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Explaining EMU Reform

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Abstract

This article develops a model to explain the roles of national governments in the reform process of rules for economic and monetary union (EMU) in Europe. A study of Germany, France and Spain underlines the importance of electoral politics and institutional arrangements in producing distinctive policy triangles on domestic economic and budget policy, and subsequent demands for specific EMU rules. It employs budget policy analysis to illustrate the collapse of stabilization state politics in France and Germany, leading to the reform of the Stability Pact in March 2005.

Introduction

Economic and monetary union (EMU) remains a controversial policy issue in Europe, not least because of the monetarist orthodoxy entrenched in its system of rules and institutions. The story of its achievement is often sold as one of an agreement based on common acceptance of neoliberal economic principles (Verdun, 2000), which means here the acceptance of central bank independence and balanced government budgets. Convinced of the futility of Keynesian demand management and the success of German monetarism and fiscal conservatism, European governments agreed on a common currency and institutionalized central bank independence based on the German policy paradigm. The subsequent entrenchment of these principles in European institutions endows them with longevity and power over national economic policy (Dyson, 2000). Since 2002, the difficulties of the French, German, Portuguese, Greek, Dutch and Italian governments in adhering to the terms of the Stability Pact[1] (Commission, 2004) and, in March 2005, the Council's decision to alter the Pact have raised the need for reassessment. This article argues that a combination of short-term electoral and long-term institutional pressures on national fiscal policies concretely shapes the interests of elected governments and produces more discord and pressure for long-term reform of monetary union rules than we should expect from the literature on policy ideas and institutions. This approach provides insights into why the development of EMU in its present form was highly contingent, and why the prospects for reform have risen.

The growing literature on monetary policy and international monetary relations focuses on government choices about central bank independence and fixed exchange rates (Broz, 2002; Bernhard and Leblang, 1999). This tacitly takes the neoclassical economic paradigm as a constant in international and comparative political economy: that governments adopt policies attractive to international investors – low inflation, balanced budgets and a strong and stable exchange rate, regardless of the consequences for employment, growth and income distribution or the preferences of party politics. This assumption is expected to hold regardless of regime type or economic development of the country in question. The reasons for this assumption may be those of simple structural power, but they are often enhanced by the premise that policy learning effects have superseded class and sectoral interests in monetary and economic policy within countries and across them. Within countries, parties representing labour and domestic service industries are posited to have learned that Keynesian demand management produces no real and durable economic growth or reduction in unemployment, but rather only inflation and a continuing devaluation of the national currency, which in turn deters investors from supporting economic development (Cameron, 1996). Across countries, governments are posited to have learned that a policy of economic competitiveness through currency devaluation produces no real or durable economic growth, as inflation eats into the price advantages obtained through the lower exchange rate, and investors demand punishing rates of interest to compensate for the risk of future devaluations (Verdun, 2000).

An institutional take on policy learning relies on institutions as guardians of sound economic practice against short-term electoral interests or left-of-centre policy platforms. Way (2000) shows that parties try to follow partisan wishes, but parties of the left seeking to inflate the economy through borrowing are at a disadvantage in countries with independent central banks. Similarly, Dyson (2000) draws our attention to the long-term tutelage of the Broad Economic Policy Guidelines and the excessive deficit procedure in producing the stability

[1] Officially known as the Stability and Growth Pact.

state, one in which the policy lessons entrenched in the institutions have been internalized to the point where they form part of the policy mainstream.

If these assumptions are correct, then comparative and international political economy has nearly reached the end of history, as international competition for discriminating investment capital forces national polities to engage in self-help, thereby ensuring functional equivalence, if not full policy convergence. The fiscal policy rules of monetary union simply enhance this pressure. Representative fiscal policy studies have therefore focused on how governments might best restrain public spending in the face of central bank independence or a pegged exchange rate (Poterba and von Hagen, 1999; Persson and Tabellini, 1994). The era in which the democratization of economic and monetary policy allowed welfare state development and macroeconomic policy choice, stretching from the 1930s to the 1990s (Simmons, 1994) is implied to have come to an end (Eichengreen, 1996, p. 175), and been replaced by an attendant retrenchment of welfare state spending (Pierson, 1996), regardless of country-specific challenges (Scharpf, 1999). Exceptions are treated as failed cases (Hall and Franzese, 1998) that did not achieve these goals, but are nevertheless assumed to have wanted to converge toward monetary and fiscal orthodoxy. A prescient exception is from Mosley (2000), who argues that international financial markets are not nearly as discriminating as commonly thought, and therefore exert less pressure on governments than expected.

