Explaining Commitments to the European Central Bank:

The Interaction of Voter Opinion and Institutional Arrangements in France, Germany and Spain

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Table of Contents

List of Tables and Figures

Abstract / Résumé

Why was it so difficult for European Union countries to establish the European Central Bank? In the 1992 Maastricht Treaty, EU governments committed themselves to an independent, stability-oriented ECB, and to ensuring low inflation rates and low budget deficits. Between 1992 and 1998, they fought over the terms of membership and whether European economic policy should promote growth more than stability. Political parties transmit voter preferences over growth and stability into national policy on the basic priorities of monetary union, while the arrangement of economic institutions reinforces or frustrates the ambitions of a governing coalition. This not only leads to governments with clear priorities that conflict at the European level. Governing coalitions frustrated by economic institutions that thwart their economic policies can promote monetary union in order to force changes domestically. Therefore, conflict arose among stability-oriented governments over whether low budget deficits and inflation were to be achieved before EMU was launched. This reflected the conflict between France and Germany. The dissertation examines the links between the politics of economic policy in France, Germany and Spain, and their policies toward Economic and Monetary Union.

Pourquoi fut-il si difficile pour les pays membres de l'Union Européenne de mettre sur pied la Banque Centrale Européenne? Dans le cadre du Traité de Maastricht de 1992, les gouvernements européens s'étaient engagés à créer une banque centrale européenne qui soit indépendente et stable, et de s'assurer que le taux d'inflation et les déficits budgétaires demeurent faibles. Entre 1992 et 1998, ils ont tenté de s'entendre sur les règles d'admission et sur la question de savoir si les politiques économiques européennes devaient encourager la stabilité plutôt que la croissance. Les partis politiques ont tradiut dans les politiques nationales les préférences nationales de l'électorat pour la croissance ou la stabilité au niveau des priorités fondamentales de l'union monétaire, alors que la nature des institutions économiques venait soit étayer soit frustrer les ambitions des coalitions au pouvoir. Il en est résulté une impossibilité de concilier au niveau paneuropéenne les priorités gouvernementales spécifiques. De plus, les coalitions gouvernementales étant frustrées par des institutions économiques qui entrent en conflit avec leurs politiques économiques, elles appuient l'union monétaire afin de forcer le changement au niveau national. Les gouvernments en faveur de la stabilité n'ont pas pu s'entendre sur la nécessité de résorber l'inflation et de réduire les déficits budgétaires avant l'entrée en vigueur de l'union monétaire. C'est à ce niveau que se situe le conflit entre la France et l'Allemagne. On examine dans cette dissertation les liens entre les politiques économiques en France, en Allemagne et en Espagne, et la position respective de ces pays sur la question de l'union économique et monétaire.

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1 National Commitments to the European Central Bank as an Analytical Problem

Why was it so difficult for the European Union (EU) to establish the European Central Bank? In the Maastricht Treaty on European Union (TEU) of 1992, EU governments agreed on the terms of establishing an Economic and Monetary Union (EMU), of which the European Central Bank (ECB) was the institutional centerpiece. Between then and 1998, EU member states fought a series of battles over the ECB's independence and the terms of membership that effectively re-opened the terms of the EMU agreement and threatened to tear it apart. The Maastricht Treaty's terms for membership in monetary union emphasized price stability over stimulating economic growth in national economic policies. The treaty demanded that prospective members achieve a high degree of nominal economic convergence toward low inflation rates, low government budget deficits and modest levels of public debt, as well as a stable exchange rate, while maintaining similar interest rates. Taken together, this package of requirements for membership required a far more thorough commitment to price stability and a strong currency than that required to peg the exchange rates of national currencies within the European Monetary System.

At the same time, the procedure for selecting EMU members made it possible for EU governments to apply the criteria with some degree of latitude to allow for political judgement on choosing members and proceeding with monetary union. Furthermore, while TEU committed the ECB to serve as the institutional anchor of a stability-oriented monetary union, the political process of appointing its leadership and the open question of how to manage the EU's economy after EMU's launch permitted national priorities and concerns over stability and growth to clash.

This basic disagreement manifested itself in five concrete battles over the institutional foundations of EMU. Sometimes acrimonious disputes over whether the membership criteria would be strictly applied (e.g. limits on budget deficits and total public debt) created political uncertainty over the prospects for proceeding with EMU until it was launched, when improved economic performance rendered many of the disputes moot. Second, disagreement over whether the membership criteria should act as permanent restrictions on the economic policies of member states after EMU's launch led to the establishment of a Stability Pact in 1996 that introduced semi-automatic sanctions on governments exceeding a deficit of three percent of GDP. Third, disappointing economic growth and persistent unemployment in many European countries during the 1990s led to disagreement over whether a political "growth and stability council" should balance the ECB's mission to ensure price stability with growth-oriented initiatives that could risk more inflation. Fourth, as it became increasingly likely that few countries would achieve the membership criteria set out in the TEU before EMU's planned launch, disputes erupted over whether a delay in the final stage of monetary union would be possible. Finally, the final European summit to launch the third and final stage of EMU was the scene of a heated conflict over whether political criteria unrelated to the ECB's mission to promote stability would play an explicit role in choosing its president. Each of these conflicts placed the ECB's credibility as a guarantor of monetary stability in question.

The impact that monetary policy rules have on politically sensitive economic and social policies explains the high intensity and frequency of conflict among European governments over the priorities of a European monetary policy. When countries establish a monetary union and choose the guidelines of a single monetary policy, they also set the parameters within which governments can effectively carry out economic and social policies. Monetary policy determines the amount of money that a government can spend without triggering a contraction of the money supply, and an increase in unemployment, that would counteract the benefits of spending.

Consequently, a monetary policy designed to ensure price stability pressures governments to restrict spending commitments that consistently generate budget deficits. It also pressures businesses and employees to restrain price and wage increases. Under these conditions, stability might be bought at the price of lower social spending, and during periods of fighting inflation, higher unemployment levels. Conversely, in the context of a growth-oriented monetary policy, economic policy-makers could attempt to stimulate economic growth with financial transfers and higher borrowing levels. Businesses and employees would have more leeway within which to raise prices and wages. Under these conditions, the prospect of inflation would threaten the value of savings and investments. Therefore, setting a common monetary policy eventually affects the distribution of wealth and income in national economies in clear and predictable ways.

The ECB project, from the initial agreement in 1992 to the selection of members in 1998, demonstrated on balance a dominant political preference for balanced budgets and low inflation, but also the fragility of the political consensus among EU governments. European governments did not just create a central bank. They made concrete decisions to insulate the institution from political interference, to set economic standards of membership and to shut out candidate countries that could not meet them, to further deter countries from entering if they doubted they could meet the membership criteria on a lasting basis, and to entrench price stability (i.e. low inflation) as a higher priority than economic growth in an international treaty. In the words of European state representatives, they made a conscious political choice to establish the ECB as part of a 'stability community' that places concrete limits on government borrowing, and therefore, restricts the freedom of movement that governments had previously had to stimulate economic growth and promote social welfare. The alternative of establishing EMU as a 'growth community' was not promoted by the French government that initiated the project, nor by the council of central bank governors which drafted the first concrete proposals to establish EMU, and did not come into discussion until well after its stability orientation had been anchored in the Maastricht Treaty. Only toward the deadline for selecting members for EMU did the difficulties of attaining the criteria for membership weaken the consensus on EMU stability.

