

SUSTAINING

**EUROPEAN
MONETARY
UNION**

CONFRONTING THE COST OF DIVERSITY

TAL SADEH

Sustaining European Monetary Union

Confronting
the Cost of Diversity

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Preface

In the fall of 1992, I was a foreign exchange dealer at Union Bank of Israel, a fresh university graduate, and an enthusiast of European monetary integration. I believed that policymakers would never break their promises to maintain declared exchange rate parities. When the skies fell on the European Monetary System (EMS), making my advice to the bank's management very costly, I realized that I had a lot more to learn. So I quit my job at the bank and became a doctoral student, encouraged by Yaacov Bar Siman Tov and supervised by Alfred Tovias and Emanuel Adler. Ever since, my fascination with European integration in general and with monetary integration in particular grew as my knowledge expanded.

When the euro was launched in 1999, I had a feeling of "mission accomplished." What more could we say and write about European monetary integration, which seemed to have arrived at its final destination after thirty years? However, as the expansion of the European Union to the east loomed, the potential membership of the transition countries in Economic and Monetary Union (EMU) seemed like the next intriguing issue. It was then that I came across Bayoumi and Eichengreen's (1997) paper in *European Economic Review*. I once again realized that observed policies, even currency unions, may not necessarily be consistent with economic and political realities, and that membership in the euro zone (the European Union's currency union) could be questionable not only for the transition countries, but also for countries already participating in it. I wanted to know how sustainable EMU is, and I have been seeking that answer ever since.

My intention in this book is to put a political *and* economic price tag on a currency union in general and on EMU in particular, and to suggest institutional reforms that would lower this price. My analysis encompasses all European Union (EU) member states and candidate countries, and even countries from the EU's neighborhood, taking account of both pre-euro data and endogenous post-euro effects. I assume in this presentation that the reader is acquainted with simple statistical analysis as taught in standard undergraduate courses on research methods in the social sciences; nevertheless, the presentation of equations and mathematical expressions is kept to a

minimum, with more detailed technical explanations provided in boxes throughout the book. All of the implications arising from calculations and statistical analyses are spelled out, so the reader can just skip the tables and equations without losing the main themes.

* * *

There are many people whose help contributed to this book and to whom I am indebted. I first worked on the project while I was a postdoctoral fellow at the Davis Institute for International Relations, the Hebrew University of Jerusalem. The support of the Konrad Adenauer Foundation and the Helmut Kohl Institute for European Studies at the Hebrew University at that time is acknowledged. In particular, I would like to thank Shlomo Avineri for giving me the opportunity to participate in the Kohl Institute's activities. I am also greatly indebted to Nathan Sussman, who saw endless versions of the project's early results and guided me through its initial econometric steps.

The book would never have materialized without Jeffrey Frieden's friendly approach, his patience with my ignorance, and his illuminating comments and references. Jeff's work inspired my research agenda to a great extent. I would like to thank Alex Cukierman for his advice on collecting and analyzing the statutes of European central banks and for encouraging me to develop the project and present its results. I was also fortunate to receive encouragement from Benjamin Cohen as well as thoughtful comments that shaped much of the methodological discussion presented in Chapter 2.

Leo Leiderman enabled me to present my work to distinguished audiences at Tel Aviv University's School of Economics and the Israel Economics Association. Erik Jones offered useful suggestions in the preparation of the book proposal. Amy Verdun provided helpful comments and hosted me as a visiting fellow at the EU Centre of the University of Victoria, where parts of the manuscript were written. Chapter 8 developed from a Jean Monnet Transnational Regional Research Project coordinated by the European Documentation and Research Centre, University of Malta. I wish to thank Peter Xuereb for allowing me to participate in that project and for including some of my work in his edited collection, *The European Union and the Mediterranean, Volume 5*. Michael Beenstock, Yona Rubinstein, Graham Voss, and especially Saul Lach and Daniele Paserman patiently answered technical econometric questions and referred me to relevant literature.

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Keren Raz-Netzer and Yael Proaktor provided excellent assistance in collecting data on institutional features of European democracies. Amit Granek, Shai Moses, and Nizan Feldman collected data on the countries of the European neighborhood and the United States. I thank you all. Any remaining errors are obviously mine.

Finally, I wish to commemorate our housekeeper, Nelly Perov, with whom I also shared my thoughts on the project. Nelly was an immigrant from Kazakhstan who sought a better life but was murdered by a suicide bomber on an early morning bus on her way to work. May she rest in peace.

