration did not dampen the upward pressure on the peseta until shortly before the September 1992 currency crisis.

The peseta's immediate move to the upper limit of its fluctuation band set in motion a highly perverse circle in Spanish policy. Short-term capital inflows (responding to high interest rate differentials) had an inflationary impact on the Spanish economy, feeding a boom in demand in 1989. To counter this, the Spanish authorities raised interest rates further. Yet this only intensified the inflow of short-term capital and the appreciation of the peseta. Having joined the EMS at a high parity rate with the intention of cheapening imports and placing a damper on inflation, Spanish authorities thus came to face an unexpected policy dilemma. The peseta's nominal appreciation conflicted with the commitment to stay within the six per cent band. However, Spanish authorities believed that if they tried to redress this situation by altering their interest rate stance, they would jeopardize their fight against inflation. EMS membership thus suddenly appeared to conflict with domestic price stability. To address this problem, Spanish policy-makers were forced to impose a ten per cent ceiling on credit growth along with a draconian 30 per cent deposit (to be placed with the central bank) on any loans raised abroad. Yet, despite these measures, the upward pressure on the peseta's nominal value persisted. As the *Financial Times* summarized the situation a year after the imposition of the controls, 'Spain's monetary policy options [had] probably been exhausted by EMS membership, the existing high rates and credit restrictions. Every time the Bank of Spain has to intervene to soften the currency by placing pesetas in the market, it damages progress made on controlling the supply of money and delays any fall in interest rates'.²²

The peseta's persistent appreciation also became a major source of tension between the Spanish government and other ERM members. In the months following the peseta's entry into the system, Spanish policy became the object of generalized criticism from French, German, Dutch, and eventually also British officials (after the pound joined the ERM in October of 1990), all of whom expressed frustration at having to 'tailor

their domestic monetary policies to help rein in the peseta'.²³ One of the most adamant critics was the French Prime Minister, Pierre Berengevoy, who over the period 1990–91 called openly and repeatedly for Spanish interest rate cuts in order to allow for an easing of French interest rates. The peseta's pressure against the upper limit of its six per cent band pinned the French franc and the British pound to the bottom of their bands, and came to be seen as 'as the main constraint on monetary relaxation in the UK and France – whose currencies languish[ed] at the bottom of the ERM'.²⁴ Thus, while these currencies were trading in 1991 around the middle of their permitted ranges against the DM, interest rates could not be cut because they were trading at the bottom of their range against the peseta.²⁵

Perhaps the most important critic of Spanish economic policy, however, was the Bundesbank, which found itself having to intervene repeatedly in currency markets in order to maintain the DM's position vis-à-vis the peseta. There were more than economic costs involved for the German monetary authority. The effective constraint that Spanish interest rates came to exert on French and British policy reflected an awkward usurpation of its habitual dominance over events in the EMS. Only three months after the peseta's entry into the system, Bundesbank officials thus began to call openly for a Spanish devaluation, leading one Bank of Spain official to retort angrily that 'you cannot devalue against the markets'.²⁶

Unable to convince the Spanish government to devalue, yet unwilling to take issue with the restrictive character of Spanish monetary policy, Bundesbank officials focused their criticism on the relative lack of restraint in Spanish fiscal policy. The unorthodox policy mix pursued by Spain in the late 1980s, reminiscent of the course pursued by the US in the early 1980s (and of the course the Bundesbank would eventually chart itself after German unification), was identified as the principal culprit behind the level of Spanish interest rates. Yet, as one set of observers noted, Spain's ability to sustain such a course for over three years was directly related to the operation of the ERM. 'The still prevailing lack of questioning of the existing parities in the system allowed [Spanish authorities] to continue "importing" anti-inflationary "credibility" in a remarkable fashion from other European countries with a strong reputation in the fight against inflation.'²⁷

Indeed, although Spain offers the most spectacular instance of such 'undeserved credibility' within the ERM (Artus and Bourguinat 1994), it is not the sole instance. Economists have pointed out that a similar set of

dynamics characterized the Italian economy from 1989 up to the second quarter of 1992. Like Spain, Italy (which had been a member of the ERM since 1979) began to pursue a very tight monetary stance without a commensurate degree of restriction on the fiscal side. Up until the ERM realignment of 1987, this imbalance was reflected in the lira's weakness within the bilateral parity-grid. Starting in 1988, however, and lasting through 1991, the lira began to experience a steady appreciation of its nominal exchange rate *vis-à-vis* the DM driven by short-term capital inflows, despite little change in Italy's macroeconomic fundamentals and a significant deterioration of its current account position. Coupled with the relatively high Italian inflation rate, this nominal appreciation implied, as in the Spanish case, an acute appreciation of the lira's real effective exchange rate.