Since social entitlements constituted such a large and growing component of government spending in Europe during the 1990s, the EMU agreement became heavily politicized in some countries when governments cut social spending commitments in the effort to reduce their budget deficits. Other means of social protection, such as restrictive layoff rules also became focal points of confrontation as some governments attempted to force inflation rates down. In other countries, voters feared precisely the opposite: that other national governments would demand a weaker orientation of European monetary policy to price stability, so that spending cuts and labor market reforms could be avoided. In short, the rules of EMU and the structure of the ECB opened a debate about the future of the welfare state in Europe. This basic distributional conflict is why it is much more difficult for governments to agree on establishing a monetary union and a common central bank than on a simple exchange rate mechanism. The latter allows for different monetary policies, for exchange rate adjustments, and for countries to withdraw when they are dissatisfied with the consequences.

Until the final stage of EMU was launched in 1998, the disputes over the terms of membership and the ECB's independence were paralleled by disparate capacities to meet the criteria set out in the TEU. While most EU countries reduced inflation significantly during the early 1990s, few of them were able to implement spending cuts that would have ensured compliance with the membership criteria. When countries that had difficulty meeting the criteria began demanding lower standards for membership, a more growth-oriented monetary policy and a less independent ECB, attention naturally focused on how voters and economic institutions could influence a government's policy toward monetary union. Under these circumstances, it would be useful to undertake a systematic investigation of how voters and economic institutions influence national commitments to the ECB and to the EMU project.

Not only are the disputes surprising, considering the terms of proceeding with EMU spelled out in the Maastricht Treaty, but considering the subsequent conflicts, it is somewhat surprising that EU governments went ahead with monetary union. A theoretical approach needs to answer three main questions: how do we explain the incentive to establish the European Central Bank; how do we explain the subsequent disputes; and how do we explain the political bias in favor of price stability over economic growth and social welfare?

1.1 Argument Summary

The most challenging aspect to explaining the politics of EMU lies in finding the incentives that drive conflicting patterns of state behavior. The lack of a direct and uniform incentive to establish EMU makes it difficult to use conventional models of institution building, which require such an interest to make collective action attractive, whether organized unilaterally or voluntarily among several parties. Without this, we are at a loss to use conventional models to explain why EMU was initiated and followed through on. The transaction cost benefits of monetary union are modest at about 0.5 percent of GDP[1] and European countries have different monetary policy requirements.[2] This means that European countries vary in their sensitivity and vulnerability to negative economic shocks, which in turn means that a restrictive, stability-oriented monetary policy would prevent or undermine economic growth in some countries relatively frequently.

Monetary union has never been a hegemonic project[3], nor has any European country had the capacity to play the role of a hegemon[4] despite France's leadership and Germany's profound influence on the structure of EMU. Nor has the celebrated linkage of EMU and Political Union[5] had much effect on the outcome of EMU's rules. Similarly, neither the

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[1] Eichengreen, Barry and Jeffry Frieden *The Political Economy of European Monetary Unification.* Boulder: Westview Press, 1994.

[2] Goldstein, Morris and Jacob Frenkel, "The Macroeconomics of Currency Zones," in Berhanu Abegaz, Patricia Dillon, David Feldman and Paul Whitely, eds., *The Challenge of European Integration: Internal and External Problems of Trade and Money.* Boulder: Westview Press, 1994.

[3] Germany's currency and central bank are the most influential in Europe, although Germany had little interest in promoting monetary union. See Kathleen McNamara, "Economic and Monetary Union in Europe: Do Domestic Politics Matter?" Paper presented to the American Political Science Association, 1994.

[4] This role would require the capacity to guarantee stable exchange rates through intervention in international currency markets, in the capacity of a benign hegemon as described by Kindleberger (*The World in Depression*, London: Allen Lane, 1973). Furthermore, Germany had little to gain economically that could justify the establishment of an hegemonic system, along the lines proposed by Gilpin (*War and Change in World Politics.* New York: Cambridge University Press, 1982).

[5] This proposition, put forward by Barry Eichengreen and Jeffry Frieden in 1994, suggested France pursued EMU as a means of binding the reunified Germany into Europe, and that Germany agreed to a monetary union that it would otherwise have not supported in exchange for increasing political union within the EU, i.e. permitting the Council of Ministers to decide many more issues of common concern by qualified majority vote. However, this approach does not take into account, why France agreed to a stability-oriented monetary union if it had leverage over Germany in 1990 during the German reunification talks. Nor does it consider that commitments on political union proved to be remarkably weak.

European Commission[6] nor expert opinions on the benefits of monetary union[7] have been able to push national governments to agree where the latter see their vital interests at stake.

The disputes over the terms of EMU that erupted after the Maastricht Treaty was signed are not rooted in the quality of institutions that prevent defection[8], nor has there been

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[6] George Ross' 1995 work on Jacques Delors (*Jacques Delors and European Integration.* New York, Oxford University Press), which includes an account on the early planning on EMU, focuses on the impact that the presidency of the European Commission can have on the course of European integration, provided that European governments do not block proposals for one reason or another. Delors organized the committee of central bank governors to draft a plan for proceeding with monetary union upon direction from the European Council, which took the decisive decision to study the options.

[7] McNamara's 1994 paper (op cit.) proposed that the EMU project was made possible by the widespread acceptance among European governments that price stability was the proper way to manage European monetary policy. It draws on the influence of ideas on foreign policy and international relations elaborated in Robert Keohane and Judith Goldstein, eds., *Ideas and Foreign Policy*. Ithaca: Cornell University Press, 1993.

[8] Defection-preventing institutions play a central role in cooperation theory, which addresses two concerns that might deter states from cooperating despite the promise of gains in the absence of a hegemon. First, it expects states to sustain interest in collective action by addressing concerns about the distribution of gains and costs. Second, it tries to minimize the risk of defection from agreed terms that could cost some members dearly. In the case of EMU, defection would occur when a country ignored the limits on government spending or on inflation levels after acceding to membership. Protection is offered by devising effective methods of monitoring compliance and by punishing defectors. Although such institutions became terribly important for Germany in the run-up to EMU's launch, the real problem of cooperation revolved around the disparate priorities of EU governments in monetary policy.