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The Puzzle of EMU

Ever since its inception, the process of monetary integration in post-World War II Europe was fraught with upheavals, as the member states of the European Community (EC), later the European Union (EU), progressed on the road to a single European currency. Periods of productive cooperation among the member states, stable exchange rates, and rapid progress were interrupted by periods of acrimonious intra-European relations, significant exchange rate adjustments, and stagnation in integration.¹ The process, which has been buried by its critics as many times as it has been praised by its supporters, culminated in 1999 in the establishment of Economic and Monetary Union (EMU) among the EU's member states and the launch of the single currency (the euro) currently shared by a large group of member states.

The historical record of political and economic instability in the process of European monetary integration poses some questions. Have the member states converged sufficiently to make a monetary union among them natural? Or could it be that the seeming calm recently observed in Europe's monetary affairs is as temporary as the calm of previous periods? Where did all the diversity disappear to in the 2000s? Is EMU an institutional lid on a simmering pot of diverse societies and economies locked together, in which tensions build up to erupt at a future international crisis? If so, what can be done to remedy the situation?

The main theme of this book is that EMU is indeed socially expensive for many of its actual or potential member states. The reason is that divergence in relevant economic and political idiosyncratic variables among EMU member states is still large, even when endogenous effects of currency union membership are considered.

The tranquility of the period of transition to the euro from 1997 contrasts dramatically with the previous tumultuous 1992–1996 period, which was characterized by exchange rate crises and political and financial upheavals. It also contrasts with the longer history of monetary integration in Europe. In fact, of the 30 years surveyed here (1969–1998), arguably only a total of seven and a half (during 1987–1992 and 1997–1998) were truly tranquil.²

The Snake

The roots of European monetary integration can be traced to the 1957 Treaty of Rome, which established the European Economic Community (later to become the EU), but sharing a currency among the peoples of Europe was not on the European agenda as a practical issue until the late 1960s (Tsoukalis, 1977). During the period 1946–1973, exchange rates of most countries were generally fixed versus the US dollar anyway in accordance with the Bretton Woods regime.

At the end of the 1960s, the EC had completed the establishment of its customs union and Common Agricultural Policy (CAP) and seemed prepared to face new challenges and make further progress with the process of economic and political integration. Indeed, the EC soon had to face great challenges in monetary issues. The tranquility of Bretton Woods was interrupted in Europe by the unilateral devaluation of the French franc in August 1969 following social unrest and wage increases. Another interruption came with the unilateral float of the German mark the next month and its revaluation in October following continuing trade surpluses. These developments created the impetus in December 1969 for the declaration of the six EC member states in The Hague that they were seeking a plan for the establishment of an EMU among them (Apel, 1998, 31–32).

In the early months of 1970, The Hague summit produced a flurry of plans for EMU. The Germans came up with the Schiller Plan. Belgium, Luxembourg, and the Commission of the European Communities (the Commission) submitted other plans (Ungerer, 1997, 99–106). In March 1970, the Council of Ministers set up the well-known Werner committee of experts to recommend practical steps to achieving an EMU. Named after Luxembourg's prime minister, who headed the committee, the Werner report, published in October 1970, suggested that an EMU was attainable within ten years.

According to the Werner report, in the first stage of the EMU process, exchange rate fluctuations among the EC members' currencies would be limited through a system of bilateral exchange rate commitments. In addition, a European Monetary Cooperation Fund (EMCF) would be established as a precursor to a system of European central banks, and the member states would manage their budgets according to the EC's objectives. The Werner report detailed the operation of a system of exchange rates, later known as the "Snake in the Tunnel." The Tunnel was the nickname for the fluctuation band of the members' currencies versus the US dollar, and the narrower band within it for cross exchange rates was dubbed the Snake (Apel, 1998, 32–33; and Ungerer, 1997, 113–114).

In March 1971, the Council of Ministers for Economic and Financial Affairs (ECOFIN) adopted the Werner plan, and in April 1972, the central

banks of the member states launched the Snake. Under the Snake, member states were to keep their bilateral exchange rates within a ± 2.25 percent band, and were committed to extend credit to each other for that purpose.