The Italian and Spanish experiences together formed the core of what economists in the late 1980s began to refer to as the 'new EMS' (Giavazzi and Spaventa 1990), the main characteristics of which are illustrated in Table 2, and are summarized by Artus and Bourguinat (1994: 150) as follows:

The credibility of the exchange rate system is such that no [interest rate] premium due to the expectation of a devaluation appears; no realignment occurs in the EMS; since Italy and Spain have higher inflation than other European countries, their real exchange rate appreciates, and their competitiveness deteriorates; the loss in competitiveness leads to a sizeable worsening of the trade balance, but no loss in official reserves occurs. On the contrary, because of capital inflows, reserves increase: no depreciation being expected, investors are attracted by high nominal yields; the increase in official reserves leads to an acceleration of domestic credit and of money supply, which further increases inflationary pressures and causes higher interest rates.

This situation could only last for as long as the credibility of the ERM as a whole was not questioned. Once German policy itself turned highly unbalanced (as a result of the Bundesbank's austere reaction to German monetary unification and fiscal expansion) and the Maastricht treaty provided specific convergence deadlines, the existing discrepancies between economic fundamentals and currency valuations would prove unsustainable. The lira dropped from its position near the top of the EMS parity-grid to the very bottom immediately after the Danish referendum on Maastricht in June 1992. On 14 September and in anticipation of the

TABLE 2
REAL EFFECTIVE EXCHANGE RATES, CURRENT ACCOUNT BALANCES, AND
OFFICIAL RESERVES IN THE 'NEW EMS'*

	year	real effective exchange rate index (1985=100) (1)	% change 1987-91	Current Account Balance in billions of US\$ (1)	Foreign Exchange Reserves in billions of US\$ (2)
Germany	1987	110.4		46.29	72.89
	1988	108.1		50.63	53.32
	1989	105.8	-1.8	57.72	55.86
	1990	109.4		46.55	62.97
	1991	108.6		19.58	57.52
France	1987	108.2		-4.45	29.63
	1988	104.9		-4.80	22.36
	1989	102.1	-3.4	-5.62	21.87
	1990	106.6		-13.77	34.07
	1991	104.8		-6.15	28.29
Netherlands	1987	110.2		3.96	14.17
	1988	108.3		6.92	14.54
	1989	107.3	-1.5	9.81	15.03
	1990	109.3		8.86	16.03
	1991	108.7		7.77	16.24
Belgium	1987	94.6		2.79	8.36
	1988	92.4		3.59	8.31
	1989	93.4	-2.4	3.20	9.76
	1990	95.6		4.95	11.12
	1991	92.2		4.73	11.07
Italy	1987	104.4		-1.52	27.82
	1988	103.4		-5.93	32.50
	1989	106.9	13.8	-10.88	44.28
	1990	114.5		-14.42	60.18
	1991	116.1		-21.43	45.50
Spain	1987	102.0		-.23	29.9
	1988	105.7		-3.78	35.40
	1989	110.7	10.5	-10.88	39.56
	1990	114.0		-16.82	49.40
	1991	112.5		-15.95	64.30
UK	1987	99.3		-7.56	38.56
	1988	107.2		-28.79	41.12
	1989	105.0	12.5	-35.59	31.99
	1990	106.8		-29.39	32.93
	1991	111.8		-11.55	38.73

Source: (1) IMF, *International Financial Statistics Yearbook* (1993); (2) IMF, *International Financial Statistics*, June 1993.

*Both the peseta and the pound shadowed the ERM after the last realignment of 1987, before joining in 1989 and 1990 respectively.

French referendum, the lira was devalued, and two days later it was forced out of the system along with the British pound.²⁸ The peseta maintained its extraordinarily high position until the lira devaluation, but during the crisis, speculation in its favour rapidly turned to speculation against it, forcing the Spanish authorities to devalue repeatedly and to impose a draconian adjustment programme.²⁹ However, before these adjustments took place, the ERM had sustained an unprecedented overvaluation of the lira and an equally intense overvaluation of the peseta for over three years, setting the stage for the dramatic developments of September 1992. Indeed, it is likely that, without these extreme discrepancies between currency valuations and economic fundamentals in the system, the self-fulfilling element of the crisis set off by the Maastricht convergence criteria and the treaty's difficult ratification process might have been avoided.

EXPLAINING THE SOUTHERN PARADOX

The experiences of Spain and Italy in the period prior to the crisis challenge the widespread belief that ERM membership required governments to pursue a course of macro-economic orthodoxy and would thus produce policy convergence within the zone. The inability of the Bundesbank to exact greater balance in Spanish and Italian economic policy during the four years leading up to the crisis contrasts with the influence that German monetary authority was seen to exert habitually over economic policy in those ERM countries whose governments were committed to a more balanced course (that is, whose economic policies conformed to the first policy strategy identified above).

The Bundesbank's waning ability to set the tone of economic policies across the ERM at the end of the 1980s was the unintended consequence of an interaction between two factors: the liberalization of capital flows and the ERM's own rules of adjustment. As some economists have noted, in a context of high capital mobility, fixed exchange rates may create perverse incentives for loose fiscal policy because the currency credibility attained through the exchange rate peg can allow inflation-averse governments to attract sufficient capital inflows to finance a fiscal shortfall without risking an immediate currency devaluation (Tornell and Velasco 1995). In the case of the ERM, the likelihood of such a hypothesized effect was augmented by ERM rules that were originally intended to shield the Bundesbank from the inflationary proclivities of its ERM partners.