The most significant obstacle to applying cooperation theory to the EMU project, however, is the fact that there was little in the way of obvious gains that EU governments were supposed to be pursuing that would justify the cost of erecting the institutions. The most commonly cited benefit of EMU was the reduction of transaction costs for traders and investors that the common currency would bring. However, Frieden and Eichengreen estimate that the benefits would be small, amounting to 0.5% of GDP, and dubious for countries that already had achieved price stability and could lose their gains if the new central bank allowed more inflation in the future. In contrast, the immediate cost to the EU's weaker economies during the 1990s was large and more certain as they disinflated their economies and reduced public spending in the hope of distant economic payoffs in the form of more robust, stable economic growth. Since risk and uncertainty loom much larger than payoffs, cooperation theory lacks a key component for explaining the ECB project. For a review of the cooperation theory approach, see Robert Axelrod, *The Evolution of Cooperation.* New York, Basic Books, 1984. For a discussion of the incentives for proceeding with monetary union, see Barry Eichengreen and Jeffry Frieden, eds., *The Political Economy of European Monetary Unification.* Boulder: Westview, 1994, chapter 1.

any attempt to accommodate diverging economic interests with rules that match complementary monetary interests, as occurred during the classical gold standard.[9] Much more, disputes revolve around the fact that a single currency and central bank necessitate a single monetary policy.[10] If countries have different economic policy priorities, they will either conflict over monetary policy itself or over the economic practices of other member countries that could have an impact on monetary policy.[11] Therefore, friction over monetary union is based on the differences in priorities that voters have in national economic policy. This requires us to abandon the assumption that monetary policy is insulated from politics[12] and to examine the political requirements of monetary cooperation.

The establishment of the ECB and subsequent disputes over the terms of monetary union are inseparable from the political preferences entrenched in European monetary policies and the distributional consequences that flow from them. Accordingly, a theoretical approach that exposes the roots of conflict in the ECB case must reliably explain the pre-strategic preferences of national governments in monetary policy, and then how those governments secure those interests.

A liberal framework of international relations is best suited to explaining the ECB conflict. It allows a systematic investigation of how societal actors and state institutions

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[9] Broz's 1994 paper illustrates how countries with different preferences performed divergent but complementary functions within the classical gold standard. Some countries such as the UK provided more liquidity than would have been the case if all countries followed the same rules, while others provided reserves in time of shortage. See "National Goals and Positive Externalities: The Domestic Politics of International Money Order." Presented to the American Political Science Association. The EMU proposal, however, forced member states to pursue similar fiscal politics that rendered national economies functionally similar rather than different as providers of liquidity and reserves within the currency zone. Not only did the entrance criteria demand this on entering EMU, but the Stability Pact locked in the functional similarity on a lasting basis.

[10] Goldstein and Frenkel, 1994.

[11] For example, if Country A values price stability and that keeps inflation and government borrowing levels low to ensure low interest rates for the economy, is likely to oppose higher inflation rates and borrowing in Country B that could lead to higher interest rates and tighter credit for the entire monetary union, and slower economic growth for Country A.

[12] Katzenstein, Peter, *Between Power and Plenty*. Madison: University of Wisconsin Press, 1978.

determine foreign policy preferences at the national level, and of how differences across countries generate conflicting or compatible interests between states.[13] Since an explanation of pre-strategic preferences is indispensable to solving the ECB puzzle, a liberal framework of study is required.

Propositions one through four, which follow, elaborate the following approach to examining conflict over the ECB project, particularly after the TEU was signed.

I begin with the proposition that electoral coalitions and state institutions interact to determine the national interests of countries toward the central bank project. The economic policy alignment of electoral coalitions determines whether a government prefers a monetary policy that emphasizes price stability, or one that provides more leeway for economic growth. Economic institutions, such as pre-programmed spending commitments and independent central banks, can act independently to either reinforce or frustrate a government's economic policy agenda. Where institutions and government preferences reinforce one another, a government's interest in trading a national institution for an international one is low. This type of country would not propose such an institution, and any support it might lend to a foreign proposal would be heavily conditioned by the policy implications of the rules that would govern the proposed institution.

From these propositions, I expect that proposals for an international central bank to emanate from countries in which a government is faced with entrenched institutions that frustrate its economic policies. Because the proposing government wants to move economic policy in a particular direction, and because it will seek out allies who are particularly hard defenders of similar preferences in economic policy, the central bank proposal should be characterized by a clear political bias in favor of either price stability or economic growth.

In the European case, French economic conservatives promoted monetary union in order to aid the stalled reform of domestic economic institutions. Other governments facing similar incentives supported the project. Germany led a smaller coalition of hard-bargaining conservative countries that signed on to monetary union under the condition that it reflect

[13] Moravscik, Andrew, "Taking Preferences Seriously: A Liberal Theory of International Relations," *International Organization* 51, 4: 513-554. (1997).

their preferences. The following sections treat each proposition in detail.

1.2 The Arguments

Proposition 1: *Electoral coalitions set the basic priorities of economic and foreign economic policy.*

I begin with the assumption that governments are central decision makers in economic and foreign policy, and that the basic priorities reflect the interests of a dominant coalition of voters, which are transmitted through political parties.[14] As political entrepreneurs, governments may launch initiatives designed to attract and secure political support without a direct stimulus from the electorate, but their policy commitments depend on their capacity to retain the allegiance of their supporters.

The most basic choice distinguishing coalitions in the EMU case is whether the country places more importance on price stability (which maximizes the value of savings, investments, and fairly secure sources of income), or on stimulating economic growth and social welfare (which maximizes the prospect of generating income for the economically insecure). While all governments are expected to promote economic growth in principle, stability-oriented countries restrict the growth rate when they see evidence that prices are rising substantially, or that the supply of money has grown quickly enough for price increases to follow. They would then expect sustainable growth to follow, as expectations of economic stability encouraged investment and employment. The timing and extent of economic restraint has distributive consequences that constitute the basis of the key political

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[14] Parties capable of forming the government are expected to pursue public support from the country's political center, as in Anthony Downs, *Economic Theory of Democracy* (1957). Societal interests regarding economic policy also find themselves expressed in coalitions in Peter Gourevitch, *Politics in Hard Times* (Ithaca, Cornell University Press, 1986), Ronald Rogowski, *Commerce and Coalitions* (Ithaca, Cornell University Press, 1989), Mark Brawley, *Liberal Leadership* (Ithaca: Cornell University Press, 1993) and Beth Simmons, *Who Adjusts?* (Princeton: Princeton University Press, 1994). Of course, the importance of domestic politics in international relations was pointed out in Robert Putnam, "Diplomacy and domestic politics: the logic of two-level games," *International Organization*, 42, Summer 1988, pp. 427-460.

cleavage on economic policy.

The concrete interaction between voters and parties takes place most intensively on issues that are more salient than monetary policy or even EMU policy itself. These are issues such as appropriate interest rates (when to restrict economic growth to preserve price stability), employment targets, inflation rates (as an instrument to restrict or encourage economic growth), the budget deficit (for the impact on economic growth and the inflation rate), the exchange rate, (which can be devalued to stimulate growth). and the rules governing social entitlements (as a key component of budgetary and social policy) and labor legislation (as a key determinant of job protection and unemployment).