The Achilles heel of this approach is fiscal policy, and the pressure placed on it by unemployment during extended recessions. Idea-based explanations of monetary union assume that governments genuinely desire budget restraint and will pursue it unless intervening factors lead to policy failure. This is a bold assumption for countries shifting to low inflation for the first time, as unemployment rises in the initial stages of a war against inflation, public finances turn to deficits, and unpopular cuts become necessary, an assumption that has been buttressed by Pierson's (1996) argument that governments collectively are in a phase of welfare state retrenchment and blame avoidance. Hall and Franzese (1998) have shown that only countries with a very high or a very low degree of labour market co-ordination can manage to combine low unemployment with low inflation, thereby affecting public finances. Way (2000) points to conflicts between centre-left governments and independent central banks that can lead to higher unemployment. Hallerberg and von Hagen (1997) have shown the importance of the institutional capacity of finance ministers to control spending, and the impact of coalition and majority governments on deficit spending.

These approaches move us forward in recognizing that not all countries will have similar fiscal policy circumstances, but the assumption of policy goal convergence remains, and the choice between central bank independence, exchange rate pegging, and institutional engineering at the national level is one of modality rather than a more fundamental policy choice in favour of a strong or weak currency. We can move even further, however, to question under what conditions the existing combination of economic policy orthodoxy and supporting institutions might be rejected, and by whom. They can also be expanded by picking up on the expectation of optimal currency area theory that political differences are more likely to be found between countries, rather than reflected within them through partisan differences (Willett, 2003).

This article challenges the assumption that budget policy is embedded within a strong currency paradigm, and shows that governments listen to sustained electoral pressure as much as they do to policy ideas and inherited institutions. Budget politics are not only the means by which implementation succeeds or fails in the short term, but also how long-term support for or opposition to EMU rules is rallied, which in turn affects government positions on reforming or protecting the institutional matrix of EMU. This article tests the proposition that governments adopt specific roles in the politics of EMU reform that favour the direction in which the rules of monetary union develop. This is applied to the period from 1993 to 1999, when the terms of EMU were rediscussed and reshaped, and conclusions are drawn applying to EMU reform in 2005. As that reform loosened the treaty budgetary restrictions, the centrality of fiscal policy is clear. One of the principle conclusions is that countries that experience chronic economic weakness under the EMU system are more likely to challenge its rules than accept them, in order to maintain domestic political support over economic policy. Another result is that government leaders need to be more strongly viewed as entrepreneurs dealing with both domestic and international pressures (Putnam, 1987), rather than recipients of ideas or rules.

I. Electoral and Institutional Effects

Proposition 1: Electoral coalitions set national tendencies toward stability-oriented and growth-oriented fiscal and exchange rate policies

Major political parties will compete for the political centre, following societal preferences for stability or growth in the short and medium term. Any other pressures will be counteracted through expectations on public spending, as well as inflation and interest rates, and the exchange rate. Governments conform to internal pressure for fear of replacement, or are in fact replaced. This means that interest groups have a lesser impact on policy than the broad electorate. While they have influence on single issues, the findings presented below suggest that they were not influential enough in any of the countries studied to get what they wanted on the broad scope of monetary policy and corresponding rules in EMU.

Proposition 2: Inherited institutional arrangements may reinforce or frustrate the current government's policy wishes

Inherited institutional arrangements comprise central bank independence promoting price stability, and strongly institutionalized and protected spending commitments promoting transfers and growth. Government finds itself from time to time under pressure from two sorts of institutional directions. The first is from spending commitments that do not automatically adjust themselves downwards during periods when income begins to weaken in relation to expenditure. In policy discourse over monetary union in Europe, these were frequently taken to be social entitlements such as public pensions, health and unemployment insurance. The second direction is from the central bank, where this institution enjoys enough independence from government control to restrict the money supply when it feels the government ought to rein in its borrowing.

Where there is a policy choice to be made, the general interests of electoral coalitions determine which policy triangle will prevail. The first, in which price stability preferences prevail in the electorate, it is advantageous for government, seeking re-election, to work with the support of an independent central bank in retrenching public spending commitments, i.e. working toward balancing the budget. The second, in which growth and social welfare preferences prevail in the electorate, may advantageously be disregarded by government, who may even remove any pressure from the central bank to restrain spending. These situations are the only stable equilibria imaginable, so that all countries will gravitate either to a stability-promoting political economy with an independent central bank, or a growth-oriented economy with an accommodating central bank.

The hypothesis to be tested below is that this logic of budget politics will take precedence over other more general commitments to monetary orthodoxy derived from the spread of ideas.

Proposition 3: Governments prefer international monetary arrangements that strengthen policy triangles

Countries with strongly established policy triangles gain little and risk much by engaging in close monetary relations with countries whose situations do not closely resemble their own. Countries in which electoral coalitions and institutional arrangements persistently contradict one another have the strongest interest in an international institution that will help complete institutional reforms and put an end to political-economic instability. This differs from Gourevitch's (1986) expectation that coalitions will be able to change institutions to suit their interests without external help.