One of the principal controversies surrounding the creation of the ERM involved the question of who would bear the burden of domestic policy adjustments in maintaining currency parities.³⁰ Although there are some dissenters (e.g. Fratianni and von Hagen 1990), the prevailing view among economists is that the ERM functioned in an asymmetric way, with the German Bundesbank following a relatively independent money supply rule that other countries were forced to adjust to in regular fashion (Tietmeyer 1994: 33–4; Welfens 1994: 234–8; Giavazzi and Giovannini 1989: Ch.4; Mastropasqua, Micossi and Rinaldi 1988; Fischer 1988a). The evidence for this view comes from data on central bank interventions in foreign exchange markets, from data on how those interventions were sterilized, and from interest rate data showing that 'German interest rates [were] unaffected by most intra-EMS shocks ... while interest rates denominated in other currencies [were] those that suffer[ed] the full impact of intra-EMS portfolio disturbances' (Giavazzi 1990: 42).

This asymmetry in the ERM was partly a consequence of the German economy's strength and of the DM's role as the anchor of the system. Yet it also followed in a very direct form from the rules of adjustment that prevailed in the ERM until its effective suspension in 1993. In the negotiations that led to the creation of the EMS, there was considerable haggling over the relative weight that would be given to the ERM's bilateral parity-grid as opposed to the central ECU rates of member currencies.³¹ The former obliged governments to maintain their currencies within the 2.25 per cent fluctuation bands in relation to each of the other currencies in the system. The latter served as the basis for a divergence indicator that was meant to trigger central bank intervention when a currency strayed more than 0.75 per cent from its central ECU rate. Anticipating that Germany would be able to carry the day in the bilateral grid, weaker currency countries argued for the 'basket' solution embodied in the divergence indicator (Cohen 1981: 2). Bundesbank opposition to that solution, however, meant that in the end central banks were obliged to intervene only when their currencies came under pressure in the bilateral parity-grid.³²

The dominance of the bilateral parity-grid over other adjustment mechanisms in the ERM meant that, in practice, when parities came under pressure, it was the country with the weaker currency that had to carry the brunt of the policy adjustment. In addressing pressure on a bilateral rate, the central bank of a country facing downward pressure on its currency has only a limited pool of reserves. That of the country

whose currency is experiencing upward pressure has a much greater capacity to stay in the game without a substantial domestic policy adjustment, since it need only print more of its own currency to meet its intervention obligation, and later sterilize the added money base through purchases in exchange rate markets. As Goodman (1992: 193) explains, this meant in essence that weaker currency countries were forced to adjust before stronger currency countries, allowing the latter to set the course in the ERM.

The asymmetric effect of the ERM's adjustment rules is central to the view of the system as an external policy constraint that was used by Germany's ERM partners to impose macroeconomic rigour at home.³³ From 1983 until 1987, the system appeared to function in this way, leading to steady downward convergence of inflation rates toward the German standard in most other ERM states (including Italy after 1984). The record on the fiscal front, however, was mixed. While the general trend was toward fiscal consolidation, there was substantial divergence among ERM countries. Some countries, most notably Denmark and France, engaged in significant fiscal consolidation, while others, most notably Italy, failed to do so (Vona 1990; Holmes and Luintel 1999). Until 1988, these differences in macroeconomic trends were reflected in the exchange rate performance of ERM currencies, with the French franc rising steadily from the lower end of its bilateral DM band toward the centre of its range, while the Italian lira experienced chronic weakness.³⁴

Starting in 1988, however, the pattern unravelled, as the trend toward fiscal consolidation ceased, the average inflation rate rose, and the standing of currencies within the system became dissociated from inflation rates and current account performance. Giavazzi and Spaventa (1990: 68) note another important feature of this 'new EMS': two Bundesbank interest rate hikes in 1989 were followed by all members of the EMS except for Italy and Spain, 'the two countries with the higher inflation differential with respect to the FRG'.

In seeking to explain this apparent usurpation by Italy and Spain of the Bundesbank's pole of gravity at the end of the 1980s, economists have emphasized two changes: (1) the decision by ERM governments after the realignment of 1987 to resist any further realignments (as underpinned by the Basle-Nyborg agreement of that year), and (2) the lifting of capital controls at the end of the decade. It is noteworthy that both of these developments were expected to strengthen the credibility of ERM parities as well as the ERM's disciplining effect on national policies (e.g. Viñals 1990: 211). In practice, however, they aggravated a

latent tendency of the ERM's rules to reward tight money and high interest rates more than macroeconomic balance or balance-of-payments performance.