Interaction between voters and parties on monetary policy, in contrast, tends to be indirect, based on the monetary policy consequences of the above-mentioned highly politicized decisions. Voters set the parameters of foreign economic policy decisions, such as the commitment to EMU in the same manner, by judging the impact that they have on salient issues. I assume that voters recognize their relative interest in stability or growth, based on their personal economic positions, and that they vote for electoral platforms that reflect their interests. This approach allows a clear focus on the linkages between voter demands and the politics of institutional reform that is central to the ECB issue.[15]

Now follow the qualifications. Voters set the parameters within which governments can make commitments, but the bluntness of the electoral weapon is often insufficient to dictate the details of government policy. It is possible. therefore, that a government deviates from public opinion if it believes that the opposition is incapable of capitalizing on the gap between policy and voter preferences. However, the fact that there is a threshold at which

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[15] As chapters two, three and four illustrate, interest groups representing business and labor had a relatively low impact on national policies toward EMU, particularly before the Maastricht Treaty was signed. In most cases, pressure groups were active in more traditional policy areas ranging from wage policy to tax policy and macroeconomic policy. All of these activities had implications for governments working to converge with the membership criteria for EMU, but were not normally directed at supporting or rejecting the national commitment to monetary union. These considerations first became public in the last year before EMU's launch, when it became increasingly likely that monetary union would actually take place. This lack of public lobbying activity stands in contrast to other foreign economic policy cases, as in Helen Milner, *Resisting Protectionism*, 1988 and Jeffry Frieden, *Debt, Development and Democracy*. Princeton: Princeton University Press, 1991.

the government can no longer support its policy means that the basic interests of society must be reflected on important issues.

Since parties influence the position of voters and vice versa, the decisive impact of voters and their interests on economic and foreign policy can only be confirmed in conjunction with hypotheses that flow from a theory of economic interests. This theoretical anchor not only provides direction and predictability to the study; it also provides an opportunity to falsify the predicted parameters and undertake a meaningful test of voter influence. Proposition 1a provides a testable suggestion of how economic structure should lead coalitions to support stability or growth.

Proposition 1a: *Pro-stability coalitions are most likely to be found in countries that combine highly diversified economies with high capital intensity.*

This proposition is based on two components of a commitment to price stability. First, the country should have a direct, dominant interest in low inflation and a strong exchange rate. Second, this dominant interest should be as durable as possible. This means that the country should be as invulnerable as possible to external economic shocks that disrupt the economy.

The hard test of a country's stability commitment lies in its willingness to accept the costs of ensuring the currency's value. Government must be willing to accept lower export sales of some products as the consequence of a higher exchange rate, it should not be concerned about unemployment as the price of combating inflation, and it should not shy away from spending cuts when deficits become chronic. Here, I work from the premise that the country's economic structure helps determine whether unemployment and deficits are a relatively large concern, when compared with other countries.

How are the structural features of a country's economy conducive to supporting one type of coalition over another? We can begin with the observation that savers and investors depend on the value of money in order to ensure the value of their wealth and the real returns on their investments. When people rely on capital-based pension plans[16] to fund their retirement, they also acquire a strong interest in stable money through the large investment they have made. If voters invest money abroad in their national currency, they also acquire a direct interest in a strong exchange rate, since this protects the value of their income. Frieden suggests that this factor is decisive: that a country's reliance on income from investments abroad is an important factor in ensuring that the desire for stable prices and the desire for a strong exchange rate reinforce one another as national political priorities.[17] In sum, voters for whom savings and investments constitute a sizeable share of wealth and income should have a direct interest in supporting price stability.

Optimal currency area theory also draws our attention to the structure of an economy and its impact on the commitment to price stability. It assesses the suitability of two or more countries for monetary union by contrasting their economic structures. The theory suggests that the relative commitment of a country to price stability depends on its ability to withstand negative economic shocks, including a high exchange rate.[18] The country's economy as a whole, in turn, becomes less sensitive and vulnerable to economic shocks when it possesses competitive firms that are less sensitive to price competition, and when the economy is highly diversified. Let us consider briefly how both of these factors can insulate the country

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[16] This means that future pension claims are paid out of returns on investments paid into a pension fund. Since the value of the future pension depends in part on the stability of prices in the future, inflation is undesirable. The alternative is a pension plan paid for on an ongoing basis, out of current premiums from those currently employed. This type of plan is vulnerable to shortfalls for pension recipients if current employment drops, meaning that in times of low employment, pensioners have an interest in economic policies that boost employment and economic growth. The pay-as-you-go system also offers the possibility of compensating for inflation that could result from growth-oriented economic policies by linking pension payments to wage increases. France and Spain use the pay-as-you-go systems, while Germany supplements a public pay-as-you-go system with private capital-based plans.

[17] Frieden, Jeffry, "Capital Politics: Creditors and the International Political Economy," *Journal of Public Policy* 8, 3/4: 277-278 (1988).

[18] Bofinger, Peter, "Is Europe an Optimum Currency Area?" In Alfred Steinherr, ed., *Thirty Years of Monetary Integration from the Werner Plan to the EMU*. Harlow, Essex: Longman, 1994, p. 49; Paul de Grauwe, *The Economics of Monetary Integration*. (2nd ed.) New York: Oxford University Press, 1994, p. 30.

from negative economic shocks and unemployment.

Companies which produce capital-intensive, high value-added goods such as automobile manufacturers tend to have economic advantages that allow them to manage the effects of a rising exchange rate in a way that other companies do not. First, they rely less on the production of standard products that suffer heavily from intense price competition (and demands for a lower exchange rate), and more on the production of products that compete on the basis of product features more than price. Second, highly developed sectors can compensate for rising standard component (withinputs) prices by shopping around. This forces suppliers to control their prices rather than the purchasing company.[19] In short, the market power that these firms possess endows them with less sensitivity to the effects of a high exchange rate, coupled with an interest in a stable exchange rate to attract investment from international capital markets in company shares, and to protect income from exports denominated in the national currency and to purchase components from abroad.

Most important for optimal currency area theory, however, is whether economic activity is widely diversified. If it is, we should expect the country to experience fewer and less drastic economic recessions in contrast with countries with poorly diversified economies.[20] If the country's economy is relatively poorly diversified, higher vulnerability to recession and unemployment create a more frequent and intense demand for government measures that stimulate economic growth, such as promoting exports through a lower

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[19] For an overview of arguments about firms and competitiveness, see Nicholas Owen, *Economies of Scale, Competitiveness and Trade Patterns within the European Community*. Oxford, Clarendon Press, 1983, pp. 1-22, and Arthur Francis, "The Concept of Competitiveness," in Arthur Francis and P.K.M. Tharakan, eds., *The Competitiveness of European Industry*. London: Routledge, 1989, pp. 5-20. Focusing on firm competitiveness is considered to be particularly important for the study of trade and economic interests among countries in which intra-industry trade dominates, such as within the EU.