Credit for market operations designed to defend exchange rates was provided multilaterally through the Short Term Monetary Support (STMS) facility and bilaterally through the Very Short Term Facility (VSTF). Long-term (up to five years) conditional credit to overcome balance-of-payments problems was provided by the member states to each other under the Medium Term Financial Assistance (MTFA) credit facility. The newly established EMCF managed these credit facilities among the member states, and furthered the use of EC currencies in their interventions in the foreign exchange markets. The member states also decided to convene three times a year at a ministerial level to discuss and coordinate their short-term economic policies, as well as to adopt appropriate Council guidelines (Apel, 1998, 34–35).

However, the UK, Denmark, and Ireland left the Snake as early as June 1972. The UK was suffering industrial strife, and its government felt it could not keep the Snake's commitments. The Irish government, in turn, was not confident enough to break its currency union with the UK. Denmark went off the Snake temporarily because it preferred to weather its referendum on EC membership without the burden of exchange rate discipline, but returned in October. In February 1973, Italy left the Snake because its large public deficits and the practice of printing money to pay for these deficits were inconsistent with defending its exchange rates within the Snake. Between March and November of that year, Denmark and the Netherlands realigned their currencies by 5 percent against the other participating currencies, and Germany realigned its currency by more than 8 percent.³ The Werner plan was in effect abandoned when, in December 1973, ECOFIN failed to proceed to its second stage, and a month later France left the Snake as well.

By this time, the Snake evolved into a club of a few small states orbiting the German economy. This club included Norway and Sweden, which were not EC member states but were associated with the Snake. Whereas exchange rates among the participating currencies were maintained within the Snake's fluctuation margins, and no realignments occurred during the next three years, exchange rates involving nonparticipating currencies fluctuated considerably. In addition, during 1970–1973, many countries extended their exchange controls in an attempt to stabilize their exchange rates. In fact, some of these controls were mandated by a Council resolution (Tsoukalis, 1977, 121–136). Divergence among EC member states was also evident in inflation rates and economic growth rates.

An important factor explaining the divergence in economic performance was the uneven way in which the oil shock of the 1970s affected

European countries. Important policy differences also arose from partisan agendas and institutional factors. Germany was bound by its constitution to follow macroeconomic policies centered on credibility, low inflation, and central bank independence, whereas most of the other EC member states followed Keynesian demand-side policies focused on full employment. The German central bank (the Bundesbank) had objected to any fixing of the German mark's parities as early as the mid-1950s, lest this would allow imported inflation to affect the German economy. The Bundesbank never liked the Bretton Woods regime and did not welcome the Snake either (Emminger, 1977, 41; Sherman, 1990, 40–41). The Bundesbank had its opponents in Germany, and yet its authority and opinion were widely accepted and appreciated (Kennedy, 1991, 30–55). Neither the German exporting industries nor the German ministry of foreign affairs seriously challenged the Bundesbank (Ludlow, 1982, 5).

In contrast, the governments of Italy and Ireland, and above all the government of the UK, in the 1960s and 1970s were pursuing policies of “cheap money.” The UK political economy was characterized by assertive labor unions and government policies inspired by neo-Keynesian ideas. Thus, the response to inflation was further raises in wages rather than in interest rates. The three policy alternatives facing European countries were to follow German macroeconomic policies, to stay formally in the Snake while devaluing at will, or to leave the Snake. This policy dilemma characterized all subsequent attempts at monetary integration in Europe until the launch of the single currency in 1999.

Cabinet stability was another cause of divergence among the member states. Policy shifts in the wake of cabinet changes brought France back into the Snake in July 1975 and then out of it again in March 1976. Traditionally, the French central bank pursued policies that were designed to enable the French government to pursue its interventionist policies. There were quantitative credit quotas for different sectors of the economy and segmentation of the French money market. Real interest rates were often negative. France had no overriding commitment to price stability, and no central bank independence (Goodman, 1992, 103–111).

However, after the collapse of the Bretton Woods regime, the value of the French franc did become a concern for French right-wing leaders, and official interest rates rose (Loriaux, 1991, 33–45). These leaders seemed to be willing to absorb “stability” and the lessons of the “German way” through a currency link (Ludlow, 1982, 32). This explains the reentry of the franc to the Snake in July 1975 (Apel, 1998, 42). However, the Socialist Party, keen on neo-Keynesian ideas of money, was gaining strength early in 1976, and the French authorities preferred to float the franc again (Loriaux, 1991, 201; Sandholtz, 1993, 7).