As noted, convergence in monetary policy and inflation rates within the ERM was greater during the 1980s than convergence in fiscal policy. The principal reason for this difference was that the Bundesbank's ability to impose fiscal discipline through the bilateral parity-grid required that other governments be committed to minimizing the interest-rate (or employment) cost of fighting inflation. It was such a commitment that, along with the loss of *seignorage*, was expected to lead governments to fit their fiscal stances to the monetary policy constraint of the exchange rate system (e.g. Glick and Hutchison 1993). When applied to governments that did not give priority to minimizing the interest rate cost of fighting inflation, the bilateral parity-grid gave the Bundesbank little leverage. In fact, once capital controls were lifted and currency speculators could fully respond to the dynamic of imported credibility, the ERM's adjustment rules offered a perverse bias to this second category of governments: they allowed them to sustain unrealistic ECU central rates for a prolonged period of time while forcing countries that enjoyed lower interest rate differentials (thanks to a more balanced policy-mix) to adjust their interest rate policy (Artus and Bourguinat 1994: 161). Under such conditions, the ERM began to resemble not so much a prisoner's dilemma game, as some have argued, as a moral hazard situation in which some actors defected (pursuing policy strategies that took advantage of the credibility conferred by the system and the burden imposed on lower interest rate countries by the rules of adjustment) while others cooperated (pursuing balanced policy strategies that contributed to the credibility of the system). Yet, if the system allowed such behaviour to take place, why did not all countries pursue the first strategy?³⁵

The first part of the answer to this question is that the policy strategy pursued by Italy and Spain carried significant costs that policy-makers in other countries were interested in avoiding. These costs included: (1) a severe loss of competitiveness in manufacturing prices (and, as a consequence, a drop in industrial production starting in 1990); (2) a shift of resources from sectors exposed to foreign competition to less exposed (and hence more inflation-prone) sectors; and (3) a sharp rise in foreign debt dependence to finance public and current account deficits (Artus and Bourguinat 1994: 151; *OECD Economic Surveys*, Italy and Spain, 1991-92). What really requires explanation, therefore, are the policy choices of the defecting governments in the ERM rather than the co-

operators. What set policy-making in these countries apart from those of other ERM states?

Before setting out to answer this question, it is important to note some differences between the two cases. The most important of these concerns fiscal policy magnitudes in the two countries. The Italian public deficit at the end of the 1980s was, at around ten per cent, considerably larger than the Spanish, which was cut to a low of three per cent just prior to Spain's entry in the ERM and remained under five per cent at the time of the crisis. The Italian foreign debt, at over 100 per cent of GDP, also far surpassed the Spanish, which remained well below the OECD average of 60 per cent up until 1992. The Italian government initiated a programme of fiscal consolidation through tax increases in 1989, yet it continued expanding spending as a percentage of national product up to 1993 (Alesina and Perotti 1996; Walsh 1999). The Spanish socialist government, meanwhile, implemented a moderate pace of spending increases after a period of intense fiscal consolidation in the mid-1980s. Thus, while Italian policy in the period prior to the crisis may be characterized as consisting of a relatively strict monetary stance in the face of a still exceptionally lax fiscal stance, the Spanish case is better characterized as combining a moderate fiscal stance with an exceedingly tight monetary policy.

In spite of these differences in starting points and tenor, what distinguished the policy paths of the two countries from those of others in the ERM was the extent to which Spanish and Italian authorities were willing to tighten monetary policy without adjusting their fiscal stances accordingly. What explains this lack of synchronicity in Spanish and Italian macroeconomic policies in the 'new' ERM?

The first part of the answer to this question is that the disjuncture between monetary and fiscal policy, and the high interest rates and currency appreciation that it produced, were not just unintended outcomes but also elements in an economic policy strategy. One Italian central bank economist writes that 'in Italy, for instance, it was the determination to narrow inflation differentials *vis-à-vis* the other ERM countries that led to the adoption of a degree of monetary tightness implying, together with the relaxed fiscal policy followed during most of the EMS period, an appreciation of the lira in real terms'. The Italian monetary authorities, he notes, could have requested a 'larger depreciation, on the occasion of the realignments [in the 1980s], so as to avoid the loss of price competitiveness that Italy sustained in the EMS period'. Yet this was not done because the loss of competitiveness was

considered 'an acceptable price to be paid for decisive success on the inflation front' (Vona 1990: 75).

A similar logic characterized Spanish economic policy thinking in the late 1980s. One author described the view of Spanish officials at the time as follows:

The European challenge has to be met. Nationalistic economic positions make no sense in the face of relentless European integration. Spain must prepare for that integration by aligning itself with the central or hard core (that is to say, more and more, with Germany), and since the essential characteristic of that core is a low level of inflation, this must be the overriding priority ... Given these basic ideas, and taking into account the existing current account deficit, it is necessary to count on high interest rates to encourage capital inflows that can compensate [for that deficit], and to bolster the peseta's value in order to cheapen imports. The scheme requires interest rates that are higher than [those of other EC] countries. And competitiveness is hence made to hinge entirely on wage restraint (Torrero 1990).