[20] Any single economic shock is expected to negatively impact a smaller part of a diversified economy. See Morris Goldstein and Jacob Frenkel, "The Macroeconomics of Currency Zones," in Berhanu Abegaz et.al., eds., *The Challenge of European Integration: Internal and External Problems of Trade and Money*. Boulder: Westview Press, 1994, p. 177; and Paul de Grauwe, *The Economics of Monetary Integration*. (2nd ed.) New York: Oxford University Press, 1994, pp. 30-31.

exchange rate, and stimulating domestic economic activity through lower interest rates.

Government finances benefit as well if the economy is relatively well diversified and in possession of competitive firms at the top of the production chain. Decreased price competition leads to lower vulnerability to unemployment, less pressure on wages (as part of the cost factor of withinputs), and more manageable spending commitments, which in turn help to control tax levels.[21] For these reasons, we should expect highly-diversified economies with competitive industries to be least sensitive to the negative trade impact of exchange rate increases, and most likely to support a stability-oriented monetary policy.

In addition to manufacturers of standard products, service providers, including public sector workers, are expected to be proponents of a weak currency and a liberal monetary policy when economic demand begins to falter.[22] Therefore, countries in which these industries are particularly well represented should tend to support a growth coalition. The one exception, however, are the producers of specialized, capital-intensive services that export their expertise to other countries. This sector has an interest in ensuring a secure income through a stable exchange rate.

To recap, *relative* vulnerability to shocks is more important for the identification of suitable monetary union partners than is the absolute strength of their commitment to price stability, since optimal currency area theory focuses on the possible differences or similarities in monetary policy preferences that are likely to follow from economic structure. This enhances the chances for successful cooperation by minimizing the amount of economic policy adjustment that countries must undertake to participate in the monetary union,[23] in addition to minimizing the likelihood of future conflicts over monetary policy. Also important is that this approach factors in the political demands on monetary policy that flow

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[21] In particular, relatively low levels of unemployment keep the tax burden on individual jobs low, and modest payroll taxes in turn insure against tax-related labor costs from pricing jobs out of the market in price-sensitive industries.

[22] Frieden, Jeffry, *Debt, Development and Democracy*. Princeton: Princeton University Press, 1991.

[23] For a review of the challenges of coordinating monetary policies in the broader international system, see Michael Webb, *The Political Economy of Policy Coordination*. Ithaca: Cornell University Press, 1995.

from economic recessions.

Proposition 2: *Economic institutions act independently to reinforce or frustrate the preferences of electoral coalitions.*

This proposition begins with the premise that governments seek to mould the country's institutional environment to reflect the interests of its supporting coalition. When they achieve this task, governments are highly committed to their policy preferences and to existing institutions. If they enter international negotiations that involve changing the institutional status quo at the international level, they will prove to be exceptionally hard bargainers, for fear of alienating their supporters.

Stability-oriented governments are reinforced by an institutional environment that limits inflation and promotes economic adjustment. The most important institutional feature is an independent central bank, since it punishes inflation and excessive government borrowing with higher interest rates that depress economic activity. This, in turn, raises the pressure on government and society to take corrective action, rather than accepting the status quo. Assuming the legitimacy of price stability to the general public, the central bank's independence allows it to embody that political preference and to ensure public support for its actions.[24]

Growth and welfare-oriented governments are reinforced by a strong system of entrenched claims to economic benefits, in the absence of an independent central bank. Here, social security entitlements are particularly important, because spending levels are determined by the number of residents who meet the eligibility criteria rather than a pre-set sum of money.[25] Domestically, claims for benefits, public investment in infrastructure and

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[24] Yee, Albert, "The Effects of Ideas on Policies," *International Organization* 50, 1: 69-108 (1996).

[25] Michael Smith notes that these programs have increased the cost of government since the 1970s principally by expanding the eligibility criteria. See the conclusion of *Power, Norms and Inflation*,

monetary room for economic growth (i.e. lower interest rates) would take priority over a tight money supply.

In addition to the direct focus on expenditure (particularly entitlements that incur costs that are difficult to control, such as health care and pensions), institutions and rules that slow economic adjustment (unemployment insurance, layoff protection, centrally enforced wage agreements) need to be considered, because they can contribute to structural overspending by increasing or perpetuating unemployment. This means that unemployment would have reached the point where taxes could no longer pay for existing spending commitments. If these programs are underpinned by broad public support, we should expect that a government would not commit the country to a proposal that undermined the interests of the people who benefit from them. A proposal of monetary union to such a government would be judged on the opportunities it allows for growth and development, without adjusting national institutions.

Governments may inherit institutions that constrain their ability to conduct economic policy as they and their supporting coalitions would like. As manifestations of previous political choices, the priorities that institutions impose on economic policy may conflict with interests of the coalition that supports the incumbent government.[26] As a result, governments in this position should have less stable preferences about their concrete economic and social policy goals, despite having a discernible general orientation.

Proposition 3: *If institutions frustrate a government's economic policies badly enough to put its competence in question, it has a uniquely high incentive to promote the establishment of an international institution that will aid the completion of domestic institutional reforms.*

The tension between the organized power of two electoral coalitions, one currently in

New York: A de Gruyter, 1992.

[26] Gourevitch, Peter, *Politics in Hard Times: Comparative Responses to International Economic Crises*. Ithaca: Cornell University Press, 1986.

government, the other 'stored' in state institutions and defended by its clientele, can generate an interest in international institutions with a distinct political bias. The more intense the clash of past and present power, whether due to deep divisions in society (for example, an electoral realignment in the making but not consolidated), or due to the deeply entrenched autonomy of particular institutions from government tampering, the stronger the incentive should be to "go international."

This differs from Gourevitch's (1986) approach to the relations between governments and institutions in an important way. His model expects successfully organized electoral coalitions to possess the strength to alter national institutions to suit their priorities. If this did not happen, then one would look to organizational and institutional factors that kept the government from achieving their goals. In contrast, this proposition relies on the fact that an electoral realignment can take place without the new dominant coalition having the capacity to shape national institutions to conform to their wishes.

Based on this proposition, the most likely proponents of the proposed Economic and Monetary Union are governments that have been elected at least in part on a promise to support low inflation and balanced budgets, but face tough institutional opposition to their goals. These governments would benefit most from an autonomous European central bank enforcing fiscal and monetary discipline on national institutions and on private actors.

In the case of EMU in Europe, this incentive would apply not only to the promoter's initial desire to promote the establishment a common central bank, but should also lead the country in question to insist on its establishment.

This argument does not expect governments to sell voters directly on the need for a common central bank, but rather on the salient economic policy benefits that result from the commitment, as it Proposition 1.

Proposition 4: *The configuration of national interests regarding monetary integration leads countries to assume distinct negotiating positions and generate monetary unions with distinct political biases.*

Propositions one to three allows us to predict what kind of monetary union a country prefers, and how hard it bargains to translate those preferences into the institutional rules that the define the monetary union, including the central bank. It also allows a prediction of what type of country proposes a monetary union, whether it seeks a monetary union oriented to price stability or growth, and consequently, the roles that other countries play in the negotiations.