The European Monetary System

The 1977–1978 period was characterized by competitive devaluations of the Nordic currencies, whereas Belgium and the Netherlands increasingly hardened their commitment to the peg with the German currency.⁴ However, against a backdrop of deteriorating transatlantic relations in those years, France and Germany led a renewed attempt to achieve greater exchange rate stability in Europe. Such stability accompanied by a new European medium of account could lower the French and German need to hold US dollar reserves and minimize their exposure to the declining value of the dollar. It would also help both countries in their diplomatic maneuvers with the United States. Perhaps such an ambitious plan would also help to boost the more general European integration process (Ludlow, 1982).

Of course, such a move depended on the ability of these countries' leaders to face down their domestic oppositions, namely, the Bundesbank and the French left. Indeed, the domestic constellation in Germany in late 1977 and the parliamentary elections in France in March 1978 strengthened the domestic positions of both German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing (Carr, 1985, 141; Gros and Thygesen, 1998, 36; Ludlow, 1982, 63–77). Still, a full EMU was not on the agenda.

In March 1979, the European Monetary System (EMS) was launched by all EC member states. The system was originally conceived as a multilateral regime in which all the member states would subject their macroeconomic policies to their exchange rate commitments. A divergence indicator was constructed to calculate the deviation of each member state from its central parity against a basket of EC currencies called the European Currency Unit (ECU). Quotas under the credit schemes described in the last section were extended in both their financial scope and their duration.

However, the UK would not commit to defending exchange rates, not even under the new multilateral scheme. Again, partisan stances and the durability of leadership were important factors. The Labor Party, which wanted to preserve the ability to devalue the British pound whenever this was needed to fight unemployment, buried the idea of full membership for the UK in the EMS in its conference in October 1978 (Apel, 1998, 46). Furthermore, Prime Minister James Callaghan was politically weak in the run-up to the May 1979 general elections, and he was not willing to discuss the EMS in cabinet until November 1978 (Gros and Thygesen, 1998, 53; Ludlow, 1982, 219).

Because the UK would not commit to defending exchange rates, it became technically impossible to abide by the divergence indicator as originally conceived. Stripping the ECU of its UK component would not have

solved this problem because the combined weight of Germany and the Netherlands (which followed a declared policy of a near currency fix with Germany) in such an ECU would have been large enough to turn the German mark into a *de facto* anchor of the EMS.

Thus, the EMS ended up preserving the bilateral commitments of the Snake, now referred to as the Exchange Rate Mechanism (ERM), which enabled Germany to keep its policy autonomy (Ludlow, 1982). Faced with the same policy dilemma outlined previously, the member states chose this time to stay in and devalue when the need arose. However, realignments in the ERM were unanimously agreed upon, not unilaterally decided as in the Snake. The UK was the only EC member state not to assume exchange rate commitments, although Italy assumed the wider margin of a ± 6.00 percent band.

The EMS could have been launched in December 1978 after its complicated technical issues were finalized. However, the EMS fell hostage to domestic interest groups, namely the farmers. The campaign in the first direct elections to the European Parliament produced unexpected pressure on Giscard during October and November 1978. The government was pressured to show its loyalty to the Fifth Republic and to make sure that the European Parliament's authority would not be expanded after the elections. The French farmers used this opportunity to demand the dismantling of a mechanism under which they compensated German and Dutch farmers for devaluation of the French franc. The EMS was not launched until March 1979, after the French government softened its demands (see Goodman, 1992, 125; Gros and Thygesen, 1998, 36; Ludlow, 1982, 199–205, 263).

The next four years saw an official realignment of the German currency once every eight months on average; the magnitude of these adjustments were determined by the significant differences in the rate of inflation among the member states (Cameron, 1996). In this sense the EMS really did not seem much different than the Snake. The currencies of the UK and Greece (which joined the EC in 1981 but stayed out of the ERM) were even more volatile than those of the ERM member states.

In May 1981, domestic politics once again put European monetary integration to a severe test. The winner of the presidential elections in France was the Socialist leader François Mitterand, whose economic philosophy was completely different from that of Giscard d'Estaing. Mitterand emphasized higher government spending and the nationalization of big firms, and he was reconsidering French participation in the ERM. Eventually, these measures brought France close to a balance-of-payments crisis and caused price inflation. In 1983, the French government famously changed its policy, emphasizing fiscal and monetary restraint and exchange rate stabilization (Cameron, 1996; Loriaux, 1991).