In both Italy and Spain, economic policy in the late 1980s was thus based on an unequivocal belief that the nominal exchange rate anchor (and the real exchange rate appreciation that it implied for higher inflation countries) could be used to enforce disinflation at home, by cheapening imports and by placing pressure on wage-setters to restore competitiveness through wage restraint. As Giavazzi and Spaventa (1990) point out, it is the unconditional commitment to a 'strong currency' on the part of Spanish and Italian authorities despite otherwise weak fundamentals that explains the spectacular rush of capital into the two countries at the end of the 1980s and the paradoxical performance of the lira and the peseta in the EMS.³⁶ Still, what explains this choice of what we might term a 'strong-currency-in-a-country-with-weak-fundamentals' strategy, given the enormous costs in terms of competitiveness that it carried?

One possibility is simply that the strategy constituted a policy mistake on the part of Italian and Spanish authorities, and that it should be seen as a fluke within the EMS that is not likely to be repeated by other governments under similar exchange rate arrangements. Such a view, however, overlooks other determinants of the Spanish and Italian policy course that render it a more likely course to be pursued by other governments under a similar exchange rate framework. Although in some

ultimate sense, policy-makers in Italy and Spain failed to recognize the limits to the ERM's ability to sustain policy imbalances (and hence may be said to have been myopic), the unorthodox policy mix that the system's adjustment rules accommodated up until the crisis served to reconcile important (and conflicting) political and economic objectives.

First, as the references above reveal, the 'strong currency' strategy pursued by the Italian and Spanish governments in the ERM was based on a stark prioritization of the fight against inflation over other policy objectives (such as maintaining competitiveness or fighting unemployment). This overriding focus on the problem of price stability had its origins in a series of confrontations between governments and labour unions, which in the mid-1980s led to the collapse of national wage agreements in both countries. In Italy, the confrontation centred on the established practice of automatic wage indexation (the *scala mobile*) which was believed by Italian authorities (and employers) to perpetuate a wage price spiral. In Spain, it centred on the socialist government's insistence in 1987, and again in 1988, that the unions agree to nominal wage increases which would have extended real wage losses incurred in the first half of the 1980s. The impasse over wages, and the collapse of national wage negotiations, led governments in the two countries to opt for a highly proactive use of monetary policy in their effort to break the unions' will in their bargaining with employers. It also led officials to view short-term competitiveness losses resulting from currency overvaluation as a lesser evil that would need to be incurred in order to restore wage restraint, and with it price competitiveness in the longer term.³⁷

Secondly, while the policy strategy pursued by the Italian and Spanish governments responded in large measure to the political dynamics of domestic wage negotiations, it also served other political purposes. One of these was to finance the public deficit without: (1) giving up on institutional gains made by the central bank, or (2) implementing fiscal cuts that were likely to prove politically costly. In Italy, for instance, the central bank had been exempted from having to finance the Treasury's shortfall in 1981 (Goodman 1992: Ch.5). Yet the public deficit continued to grow, because both the labour unions and employers favoured a system of welfare provision that heavily subsidized early retirement, temporary layoffs, and new employment contracts. Indeed, although Italian export firms were hurt by the overvaluation of the lira in the ERM, Italian business refrained from opposing the tighter monetary stance imposed by the Bank of Italy, because it feared exclusion from a future monetary

union if the lira was devalued again (Walsh 1999: 78). The employers' confederation (*Confindustria*), moreover, maintained an ambiguous position on the issue of fiscal policy. While export sectors called for fiscal consolidation in order to mitigate the real appreciation of the lira, *Confindustria* was also concerned with demanding a reduction in employment taxes. On the other hand, in Spain, where the central bank had been given *de facto* (although not *de jure*) authority over monetary policy in the early 1980s, the socialist government decided to end an intense process of fiscal consolidation after the party's significant electoral decline in the 1989 elections (Pérez 1997: Ch.5; Chhibber and Torcal 1997). Thus, in both Italy and Spain, economic policy during the late 1980s came to be based on a *de facto* accommodation between elected government officials and central bank authorities. The latter were allowed to determine monetary and exchange rate policy, while the former – who retained control over fiscal policy – were unwilling to engage in a degree of fiscal consolidation commensurate with the degree of monetary restriction.

The dynamics of imported credibility and capital mobility of the 'new EMS' fed into such a policy pattern because they allowed governments to finance the resulting public and current account shortfalls through capital inflows. As long as the credibility of the system as a whole was not challenged, the ERM's rules of adjustment supported the domestic policy accommodation between monetary authorities and elected officials in the two countries. Meanwhile, they prevented governments pursuing a more balanced policy course (such as France or the Netherlands, for instance), from cutting interest rates by as much as their fundamentals might have allowed if the system had not also included Italy and Spain.³⁸

What the Spanish and Italian experiences tell us is that it is precisely those governments with higher than average inflation rates that may be most inclined to pursue an unbalanced policy course within an exchange rate system that is designed solely around a monetary policy constraint. It is precisely in such countries that governments are likely to come to view a real exchange rate appreciation as a necessary evil in the fight against inflation, and hence to be least concerned with minimizing the interest rate cost of that fight. It is also in such countries where it is likely to be most difficult to impose fiscal cuts commensurate with a monetary stance that is tight enough to ensure the exchange rate commitment. Any exchange rate system that allows countries imposing a very tight monetary policy to finance large public and current account deficits through capital inflows while forcing other

countries to adjust their monetary stances is thus likely to produce a similar outcome.