When a government seeks out support for a monetary union initiative, it will already have a political agenda and choose its program and principal allies accordingly. At an early stage, the stability or growth orientation of the proposed monetary union will become apparent, either as a direct statement, or expressed in proposed institutional rules. This declaration attracts like-minded governments and isolates governments with opposing priorities, if they form the minority. Hard bargaining governments faced with a proposal for monetary union are likely to define this interest clearly and pull the monetary union proposal unequivocally in the direction of stability or growth, as the rules of monetary union and the central bank are determined.

This dynamic reveals two types of intensive debate that should take place at some stage of a discussion to establish a monetary union. During the early stages, a debate should emerge on the basic orientation of the monetary union, and the principles that will guide the subsequent negotiations on institutional rules. This stage not only sets the parameters of membership in a technical sense; it sets out which countries are most likely to join together, and which countries are more likely to be isolated from the process. After this stage of negotiations has been completed, debate should be most intense between two types of countries committed to the same monetary policy principles: those attempting to implement the principles for the first time, and those with a proven track record of commitment over actual performance.

1.3 Electoral Coalitions, Economic Institutions and Monetary Integration

European governments represented three distinct views on whether prospective members

Treaty. In each case, a distinct combination of electoral pressure and state institutions coincided with the foreign policy preferences of the countries in question.

Germany, the Netherlands and Luxembourg are countries in which the central bank acts independently from government instruction, and in which voters support low inflation and low public debt levels, whether or not a European institution exists. Named Gatekeepers in Figure 1, they can achieve marginal transaction cost gains, as long as the new currency is as stable as the old. When considering which countries could be accepted as members, we should expect them to prefer ensuring price stability through a smaller membership, rather than a larger membership that would protect exporters from the prospect of currency devaluations.[27] Consequently, Germany strongly resisted membership for countries that lacked its commitment to price stability, promoting a two-speed monetary union as an alternative to integration for the entire EU. In 1996, Germany insisted that a council proposed by France to discuss economic policy coordination within the euro zone remain powerless, out of fear that it could undermine the ECB's independence. The Gatekeepers also worked diligently to protect the common commitment to the convergence criteria set out in the TEU.[28] Germany had a particular concern that other countries would disregard the targets after attaining membership, and demanded (and secured) two additional agreements from other EU governments that reinforced the commitment to low deficits and debt loads over time: the Stability Pact of 1996, and the Stability Declaration of 1998. The Stability Pact, described in detail in chapter five, reinforced the commitment of EMU members to the deficit criteria through the threat of fines for countries which exceeded the three percent limit, while the Stability Declaration committed countries with debt loads in excess of 60 percent of GDP to devote any budget surpluses to debt reduction before

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[27] Manifesto of 60 German economists, "Moving Europe too fast will put Europe at Risk," in Alfred Steinherr, ed., *Thirty Years of Monetary Integration from the Werner Plan to the EMU.* Harlow, Essex: Longman, 1994.

[28] The Maastricht Treaty required candidates to hold their exchange rates within the European Monetary System parities for at least two years, converge their interest rates, bring their inflation rates down to within one percentage point per year of the average of the three lowest inflation rates in the EU, restrict total government debt to 60 percent of GDP, and restrict the government budget deficit in any one year to three percent of GDP.

deficit criteria through the threat of fines for countries which exceeded the three percent limit, while the Stability Declaration committed countries with debt loads in excess of 60 percent of GDP to devote any budget surpluses to debt reduction before spending them at their discretion.

Voter preferences and institutional arrangements lead Gatekeepers to form the following preference structure regarding criteria for ECB membership:

Prior Convergence to Hard Criteria	>	No Institution	>	Later Convergence to Hard Criteria	>	Softer Criteria

Figure 1: National Positions on the Need for the ECB to Tie Hands on Economic Policy

	Societal Pressure for Price Stability	**Societal Pressure for Growth, Social Welfare**
Central Bank Independent: **Adjustable Spending Commitments***	**GATEKEEPERS** *Germany* (EMU candidates must tie hands first)	**REFORMERS** (Anti-EMU: hands tied with pressure to loosen)
Adjustment-Resistant Spending Commitments	**PROMOTERS** *France* (EMU to tie hands)	**DEFECTORS** *Spain* (Tying Hands Avoided or Compensated)

* Central bank independence aids adjustment of spending commitments

France best exemplifies a category of countries named Promoters in Figure 1. Voters supported government commitments to low inflation and budgetary conservatism, but organized opposition made it difficult to implement public sector spending cuts.[29] In addition, while the government successfully controlled the average inflation rate, public sector unions succeeded repeatedly at winning increases in pay and pensions that exceed increases in productivity. Reform in this sector was only achieved where the government privatized state enterprises.

Figure 2: Ability of Finance Ministries to Pursue Hard Convergence Criteria

	Societal Pressure for Price Stability	**Societal Pressure for Growth, Social Welfare**
Adjustable Spending Commitments	**Hard Convergence Criteria Supported** *Germany*	**Hard Convergence Controversial, Unsupported**
Adjustment-Resistant Spending Commitments	**Hard Convergence Supported with Difficulty** *France*	**Hard Convergence Unsupported** *Spain*

France pushed Germany and other stability-oriented governments to support the establishment the European Central Bank. French governments also remained committed to the hard entrance criteria as a best option for evaluating membership, and supported the

[29] Hankel, Wilhelm, "Für Keynes kein Platz in Europa," *Handelsblatt*, September 13, 1994.

German plan for a two-speed monetary union. At the same time, successive governments justified new austerity measures to voters as requirements for EMU. They only dropped this connection when backlash against cutbacks threatened to undermine the EMU commitment altogether.

As a Promoter, France balanced the sanctity of the membership criteria with the desire to establish the ECB quickly. France insisted that the membership criteria could be interpreted flexibly, based on 'substantial progress' toward fulfilling the benchmark values, so as to not miss an opportunity to begin with monetary union.[30] This combination of reform and haste suggests that France promoted the central bank in order to entrench controversial economic policy changes that it had failed to implement.

Voter preferences and institutional arrangements lead Promoters to form the following preference structure regarding international institutions like the proposed central bank:

Prior Convergence to Hard Criteria	>	Later Convergence to Hard Criteria	>	Softer Criteria	>	No Institution

Despite this order of preference, interest in the last two options should be considerably weaker, since neither provide help for the government's economic policy.

Southern European countries demonstrated a third type of behavior, and are named Defectors in Figure 1. These countries harbored more stubborn tendencies of inflation and government overspending and lacked a history of central bank independence. Although the governments were concerned about the effect that inflation and public borrowing were having on the economy,[31] they had more difficulty introducing reforms than most EU countries. The Spanish and Italian governments forced inflation down from historically high levels, but were not as committed to cutting spending, given public opposition. This

[30] Elaborated in chapter five.

[31] The willingness of these countries to control inflation and public spending to some extent is documented by Michael Webb, *The Political Economy of Economic Policy Coordination*. Ithaca: Cornell University Press, 1995.

resistance reflects the lower diversity and competitiveness of the economic base, which leaves a greater percentage of the work force simultaneously vulnerable to economic shocks, as well as the prospect that currency devaluations and inflation could re-ignite economic growth when necessary.