Proposition 4: Exogenous economic factors increase the incentives for governments with weak commitments to price stability to take part in stability-oriented monetary unions

Countries with political preferences for growth over stability may seek to join a low-inflation monetary union as they fear that risk-averse investment capital will flow away from them and to other member countries. These countries can sustain membership only with fiscal transfers across members. Countries that prefer stability but have not achieved the fiscal adjustment typical of a strong policy triangle will be periodically punished by speculative attacks until they make a full adjustment, or abandon the strong currency entirely. Frieden and Jones refer to this factor as market credibility (Frieden and Jones, 1999, p. 174). Leblang (2003) underlines poor credibility of political commitment to a strong currency as a central factor.

II. Impact on EMU

The governance arrangements for monetary union are the product of a political agreement based on domestic win sets, as determined by electoral and institutional pressure on government. France pushed monetary union forward with early deadlines, and used those commitments to carry through domestic fiscal policy reforms that would lock in the strong currency policy France had adopted in the 1980s. Germany pushed through extensive rules promoting budget reform and debt reduction to reassure its voters that Member States were committed to a strong currency policy, and to deter others from seeking membership. Despite this, Spain, acting as well for Portugal, Italy and Greece, sought membership, but with the loosest criteria and the strongest financial transfers possible. Given this, it is not surprising that the three EU countries that have not participated in EMU – Denmark, Sweden and the UK – share a combination of a strong currency and scepticism among voters and governments about the changes that EMU membership might bring.

Table 1 illustrates the roles that develop in monetary relations, as applied to EMU. The rows distinguish between countries with and without established central bank independence. Central bank independence refers to autonomy from political direction in setting and carrying out monetary policy. Although central bank independence is a matter of degree, rather than an either/or proposition (Cukierman, 1992), the expected impacts justify a distinction. The threshold is the point where the central bank is free to set interest rates and conduct monetary policy on the basis of inflation or money supply targets of its own choosing, and where the central bank is not obliged to fund any government budget deficit by printing money.

Table 1: Impact of Institutional Arrangements and Public Preferences on EMU Roles

		Public Price Stability Preference *High*	*Low*
Central bank independence	High	*Gatekeeper* Rapid budget adjustment	*Reformer* No budget adjustment
		Monetary union contingent on tied hands	Monetary union rules to untie hands
	Low	*Promoter* Frustrated budget adjustment	*Defector* No budget adjustment
		Early monetary union with tied hands	Delayed monetary union to keep hands untied

Source: Adapted from Donnelly (2004, p. 22).

This threshold is important because it allows central banks not only to advise governments to reduce their budget deficits, but to punish them with high interest rates should they fail to comply. A government operating in such an environment can, without ending central bank independence, either accept the advice and reduce its borrowing to preserve existing levels of employment and economic activity, as Germany tended to do before the 1990s, or defy the central bank and continue to borrow, in which case it would have to gamble on an entirely new national economic structure that could survive very high interest and exchange rates, as the United States did in the 1980s.

The columns distinguish between countries with an established public preference for price stability, and those that prefer activist government programmes to support economic growth and social welfare. Although no governments fail to commit themselves to last two goals, we can distinguish those that emphasize more market liberalization and structural adjustment broadly understood (the supply-side approach) as a response to poor employment and economic growth, from those that believe that deficit spending will eventually revive growth and employment to the point where they pay for larger initial outlays (the demand-side approach). Part of the assumption about converging economic ideas is that the demand-side approach has fallen by the wayside. The empirical evidence below suggests, however, that this is not the case in budget politics in Europe, despite lip service to those principles.

III. Gatekeepers

Gatekeepers, having central bank independence and a tendency for autonomous inflation and budget adjustment, may have small transaction cost gains from a monetary union (Eichengreen and Frieden, 1994, p. 6) where partners are unlikely to negate them through poor monetary policy fit. It is therefore no surprise that the debate over monetary union in such countries made frequent reference to classical optimal currency area theory, which underlines the importance of real economic convergence for partners in a successful monetary union, and downplays newer hypotheses that monetary union could also promote convergence (Willett, 2003). Such a similarity would make possible a one-size-fits-all monetary policy, without the fear of importing inflation or higher interest rates from other countries, or incurring transfer costs to compensate for weak growth in some regions of the common currency (Eichengreen, 1994). Gatekeepers are therefore likely to insist on permanent institutional rules such as central bank independence and public spending limits to rule out any future relaxation of automatic budgetary discipline on government leaders.

Domestically, these countries' fiscal and monetary policies are dominated by a triangle of voter expectations, central bank policies and government electoral incentives that force adjustment to public spending and private price behaviour when they conflict, to ensure the stability of prices and the strength of the exchange rate. Therefore, the politics of budget adjustment should be driven internally by these institutional and political factors, rather than any pressure from international commitments.