Lastly, a few observations on the aftermath of the ERM's collapse are in order. First, the priorities expressed in the Italian and Spanish 'strong currency' strategies continued to be reflected in the two governments' behaviour after September 1992. Unlike the British government, which took advantage of the pound's forced exit from the ERM to implement a series of large interest rate cuts over a short period of time, Italian authorities from the start remained committed to an early re-entry of the lira into the ERM (Gilibert 1994). They therefore cut interest rates only very gradually from the high levels to which they had been raised during the crisis. As a result, Italy was not able to replicate the dramatic drop in unemployment and the early recovery that the British economy benefited from. Spanish officials, meanwhile, continued to declare that Spain would be part of an early EMU at a time when most European governments thought such a prospect entirely unlikely. Although the Spanish trade and current account balances were positively affected by the peseta's forced devaluations, the government's commitment to stay in the system meant that interest rates (as in Italy) were cut only gradually, even as unemployment surpassed 24 per cent in 1994. Having 'fixed its sights on converging with the rich Community economies', the *Financial Times* noted, the Spanish government had 'worked out how to reach its target in closed doors meetings of motivated policymakers and relentlessly set out on its course although it [might] scorch the earth it treads on'.¹⁹

The most notable feature of the aftermath of the ERM crisis, however, was the strong convergence toward the European average that both countries undertook in their fiscal policy. This convergence was driven by the efforts of both governments to participate in EMU. Unlike the "new EMS", the EMU deadline forced governments to seek much greater balance in their monetary and fiscal policy efforts. What is noteworthy, however, is that this re-balancing in the policy strategies of Spain and Italy was also forced upon the two governments by the ERM crisis itself, which ended their ability to import undeserved credibility. Had it not been for the timing of the crisis six years prior to the onset of EMU, both countries might have continued with their unbalanced policy course for a longer period of time, perhaps preventing them from meeting the EMU criteria in time. The collapse of the ERM in 1993 may thus have done far more to allow Italy and Spain to participate in the first wave of EMU than the functioning of the exchange rate system ever did.

CONCLUSION

In this article, I have argued that the stage for the ERM's collapse was set, even prior to the change in German macroeconomic policy in the early 1990s, by the persistence of significant policy divergence among member states, and that this policy divergence was itself partly a consequence of the system's architecture. The Spanish and Italian experiences in the period prior to the crisis reveal the extent to which rules designed to shield the independence of the Bundesbank entailed a bias in favour of policies that would allow other countries to maintain large interest rate differentials *vis-à-vis* the DM. The dominance of the bilateral parity-grid among the ERM's adjustment mechanisms allowed the German monetary authority to set the general tenor of monetary policy in the EMS but not that of fiscal policy. For as long as other governments were able to shield their domestic economies through capital controls, policy divergence on this score remained relatively muted and was compatible with exchange rate stability. However, once capital controls were lifted – and markets began to respond fully to the dynamic of 'imported credibility' – the bilateral parity-grid's high-interest-rate bias came to the fore. Spain and Italy experienced the paradox of nominal currency appreciation in the face of growing public and current account deficits, and were able to finance those deficits through massive capital inflows, helping to build up speculative pressures in the system.

The 'strong-currency' strategy that lay behind this Southern paradox in the *new EMS* carried substantial costs for the domestic economies of Italy and Spain. This explains why it was not pursued more widely by other ERM member states. It also suggests that, for the ERM to function as its architects had expected, all member governments needed to be committed not just to fighting inflation, but also to minimizing the output and competitiveness costs of that fight. The rules of adjustment demanded by the German Bundesbank in 1979 did not foresee a situation in which governments might seek to exploit their high interest rates differentials to sustain an unbalanced policy course at a considerable cost to competitiveness. Because the bilateral currency grid created discrete exchange rate commitments between each pair of countries, placing the burden of adjustment on currencies nearing the lower limit of their band, the pursuit of such a policy course by any one ERM government could produce severe tension in the system as a whole. Indeed, when combined with the dynamics of free capital markets, it ended up allowing governments in the system's higher inflation countries to constrain the

actions of governments with better records in the area of inflation and fiscal consolidation.

As I have also suggested, the 'strong currency' strategy pursued by the two higher-inflation countries cannot be dismissed simply as a policy miscalculation or mistake. There was more to it than that. The strategy was more likely to be followed in countries whose governments wanted to reduce relatively high levels of inflation but where a commensurate tightening of fiscal policy would have implied severe political costs. In such countries, the strategy came to be seen as a way to impose wage restraint through real currency appreciation, and it also served to reconcile the institutional priorities of central bank officials with the electoral imperatives of politicians. The dynamics of the ERM's bilateral parity-grid after the lifting of capital controls supported such a policy accommodation, because it allowed countries to finance growing public and current account deficits, while forcing other governments that were following a more balanced policy course to carry out the necessary policy adjustments to sustain currency parities.