These governments attached their countries to EMU for three reasons: First, they feared that exclusion would punish the countries' weak economies with uncontrolled inflation, high interest rates and economic stagnation. Second, they feared that international investment would be diverted to the euro zone, thereby slowing their own development. Finally, Spain, also committed itself to the stability-orientation of monetary union in order to bolster its demand that the EU transfer development aid through the Structural Funds program to make membership compatible with the growth and welfare priorities of the electorate.

In the meantime, Defectors supported as long a transition to monetary union as possible, which gave them common ground with Gatekeepers. Privately or publicly, each of these governments supported a relaxed application of the membership criteria.

Voter preferences and institutional arrangements lead Defectors to form the following preference structure regarding international institutions like the proposed central bank:

Softer Criteria	>	Later Convergence to Hard Criteria	>	No Institution	>	Prior Convergence to Hard Criteria

The fourth category, named Reformers in Figure 1, combines central bank independence with a government willing to risk inflation to pursue growth and welfare. It would also support a looser economic policy, and have an incentive to propose the establishment of a politically dependent ECB as a means of loosening its own central bank's control over the economy. No country adopted this stance, although Germany's Oskar Lafontaine promoted it in 1997-98, as described in chapter two. Its behavior would be a mirror image of the conservative promoters of the European Central Bank.

Voter preferences and institutional arrangements lead Reformers to form the following preference structure regarding international institutions like the proposed central bank:

Softer Criteria > No Institution > Later Convergence to Hard Criteria > Prior Convergence to Hard Criteria

These country types allow a prediction that institutions like the ECB are most vigorously promoted by governments operating in very specific circumstances: where voters support low inflation, but state institutions resist the adjustment required to reduce spending, or achieve low inflation with low unemployment levels. They also predict that their most likely allies are countries in which voters support low inflation and whose governments already face fewer institutional obstacles to spending reductions and promoting adjustment. These countries will work hard to ensure that the ECB is the independent anchor of a hard currency club.

The different preference structures of Gatekeepers and Promoters also foretell the potential for serious friction in the relationship. Cooperation is possible because both types of countries prefer prior convergence to hard criteria as the test of admission to the future central bank. If the first choice isn't possible, then friction will occur. Promoters will push Gatekeepers to participate in an institution that compromises on the criteria in order to ensure some measure of external economic policy discipline through monetary union. Gatekeepers, following their preference structure, would rather have no institution at all if prior convergence is not guaranteed.

In contrast, the commitment to EMU's convergence criteria will be much weaker, and government commitments unsustainable, where voters and institutions are more concerned about growth and social welfare than low inflation. These countries may consider membership contingent on money transfers that allow them to achieve membership without sacrificing growth and welfare. The emphasis domestically could be on restructuring rather than restraint.

1.4 Cooperation and the Extensiveness of the Convergence Criteria

The country types described above indicate pre-strategic preferences and roles played in negotiating the establishment of a monetary union. In addition, we need to explain why the convergence criteria had to be so extensive before cooperation could proceed, meaning before the final stage of EMU, with the ECB's arrival, could be launched. This result is not just produced by German concerns about stability. It is also driven by the requirements for reaching agreement on a common monetary policy. This requirement places more demands on potential members than either choosing to participate in a trade regime, or participating in a monetary system like the gold standard of the late 19th century.

The key to finding a successful formula for monetary union lies in fulfilling the principle of least adjustment. This means that international commitments should require the least possible adjustment to economic policy as it applies to the choice over the balance between price stability and economic growth. In a full monetary union, this is necessary to prevent conflict between national preferences and the international commitment.

By contrast, in the case of constructing a liberal trade system, Brawley's model of liberal leadership relies on the fact that countries have different interests and perform different functions.[32] In that case, it is the fact that their interests are complementary rather than similar, that makes cooperation attractive. In the case of the gold standard, it was also possible for countries retaining their own currencies and central banks to perform different functions within the balance of payments regime that reflected their disparate policy interests.[33] However, this was only possible because states retained their national currencies and central banks. A full monetary union, in contrast, requires a single institution and policy. In addition, the gold standard cooperation could not be sustained after the countries in

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[32] Brawley, Mark. *Liberal Leadership: Great Powers and their Challengers in Peace and War.* Ithaca: Cornell University Press, 1993.

[33] Broz, Lawrence. "National Goods and Positive Externalities: The Domestic Politics of International Money Order." Paper presented to the American Political Science Association, March 1994.

question extended the franchise to most of the adult population.[34] This means that democracy is an important factor in requiring agreement among potential monetary union members over the priorities of a common monetary policy. The principle of least adjustment complements a direct interest in cooperation by minimizing the cost of entering into the arrangement (which policy adjustment impose) and by minimizing the risk of defection through a stable collection of interested actors. In the context of the European Union, this is particularly important, since, for diplomatic reasons, all EU member states had to be considered as possible participants

The principle of least adjustment, when applied to a full monetary union, demands similar interests rather than complementary ones, and this is what made it so difficult for the EU to agree on the terms of monetary union. Members will have to share the same monetary policy, the same interest rates and the same exchange rate. Consequently, it would be unattractive to participate with partners who would force a different interest rate, monetary policy or exchange rate on the national economy. Based on the propositions above, governments should bargain hard to represent domestic interests in negotiations over the terms of membership and the structure of the ECB.

The principle of least adjustment in monetary policy, interest rate policy and exchange rate policy led countries with the strongest bargaining power to demand that prospective members not push these policies in undesirable directions. In concrete terms, there was general agreement between Germany and France that candidate countries should have similar inflation rates and contain their budget deficits. The German proposals, predictably, were stricter than those of France, however.

1.5 Advantages of the Electoral-Institutional Model

The electoral-institutional model explains both the demand for a European Central Bank and the difficulties of supplying it. It explains some national preferences in monetary

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[34] Simmons, Beth, *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years*. Princeton: Princeton University Press, 1994.

policy, the degree of certainty with which a country can commit itself to low inflation and budget deficits, and the reason why national governments have pushed persistently and vigorously for membership rules and ECB structures that attempt to alter the policy mix of the new central bank. In addition, the model explains why the ECB was designed to be even more conservative and independent than the Bundesbank.[35] Each type of country assumed a given role that shaped the development of monetary union even after the Maastricht Treaty had been signed and ratified.

The hypothesis that governments promote monetary union in order to push domestic reforms forward explains the French drive to create the ECB in a way that other explanations do not. The potential economic gains were too low to incite the wave of adjustment that France and other countries undertook during the 1990s.[36]

The new approach also explains why two groups of countries with stability-oriented governments assume different roles in setting rules for monetary union, and why one of those groups, the Gatekeepers, are so reluctant to join or so insistent on side-agreements such as the stability pact.