Subordinating price stability and budget retrenchment to international cooperation is hardly conceivable, due to the mutually reinforced pressure of institutional arrangements and electoral coalitions on national governments. Although there are transaction cost benefits to be had with major trade partners, the potential benefits of eliminating the risk of currency appreciation during periods of currency speculation are countered by the potential risk of importing inflation and deficit spending through 'undisciplined' members. Further contributing to the discounting of currency appreciation during speculative attacks is the fact that such crises cause capital to enter the country, a state of affairs less disturbing than for countries experiencing capital flight. For these reasons, only two roles are conceivable for the gatekeeper: as the anchor currency of a monetary system, as Germany was in the European monetary system (EMS), or as a promoter of automatic stabilizing features in the institutional structure of a monetary union. In either case, the anarchic tendencies of gatekeepers towards international institutional arrangements should dominate unless these conditions are met.

Defectors

Defectors, having a central bank operating under the direction of the elected government, and a public preference for measures supporting economic growth over price stability, require monetary commitments that accommodate such a strategy. Accommodation could occur through flexible exchange rates, or through a flexible monetary policy that allows for inflation and credit creation in the pursuit of economic demand. Although it is useful for the purposes of attracting international investment to peg the exchange rate, this peg must be periodically adjusted to compensate for relatively high inflation levels resulting from the liberal creation of credit to the public and private sectors. The interest in a monetary union directed at price stability and monetary orthodoxy would be completely unattractive were it not for fears that international investors would favour monetary union members over non-members, thereby robbing defectors of a valuable source of development funds.

Domestically, these countries are dominated by a triangle of voter expectations, spending commitments and government electoral incentives unconstrained by the central bank that forces adjustment to restrictive monetary and fiscal policies when they conflict. Internationally, these countries prefer the retention of national currencies first, followed by monetary unions constructed to accommodate higher inflation and public borrowing levels. In the case of a stability-oriented monetary union, these are expected to seek membership, but to attempt from within to soften its orthodoxy, to seek some type of development aid to facilitate the restrictive impact of new monetary rules on the economy and public finances and, finally, to delay the onset of such restrictive rules as much as possible.

Promoters

Promoters are in a transitory and unstable position, moving from a typical defector type of political economy to a typical gatekeeper political economy, but encountering difficulty along the way. This involves a general shift in preferences away from higher levels of inflation and a softer currency towards low inflation and a stronger currency, with the goal of balanced budgets and perhaps an independent central bank. Although some countries will achieve this goal without insurmountable difficulties, those that fail will start looking for partners that will help them achieve their internal goals despite political resistance. These natural partners are gatekeepers. In addition to these internal gains, promoters also benefit from the elimination of costs related to its unstable commitment to a strong currency policy. These include the risk premium on interest rates required to secure the exchange rate, and the cost of periodically defending the exchange rate against speculative attacks in international currency markets.

Domestically, it is not enough to expect that any country characterized by high levels of unemployment and budget deficits will adopt a promoter policy. Rather, the cases of Denmark and the United Kingdom show that some countries master the challenge well of keeping budget deficits and unemployment rates under control. Hall and Franzese (1998) show that countries that perform well on these standards are likely to have economies that are either highly co-ordinated by tripartite bargaining between government, business and labour organizations over wage, price and public spending levels, as in Denmark, or economies in which there is a minimum of formal co-ordination, as in the UK. Either kind of country should be able to make the transition from defector to gatekeeper status without outside assistance. Countries with a combination of these co-ordinated and unco-ordinated features, however, will experience greater problems squaring the circle, as in France, and increasingly, in Germany. The difficulty arises as the introduction of low inflation through monetary orthodoxy produces persistently high unemployment levels, thereby raising the pressure on government to engage in more dramatic cuts to spending commitments, and increasing its chances of conflict with organized supporters of income entitlements. Internationally, the promoter is institutionally inclined, seeking natural gatekeepers as partners who will help more to establish rules that promote internal reform than weak currency countries. The fact that gatekeepers are disinclined to co-operate if the terms of monetary union are not right gives them added leverage in talks with a promoter, but the promoter already wishes to move in the direction of budget retrenchment in any case.

Finally, promoters require a monetary union as quickly as possible, and are compelled to insist on a deadline that will bind gatekeepers into the process. The political forces supporting the transition to a gatekeeper political economy do this because failure to move quickly increases the likelihood that the country will revert to its former defector type of political economy.

Reformers

Domestically, these countries have governments restrained by an independent central bank that frustrates aims to borrow heavily or to relax monetary policy to meet voter expectations for increased investment in restoring economic growth. Such conditions are most likely to obtain where central bank independence is anchored in a constitution or international treaty, as in euro area countries. Domestic services and exporters gain most from lower interest rates, higher borrowing to fund consumption and investment, and a lower exchange rate.