These experiences carry important lessons about the implications of fixed exchange rate arrangement premised solely on the anchoring role of a strong currency defended by an independent central bank. They point to the foibles of using exchange rate obligations as a forcing mechanism to achieve convergence toward core-country parameters in economies with different productive and institutional characteristics, and, very likely, different 'optimal' inflation rates (Crockett 1994: 173; Giavazzi and Giovannini 1989: 200). When coupled with the speculative dynamic of unfettered international capital markets, such arrangements are likely to conspire with the domestic politics of macro-economic policy in higher inflation countries to produce policy behaviours that ultimately serve to undermine the credibility of the exchange rate system as a whole.

NOTES

1. Buitier, Corsetti and Pesenti (1998: 27); Masera (1994: 273-4). The widening of fluctuation bands is considered by most observers to have been of sufficient magnitude to have constituted a de facto dissolution of the system. See Artus and Bourguinat (1994: 154-9); Heath (1994); Buitier, Corsetti and Pesenti (1998: 53), and William H. Branson's 'Comments' to Eichengreen and Wyplosz (1993).
2. See Buitier *et al.* for a detailed account.
3. For a detailed discussion of capital controls in France, Italy, and Belgium, see Giavazzi and Giovannini (1989: 164-72).
4. See, for example, Eichengreen and Wyplosz (1993: 62-3), Giavazzi and Giovannini (1989: 197), Giavazzi and Pagano (1988), and Fischer (1988b).

5. France and Italy dismantled their last controls in 1990. Spain and Portugal still had some controls in place in 1992 but had already undertaken significant liberalization. It should be noted, however, that during the crisis several countries re-instituted capital controls.
6. Eichengreen and Wyplosz (1993: 90–94) place particular emphasis on the exchange-rate criterion, which required countries to maintain their currencies within their 2.25 per cent ERM fluctuation band for at least two years before entering EMU, without realignments. By disqualifying a country from EMU in the event of an attack and, hence, reducing the benefits of a tight monetary stance for its government authorities, they suggest, the exchange rate criterion led investors to anticipate that monetary policy would be modified in a laxer direction if an attack took place. This analysis, however, is largely inspired by the authors' observation of the behaviour of the British government, which undertook a significant relaxation of monetary policy after the pound had been forced out of the ERM. The Italian government, by contrast, did not fulfill the expectations of this model, since it remained committed to a high interest rate/ strong currency policy even after being forced out of the system.
7. It is noteworthy, however, that the peseta's and the pound's forward rates stayed within their ERM bands even in the days leading up to the lira's devaluation on 14 Sept.
8. Even Eichengreen and Wyplosz, who make the strongest possible case for the argument that the September crisis entailed a self-fulfilling speculative attack, concede that real competitiveness problems on the part of Italy, and (more tentatively) Spain and Britain, were an important factor. Their analysis (including the results of a survey of European currency dealers) clearly suggest that (in their words) 'fundamentals played some role' (1992: 97). Indeed, their main contention is that these differences in fundamentals alone 'do not explain the timing or course of the attacks' (1993: 97).
9. For discussion of the adequacy of the convergence criteria, see the various essays on this topic in Steinherr (1994), in particular that by Crockett (1994); see also Eichengreen (1992).
10. See, for example, Masera (1994: 269–70), Zurlinden (1993), Gros and Steinherr (1994), and the comments by William H. Branson's and Rudiger Dornbusch to Eichengreen and Wyplosz (1993). Gros and Steinherr reverse Eichengreen and Wyplosz's thesis, by arguing that EMU was the 'glue' that held the EMS together in the face of the discrepancies in economic fundamentals and competitiveness trends.
11. For an opposing view, see Fratianni and von Hagen (1992).
12. The dominant role of the German monetary authority, along with other factors, is also believed by a number of authors to have given the system a deflationary bias. See, for example, Kurzer (1991: 13–16), and Vona (1990: 82–4).
13. See De Grauwe (1990: 159–62); Crockett (1994); Garrett (1994). In the debate over EMU German officials, in particular the Bundesbank, tended to espouse the 'economist' view, while non-core members of the ERM favoured the monetarist view.
14. See the various contributions to Trezise (1979). For an analysis of the concrete motivations that led the German and French governments to embrace the 'monetarist' position, see Goodman (1992: 188–9), and de Cecco (1990).
15. 'Operating Principles and Procedures of the European Monetary System', in Trezise (1979: 6).
16. Given the relatively small and open character of most ERM economies, the monetary policy constraint was thought to work as an effective constraint on fiscal policy. Any significant imbalance between fiscal and monetary policy would affect a country's current account balance negatively, and this in turn was expected to place downward pressure on a country's exchange rate. Hence, it was assumed that (with the exception of the anchor currency country, Germany) governments would be forced to keep their fiscal policies in balance with the monetary policy course charted by the Bundesbank in order to sustain their currency commitment. This expectation was also consistent with

the view of economists who argue that fixed exchange rates provide a hard budget constraint through the loss of seignorage (see, for instance, Glick and Hutchison [1993]).