As Italy and other member states followed France and adopted similar

policies, inflation rates converged across the continent and adjustments of central parities became fewer and smaller. Between 1983 and 1987, only four currency realignments took place, the magnitude of each being lower than international differences in inflation. In other words, the domestic political economies in the more inflationary countries were bearing the burden of disinflation with lower real wages and earnings. Official interest rates gradually replaced currency market intervention as the primary policy tool in defending the ERM, again at the expense of large segments of the domestic industry. In fact, no realignment occurred between early 1987 and late 1992, and it seemed that the EMS had turned into a German mark zone: Member states had to follow the path of German interest rates to maintain their currency link, at the expense of policy autonomy.

Market agents and academics doubted the resolve of European government to irrevocably maintain fixed exchange rates against Germany's currency because this choice was considered to be socially and politically costly for them. These doubts were reflected in higher interest rates in EU member states compared with those in Germany. However, the member states' determination to establish the EC's internal market in the 1980s lent credibility to the EMS, showing their willingness to lose some of their autonomy over economic policy for the sake of greater integration. The preamble to the Single European Act in 1987 made a direct reference to the vision of monetary union among the member states as its ultimate goal. The EMS also seemed credible against the backdrop of the end of the Cold War, Germany's unification, and the intergovernmental conferences launched in December 1990 to turn the EC into the EU and establish EMU among its member states.

On the Path to EMU

The 1990s version of EMU, like the original plan of the EMS, was supposed to make monetary cooperation in the EU more multilateral and reduce the dependency of the member states' monetary policies on Germany (Pauly, 1992, 98; Sandholtz, 1996, 94). The French became increasingly impatient with the asymmetrical nature of the EMS after their 1983 policy shift and the adoption of a strong currency policy, which ostensibly should have made the French franc as good and stable a currency as the German mark. The relaxation of capital controls as part of the implementation of the internal market, as well as liberalization and deregulation in European capital markets, made this policy dilemma—leave the ERM, follow the Bundesbank's policy, or devalue at will—ever starker. However, on the surface of things, the EMS looked calm and successful. In the early 1990s, many Europeans were convinced that the long journey for a single currency

in Europe had reached its destination, that they were part of a *de facto* currency union, and that all that was necessary was formal recognition of the union and some institutional arrangements.

By 1992, however, the economic case for exchange rate realignment was strong. In spite of the convergence in inflation rates among the member states during the 1980s, the accumulated differences in inflation among them were substantial (Sandholtz, 1996, 88). Substantial as well were the accumulated trade deficits of member states with Germany and the Netherlands (Cameron, 1995b, 44). In addition, Germany was experiencing a postunification boom while most other member states were in a recession (Sandholtz, 1996, 90–91). This meant that in most member states the level of interest rates required to avoid realignment was much higher than the desired level for domestic policies. Relations among member states turned acrimonious over interest rates when Germany resisted immense pressure to ease them.

The EMS was also burdened in the early 1990s by the membership of countries with low macroeconomic credibility, such as Portugal and Spain (in addition to Italy), or dubious motives, such as the UK. Portugal and Spain joined the EC in 1986, but did not assume the exchange rate obligations until 1992 and 1989, respectively. The UK assumed the ERM's exchange rate obligations in October 1990. All three countries adopted the wider ± 6.00 percent exchange rate bands. The British government was outspokenly hostile to EMU; it is often argued that the UK merely wanted a stronger hand in the intergovernmental conferences where EMU was being negotiated (Talani, 2000; Verdun, 1996, 78). Italy moved to the normal ± 2.25 percent bands in 1990, but its ability to maintain this commitment was questionable. A sharp decline in the US dollar's value in global markets in the summer of 1992 also strengthened the German mark against its European partners.

The five-year period of exchange rate tranquility came to an abrupt end in the fall of 1992, after a referendum in Denmark rejected the Maastricht Treaty and another one in France failed to deliver a convincing endorsement. In the course of the next twelve months, five separate realignments took place, two currencies were ejected out of the ERM's fluctuation margins, and the margins were widened to ± 15 percent. This crisis period demonstrated how dependent the EMS had become on the credibility of the EMU process. Once the process had been thrown in doubt, the pressure for realignment was irresistible.

However, the crisis also owed at least part of its severity to the way it was managed. ECOFIN was not convened in September 1992, and devaluation of the weak currencies was authorized by telephone, case by case. The French and German governments were determined not to allow the French franc to be devalued against the German mark. For France, the Franco-