Reformers share two features with promoters: the inherent instability of their institutional and political situations; and the strong interest in an international institution capable of overcoming an institutional problem in its political economy, in this case, central bank independence. Until this is accomplished, a reformer's political economy will be characterized by expanded government borrowing and countervailing interest rate pressure from the central bank, leading to a higher exchange rate. Its natural partners are defectors, who prefer a similar type of arrangement in monetary and fiscal policy, and who would realize some protection from international currency market speculation as part of a larger currency union.

It is also possible that a promoter, having officially reached gatekeeper status, and having allowed domestic unrest over its policy to grow, might quickly find itself advocating a reformer policy within the monetary union. Such a policy could be expected only if the country has already accepted the institution of central bank independence.

III. Reshaping EMU I: 1992–98

Germany as Gatekeeper

Germany's role as a gatekeeper was felt most strongly by other countries between 1994 and 1998, when it insisted on the conclusion of the Stability Pact and the Stability Declaration before finally committing to EMU. Explanations for its behaviour have ranged from the power of inherited ideas, in this case the inherited fear of inflation that resulted in orthodoxy after 1948 (Verdun, 2000), to the role of the Bundesbank in ensuring the commitment of other countries and German politicians (Heisenberg, 1999; Loedel, 1998). The harder stance in 1994–98 compared to 1992 is not explained, however.

Changes in electoral politics after unification explain changes to the German policy triangle, and related demands at the European level. Unification of a prosperous West Germany and an economically moribund East Germany permanently changed the electoral coalitions supporting economic policy away from an unequivocal support of orthodoxy in monetary, budgetary and even wage policies toward expansionary budgetary and wage policies after the first all-German elections of 1990. In that election, East German support for Helmut Kohl's Christian Democratic Union (CDU) proved to be a decisive factor in supporting his policies to spend and borrow, to increase social welfare entitlements greatly for the benefit of the east, to increase the money supply through the German monetary, economic and social union of 1990, and to defy the Bundesbank's insistence on low inflation and balanced budgets (Donnelly, 2004, pp. 59–63; Schmidt, 2002, p. 293). This new policy pattern broke with traditional CDU policy, and alienated the CDU from its two coalition partners, the liberal Free Democratic Party (FDP), and Bavaria's Christian Social Union

(CSU) (*FAZ*, 1996a). Until 1994, both parties were unsuccessful in demanding spending restraints to benefit the prosperous western voters supporting them (Economist Intelligence Unit, 1992), and ensure a return to Germany's traditional policy triangle.

The budget retrenchment that followed from the 1994 election onwards followed weaker eastern support for the CDU, the increased strength of the FDP and the CSU within the governing coalition, and ongoing pressure on the government from the Bundesbank, which kept interest rates high until it saw a stronger commitment to budget retrenchment. Although Kohl did his best to distance himself from budget politics disputes, he sided with retrenchment demands when tensions rose in a way that did not happen before the 1994 election (*Handelsblatt*, 1996).

Germany's hard-nosed gatekeeper position on monetary union after 1994 reflects this change in electoral politics. It is during this time that the FDP and the CSU demanded new institutional features for EMU, the Stability Pact (Linke, 1996) and the Stability Declaration, which tied the hands of national governments to support monetary and price orthodoxy strongly in a way that was never written into the Maastricht Treaty. These parties saw their demands as justified not only in order to send clear signals to other European countries, but to buttress a traditional policy triangle with far more fragile support.

There have been limits to Germany's capability to return to its old type of political economy, however. Even after 1994, the left wing of the CDU successfully managed to protect many social transfers from the budget cuts demanded by the FDP and the CSU, particularly in the area of public pensions (*FAZ*, 1996a). CDU governors from the new eastern states also underlined the need to balance economic with social responsibility in the light of high eastern unemployment (*FAZ*, 1996b). This factor continues to have a continuing impact on government finances, employment and economic growth levels that are raising the probability that Germany has shifted to a reformer policy, as discussed below.

In Germany's case, the connection between the politics of domestic economic policy and EMU policy were both direct and indirect. Directly, Bundesbank officials and economic conservatives within the CDU/CSU/FDP government were responsible for making demands on the initial rules of monetary union entrenched in the Maastricht Treaty. Although politically weakened at home between 1990 and 1994, they were also responsible for the additional demands for a Stability Pact and a Stability Declaration in 1996 and 1998 respectively.

Indirectly, it was the threat of involuntary defection of the German government from EMU membership that led less conservative elements of the Kohl government, including Kohl himself, to acquiesce to CSU and FDP demands for the Stability Pact and Declaration. Without these provisions, monetary union would have not been sellable to the German voting public. With these in hand, Kohl could reassure a sceptical German public that the German political economy would not be significantly altered by the introduction of the euro.