17. The exchange rate commitment was thought to represent a particularly strong constraint on macroeconomic policy in the context of liberalized capital flows, because, according to the Mundell-Fleming model, a fixed exchange-rate commitment in the context of free capital flows precludes governments from pursuing an independent monetary policy stance as interest rate differentials (or changes in these differentials) affect demand for a country's currency, and therefore its exchange rate *vis-à-vis* other currencies. For discussion see Frieden (1991) and Artus and Bourguinat (1994).²⁰ The escudo had just joined the system and its standing in the system was almost a direct function of that of the peseta.
18. Giavazzi and Spaventa note that over the three years to 1990, the higher-inflation countries in the system experienced higher growth of domestic demand prices than the other members, and that, as a result, existing trade-imbalances within the EMS widened. Though Gros and Steinherr show renewed convergence in the early nineties, this effect is the result of German parameters (inflation and public spending) converging toward the average of the rest of the ERM, rather than *vice-versa*.
19. Up to 1992 the basic balance remained positive (that is, long-term capital inflows covered the current account deficit), but it turned negative thereafter.
20. The escudo had just joined the system and its standing in the system was almost a direct function of that of the peseta.
21. *New York Times*, 20 June 1989. See also *Financial Times*, 31 Oct. 1989. The day after the announcement of Spanish entry, the Bank of Spain had to intervene heavily in exchange markets to brake its advance.
22. 'Spain Counts Cost of Joining the Club', *Financial Time*, 20 June 1990.
23. *Financial Times*, 27 July 1990.
24. *Financial Times*, 15 March 1991.
25. For press reports on this situation see also *Financial Times*, 27 July and 25 Sept. 1990, and 14, 16, 18 March, 17 April, 7, 15, 25 May and 20 June 1991.
26. *Financial Times*, 24 Oct. 1989.
27. Analistas Financieros, 'La peseta y el deterioro de los "fundamentos"', *Cuadernos de Información (FIES)*, April 1992, p.55.
28. The pound was the third currency in the system that was considered by financial analysts to be seriously overvalued given Britain's current account position. However, because the pound's overvaluation was a function of its entry at what was widely considered to be too high a rate, it did not display the same nominal appreciation within the ERM that was experienced by the lira and the peseta. For a discussion of the pound's experience in the ERM, see Zurlinden (1993).
29. The peseta lost 39 per cent of its value against the DM from 1992 to 1995, before beginning to appreciate again in the second half of 1995. See *The Spanish Economy: Monthly Report (La Caixa)*, Dec. 1995.
30. This question is analytically distinct to that of whether the EMS is in practice a DM-zone. The latter involves the floating relationship between ERM currencies and other currencies, in particular the dollar. The two questions are related in the sense that the relationship between ERM currencies and the dollar was one of the main sources of tension in maintaining parities within the ERM. For a discussion, see de Cecco (1990) and Kregel (1990).
31. For an excellent discussion of the various ERM mechanisms, see Goodman (1992: 191-5). A more detailed history of the negotiations is offered in Ludlow (1982).
32. The divergence indicator was included in the European Council's decision of 5 December 1978, but it carried only a 'presumption' of intervention and was quickly abandoned for technical reasons (Artus and Bourguinat 1994: 161). See also the

- explanation given by Tietmeyer (1994: 33–4).
33. A substantial game-theoretic literature that seeks to explain why governments agreed to German dominance of the system has grown out of this view. See, for example, Giavazzi and Giovannini (1989), and Collins (1988). For a dissenting view, see Fratianni and von Hagen (1990).
 34. During the same period, however, intra-EMS trade imbalances widened sharply, with Germany's surplus *vis-à-vis* other ERM countries experiencing a fourfold increase from 1979 to 1988. For a discussion, see Vona (1990).
 35. It might be argued that Germany, whose fiscal-monetary mix turned highly unbalanced in 1991, was also adopting the strategy pursued by Italy and Spain. Yet the German case is fundamentally different in the sense that the DM's credibility did not hinge on the ERM.
 36. This dynamic was exacerbated by the lifting of capital controls which, through its effect on the average cost of domestic credit, resulted in a stimulus to domestic demand, thus raising the output cost of disinflation by requiring higher interest rates. Nevertheless, they take the position that authorities in both countries should remain committed to the 'strong currency' strategy, as their model of exchange rate expectations suggests that in the longer run such a commitment would again lower the output cost of disinflation (1990: 77–83).
 37. For a detailed discussion of the struggles over wages in the 1980s, see Pérez [2000].
 38. Vona (1990: 75) notes that the anti-inflation strategy underpinning the more successful French disinflation process during the 1980s – which is often referred to as the *franc forte* policy – 'relied more than Italy's on the control of domestic costs ... rather than on the adoption of the "strong currency option"'.
 39. Tom Burns, 'Markets Distrust Dogma', *Financial Times*, Survey, 2 April 1993.

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