More telling is that the Social Democratic Party (SPD) had no chance of political support during elections without holding to this centrist position. It foundered on poor voter resonance until Gerhard Schröder distanced himself from the soft currency policies of his predecessor, Oskar Lafontaine, in the run-up to the 1998 election. Although Lafontaine's departure from cabinet in early 1999 signalled a stable commitment to monetarist policies at the time, this position eroded afterwards (Schmidt, 2002, pp. 298–300).

Spain as Defector

Spain demonstrated this role during both the Maastricht negotiations and the period leading up to the launch of stage three of EMU. Spain looked at membership as a necessary evil, to avoid the punishments of exclusion if monetary union went ahead without them. It had little confidence in its ability to converge inflation rates, interest rates and budget deficits. The achievement of nominal convergence to the Maastricht criteria was possible only under the political motto of shedding the country's Francoist past and completing Spain's process of Europeanization, and under the economic promise of transfers from Brussels negotiated repeatedly by Madrid at successive points throughout the 1990s.

Spain had many difficulties achieving the Maastricht criteria, all connected to a political economy rooted in expectations of growth over stability. The Spanish central bank, the Banco de España, and the socialist Gonzales government (1989–96) maintained an official policy of high interest rates, currency pegs and inflation control that were more of an official than a real policy. The peseta was devalued periodically to accommodate persistent inflation that defied government calls for moderation from employers and unions. Attempts to contain the large government budget deficit failed as public opposition rendered social spending cuts impossible, including increases lower than the inflation rate (Donnelly, 2004, pp. 145–53). Given the Gonzales government's failure to rally support for cost control, membership was not achievable.

The Gonzales government found itself forced into this pattern directly and indirectly. It attempted to extend the deadline for EMU as far into the future as possible, and demanded development aid from the EU to compensate for the hardship of transitioning to a low-inflation environment. Indirectly, Spain threatened involuntary defection from the commitments of the Spanish government to monetary and fiscal orthodoxy. Negotiated wage and price controls that disregarded union concerns to retain real wage levels ended in failure, and legislative packages developed for spending reductions were repeatedly rendered powerless in the face of public opposition, channelled through the government's own backbenchers, despite the leadership's preference for a strong currency (Royo, 2000, pp. 184–200).

The conservative Aznar government, far from advocating monetary and fiscal orthodoxy whatever the consequences, succeeded in capturing the political middle ground better than the socialists had done, among both voters and unions. In particular, by accepting union demands for the retention of real wages and, in particular, by reaching a tripartite deal linking wage and productivity gains, the Aznar government reduced inflation, and with it, reduced the inflation-indexed cost of personal income transfers without cutting payments that were sacred to the Spanish public. While it did this, it also succeeded in securing more development aid from Brussels to fund investment that would ensure the growth needed to keep the parties working together.

Both the Gonzales and Aznar governments demonstrated that inflation and budget control were neither politically popular nor feasible without explicit reference to the external pressure of EMU and, explicity, massive financial aid from Brussels. The entrance criteria were reached at the very last minute and, even then, it was possible to sell the new policy to voters only under the banner of becoming more European, rather than as a necessity of economic policy, as idea-centred analysis would leave us to believe. Financial transfers were important in allowing Spain to live with central bank independence and spending commitments simultaneously.

France as Promoter

The red line running through French political economy until 1997 was the desire to achieve the transformation of the economy towards a stabilization state, in the sense outlined by Dyson (2000), and to assume a gatekeeper position as described above. This was a bipartisan commitment in both the socialist and conservative electoral camps that had majority support. Although both sides of the political class in France had outspoken proponents of a return to a more traditional French political economy, meaning a return to defector status, the issue ran straight through the parties, where stabilizers retained the upper hand, rather than across them, so that it was difficult for the critics of the *franc fort* policy to force a reversal. What they did manage to do, by creating stronger fringe political parties on the left and right, was destabilize mainstream politics in support of the hard course to monetary union.

This dichotomy persisted as well in the executive branch. François Mitterrand wanted a European Central Bank that loosened the monetary policy restrictions on France, but he did not get his way. In contrast, successive socialist and conservative governments in France (Utterwede, 1998) accepted treaty provisions anchoring monetary and fiscal policy orthodoxy. At this level, the commitment appears not only intended but desired in principle.

In France, the policy of competitive disinflation and the *franc fort* in place since 1983, combined with a high degree of union militancy, poor union co-optation into the macroeconomic policy-making process and a high level of fragmentation of different spending commitments to produce high unemployment levels during the 1980s and 1990s and a worsening budget deficit. Both socialist and conservative governments during the 1990s promised budget reform, but repeatedly backed down in the face of public sector strikes, which made retrenchment plans untenable, due to both the difficulty of the conflict and the weakening support of a workforce suffering from chronically high unemployment levels. Only the Juppé government, in office from 1995 until 1997 made progress against this trend, and then only in connection with pending membership of EMU. The great difficulties of budget retrenchment under Juppé, at the time when the Banque de France had just gained its independence, and the government's rout at the polls in 1997, underlined the country's incapacity to undertake reforms single-handedly (Schmidt, 2002, pp. 276–87).

IV. Reshaping EMU II: Since 1999

EMU rules were set up to support the stabilization state identified by Dyson (2000). France and Germany's failure to comply with the criteria of the Stability Pact through the Budget and Economic Policy Guidelines (BEPG) process threw this model into doubt, and opened up two alternatives. The first is the creation of an economic government with formal powers to set an economic policy for the ECB to follow. The current treaties allow for this, provided the ECB's mission to provide price stability remains untouched. Otherwise, unanimity would be required to relieve pressure on France and Germany.

The second alternative is a direct confrontation between the ECB and the Member States, with a majority of the EU's finance ministers in Ecofin. This would require and further promote the factual erosion of the stabilization state model. Although this transformation is in the early stages, it appears that the domestic economic and political conditions have either prevented the factual consolidation of the stabilization state, as in the case of France, or led to its erosion after a long period of existence, as in the case of Germany. The result is Ecofin's unwillingness to adhere to the terms of the Stability Pact in November 2003 (Parker, 2003a), and its reform of the budget rules in March 2005.

Germany and France as Reformers

Two countries have developed reformer positions since 1998, in opposition to the ECB and the Commission. In 1997, the conservative French government of Alain Juppé lost an early election to a socialist-led coalition headed by Lionel Jospin. The sole purpose of the election had been to rally support for the final stage of budget cuts needed for France to fulfil the membership criteria for EMU, and Jospin used his landslide victory to demand sweeping changes to EMU rules. He demanded a European economic government that would give directions to the European Central Bank, and an end to the fiscal policy restrictions contained in the Stability Pact. In addition, Jospin lobbied strongly and successfully for the inclusion of members in the euro area whose economic performance would have meant their exclusion had Germany got its way (Donnelly, 2004, p. 176).

Furthermore, the conservative government that succeeded Jospin in 2002 also adopted a reformer position on fiscal policy restrictions, which in turn would require an accommodating monetary policy in order to have some positive impact on growth and employment. Finance Minister Francis Mer called for a renegotiation of the Stability Pact in November 2003 (Parker, 2003b). Conservative ideology clearly plays less of a role than the shift in public opinion away from monetary orthodoxy and toward Keynesian demand-side economics. This is in the light of persistently high unemployment levels and flat economic growth with little hope of improvement under existing monetary and fiscal policy restrictions.

The second case is Germany. Until 2002, the left wing of the Social Democratic Party (SPD) periodically discussed the reformer option, and each time met with rejection from mainstream voters and centrist social democrats. As leader of the SPD and official candidate for Chancellor between 1995 and 1998, Oskar Lafontaine had promoted such a course, and was subsequently replaced by the centrist, business-friendly Gerhard Schröder as the party's electoral candidate for Chancellor in the run-up to the October 1998 election. As part of a measure to unite the party for the elections, Lafontaine was kept in the party as finance minister, where he promoted a reformist policy until his resignation in February 1999. That resignation signalled a victory at the time for Schröder and the new finance minister, Hans Eichel, both fully committed to supporting the terms of EMU as inherited from the Kohl government (Schmidt, 2002, pp. 298–9).

In the meantime, however, Germany's political economy has come increasingly to resemble that of France, when one looks at persistent and rising unemployment, flat economic growth, public finances that resist efforts at retrenchment, and a discordant relationship between unions and the government. By the 2002 elections, in which this poor performance was attacked by cost-cutting economic conservatives under the leadership of Bavaria's Edmund Stoiber, the Schröder government moved closer to a pump-priming policy that rested on tax cuts more than spending cuts, accepting deficits that exceed the criteria for EMU membership. While not going so far as to renew calls for a European economic government, the political efforts of the Schröder government to prevent the European Commission from issuing a so-called 'blue letter' of warning and chastisement over the budget deficit issue has rung alarm bells in the traditional gatekeeper countries of the Netherlands, Austria and Finland at the creeping conversion of Europe's most influential gatekeeper.

The real question hanging over European politics, then, is whether public opinion in Germany has shifted durably in favour of promoting economic growth through deficit spending, which would lead Germany to seek a lasting escape from the restrictions imposed by the ECB and the Stability Pact. It is not yet possible to speak of a major realignment in German politics that would give a clear answer to this question, as the SPD owed its 2002 election victory to its opposition of the US-led war in Iraq. Since mid-2002, support for the SPD–Green coalition government has dwindled, and the traditional gatekeepers in the CDU/CSU/FDP have a slim majority of public opinion (ZDF, 2005). If the French course of events is any clue, however, continuing and rising unemployment, flat economic growth and obstacles to spending reforms may lead to a collapse of fiscal conservatism in Germany. The Schröder government has already made recommendations to engineer budget items such as unification costs and human and fixed capital investment out of the deficit limits, and to make sanctions more flexible (*FAZ*, 2005). The French and German governments will have until 2006 to push for a reform of the Stability Pact, which they ruptured in November 2003 (Parker and Benoit, 2003).

Spain: Converted Defector or Strategic Actor?

The big surprise in the November attack on the Stability Pact was Spain's lack of support for France and Germany. Spain's membership since 1999 has been marked, however, by generous levels of economic growth, employment, and a reduction in the government budget deficit. It has also been marked by one of the euro area's higher inflation rates.

There is, however, a plausible explanation for Spain's position that marries economics and politics. The Aznar government, like its predecessor, has proved fastidious in its calculation of the costs and benefits of participating in monetary union, and demanding accommodation for shortfalls, until now in the form of payments from the EU's structural funds. The death of the

Stability Pact, combined with the lack of a new legal framework governing monetary and fiscal policy, will hurt Spain's growth and export capacities, as the ECB forces interest rates and the euro's exchange rate to rise, countering government borrowing in France, Germany, and other countries with deficit problems such as Portugal. This likely outcome of the existing stand-off will force a repeat in the euro area of the conflicts that played themselves out in Germany in the early 1990s, and in the United States between 1981 and 1987. This is doubly so as the confrontation coincides with the new ECB presidency of Jean-Claude Trichet, a man who has proved his steadfast commitment to the politics of stability in the face of political pressure. Given this, and the steadfast attachment of the Spanish government to continued financial transfers from Brussels in the face of reductions related to European Union enlargement, the evidence speaks more strongly for Spain's strategic calculation than for its full conversion to gatekeeper status.

Conclusions

What has been learned? A model has been demonstrated in which governments follow their voters in order to support stabilizing institutions or growth promoting institutions. Policy triangles have direct impacts on fiscal policy and indirect consequences on monetary policy as the mechanisms by which the implications of monetary policy are accepted and internalized by the national governments, as external rules of the stabilization state are designed to do, or by which the rules are challenged, whether the government intends to or not. The necessity of garnering support for the government ensures this. Furthermore, public expectations have stable orientations that dominate over short-term electoral pressure, and reflect success in producing economic and job growth over time. West Germany before unification and post-unification Germany demonstrate this contrast well. The CDU's new-found interest in more growth and less conservatism after the first all-German elections of 1990 reflects the country's worsened economic situation, leading to tensions with its conservative, western supported coalition partners. The return to fiscal and monetary conservatism after the collapse of eastern CDU support for the 1994–98 government re-asserted western interests. Schröder's government has also reflected the difficulty of bridging east and west. It followed a conservative line in the first administration to get voters, learning from previous electoral defeat. The second since 2002 reflects the unwillingness of voters to sacrifice any more to deal with the rules of EMU. In France, the difficulty is that governments accept principles in general, but have difficulty implementing the fiscal policy rules and have been more ambivalent about EU rules. What is new is that France and Germany are now on the same side of opposing the restrictive rules of the Stability Pact. This puts them much closer to countries that were defectors, that never had any attachment to the rules, leaving Austria, Luxembourg and, until recently, the Netherlands as gatekeeper members of the euro. All other hard currency countries, Sweden, Denmark and the UK, stayed out of the euro, and will play no role in decision-making. Belgium still has an interest in looser restrictions, on account of its high debt levels as defector.

The implications touch on the power of ideas and policy learning, and their role in explaining how EMU emerged. These effects had to be augmented by fiscal policy, to see if governments could commit to stabilization state rules, and whether they could internalize the ideas they represent. France wobbled and fell, Germany has started to, and the Netherlands is having difficulty. Ideas do not explain the actual implementation of these rules, and that is the key to understanding how these agreements can come apart, and how the demand for institutional reform at the EU level rather than the national level can reach a critical mass.

The article also reflected on institutions, and their power to influence government policy, as a cornerstone of the stabilization state approach. Institutional impacts are thought to be long term, and electoral pressures thought to be short term, but there is also reason to take voter interests seriously, where persistent pressures on government to take one direction over another are observable. Where serious, prolonged conflicts between institutions and electoral interests occur, and there are renewed incentives for the kind of political entrepreneurship at the European level that created EMU in the first place. Given the current political climate, that could mean France and Germany seeking partners to place far more emphasis on a policy triangle focused institutionally on spending rather than restraint (Benoit, 2003).

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