A successful completion would add to our understanding of how and why international economic institutions are created: who pushes for them, who is most likely to sign on, and under what conditions. By illuminating the influence of voter preferences, central bank independence and institutionalized spending commitments on government attitudes toward the European central bank, the model described above provides advantages over conventional explanations of institution creation. Interest-based theories assume that state interests are exogenous, and focus on promoting collective action among countries within that constraint, while the proposed model focuses on explaining how states develop

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[35] The TEU commits the ECB to pursue price stability, and instructs its leadership to not take instructions on monetary policy from the respective national governments. Unlike the Bundesbank, the ECB is not faced with the context of a politically-defined economic policy. Also, the entrenchment of this mission and insulation from political pressure in an international treaty provides the European Central Bank with protection from intimidation from lawmakers not available to the Bundesbank, which is enabled simply by statute.

[36] Eichengreen, Barry and Jeffry Frieden, eds., *The Political Economy of European Monetary Unification.* Boulder: Westview Press, 1994.

an interest in a particular form of collective action. It considers both the individual incentives particular to countries with different combinations of electoral pressure and institutional arrangements and suggests how these different national preferences can contribute to a collective outcome. Illuminating interests is particularly important because we need to explain not only the organization and the operating principles of the proposed institution itself (given few obvious incentives and constraints on economic policy), but also the fact that membership is heavily linked to a set of economic norms to which few European states currently adhere.

If the linkage between developing a domestic preference for price stability and the capacity to commit to EMU can be substantiated, the importance of promoting economic convergence as a precondition to the creation of a stable institution will be underlined. The study will also allow a study of how state institutions influence government decisions by constraining government options and giving governments incentives. Not only will this have importance for EU countries that are not ready to enter Stage Three of the EMU, but also for east European countries that have expressed interest in joining the EU at some point in the future.

The structure of the argument requires contrasting countries that vary by public tolerance or intolerance of inflation, and by a history of different degrees of central bank independence, as well as by degree of institutionalization spending commitments. Differentials in capital endowment would also be examined, to evaluate Frieden's explanation of sectoral pressure for inflation or price stability. For these reasons, I have chosen Germany, France and Spain as study cases. These countries, listed in order of capital abundance and industrial diversity, have distinctly different attitudes toward policy priorities, as shown in Figure 1.

1.6 Methodology

The study requires measurement and/or evaluation of the following data at the national level for each country involved: the structure of the economy, voter opinion on economic policy, interest group lobbying on economic policy, the impact of institutions on economic policy, and macroeconomic policies and institutional reform policies, with contrasts to the convergence criteria for EMU. These variables illuminate the willingness and capability of governments to live by the type of economic rules proposed for the ECB. Foreign policy behavior comes afterward, as discussed below.

The structure of the economy is important as an indication of its diversification and ability to produce income, and its interest in a stable exchange rate. The first useful measure is the share of gross domestic product (GDP) generated in primary (raw materials), secondary (manufacturing) and tertiary (services) sectors. In addition, the closer review of economic activity in individual areas of production allow an insight into the individual strengths and weaknesses of the national economy.

A second measure of the economy is its productivity per employee by economic sector, which is measured by GDP per sector, divided by employee. This requires a review of employment share by economic sector. Where productivity is stable or increasing, it is likely that economic competitiveness is stable or increasing, and with it, the capacity to resist further economic shocks in these sectors. In addition to productivity measures, measures of unit labor cost growth help to illustrate whether wage and payroll taxes are contributing to higher or lower productivity trends. Unit labor costs are calculated by dividing productivity by employment. What these measures do not cover is whether increased productivity is being generated at the price of unemployment. This is an important indicator for the political impact of economic developments, and an indicator of stress on government finances. Production data are available from the OECD *National Accounts*, while labor data are available from the International Labor Office's *Labour Statistics Yearbook*.

Finally, a country's current account and financial account, with balance of payments information for individual sectors, provide information on the overall competitiveness of the country and its economic interests. The current account provides information on whether the country is earning more from exports of goods and services than it spends buying them from other countries. This is useful in determining the extent to which the country is a net borrower, or a net earner from exports to the rest of the world, or whether the country depends significantly on income from investments abroad. Industry-specific information also reveal where the country's strengths and weaknesses lie. This information is available from the International Monetary Fund's *Balance of Payments Statistics Yearbook*.

The appendix notes cases in which there may be inconsistencies in the data which makes them incomparable. Furthermore, due to availability of information, an analysis of the economic situation, along with economic policy in each of the countries, extends until the end of 1996.

Societal pressure on national economic policy itself is to be examined through voter opinion, and by interest group pressure. More specifically, attitudes toward the government's handling of interest rates, the budget deficit, inflation, growth, the unemployment rate, the exchange rate, and various aspects of EMU will be examined, and priorities revealed. Qualitative analyses of interest group pressure will be studied on their own, while electoral pressure will be studied principally in conjunction with a review of political parties' priorities in economic policy and EMU policy. In that section, particular attention will be paid to the relative importance of electoral and interest group incentives. Opinion data, where appropriate, are to be collected from *Eurobarometer* surveys for the years in question.

The role that institutions play in constructing national macroeconomic policy will be assessed in several ways: by examining their relative independence from government policy (discussed below), their participation in public debates about choices between growth, welfare or savings and price stability, their interaction with societal groups on institution-specific issues, and mutual support with government and opposition parties to either push restraints through or to resist them.

Central bank independence will be evaluated by examining the degree of government control over the appointment of officials, the type of constitutional or statuary guarantees of bank independence, and other means by which the government may interfere in bank decisions between appointments. Independence or the lack of it should be demonstrated in hard cases, in which expansionary government policies were reversed or accommodated.

The adjustment resistance of spending commitments is to be measured by the degree to which they respond to either government pressure for spending reforms, or the extent to which their funding formulas promote adjustment automatically when spending or borrowing reaches a certain level.

Finally, government policy on the central bank itself, on the appropriateness of the criteria, of the timing of the central bank's introduction, and on any conditions which should accompany membership should be documented as thoroughly as possible. The impact of voter opinion and institutions on government policy, and national macroeconomic performance will be the primary focus. This is accomplished through a literature review and through information from independent institutions, including the European Monetary Institute.

A third method, interviews, remains of limited use until stage three of monetary union has begun in 1999. Despite constant questioning by the press, politicians have been unwilling to confirm or elaborate on reports of disputes between EU countries over the terms of monetary union. This position is unlikely to change until exchange rates are irrevocably fixed and the ECB is already managing European monetary policy, all of which begins on January 1, 1999 Until then, politicians seem to be wary that an admission of conflict could undermine confidence in exchange rates, unleashing costly volatility before 1999.

1.7 Structure of the Dissertation

The dissertation is set out in six chapters. Chapters two through four examine the sources of German, French and Spanish policies on the independence of the ECB and the terms of monetary union. They examine each country's economic structure, central bank laws, and spending institutions as well as economic and social policies. The ease or difficulty with which each country can commit to the convergence criteria, and the priorities of economic and social policy become apparent in these chapters. In addition, these chapters contrast national debates on economic and social policy with debates over the virtues and evils of EMU membership. This sets the context in which demands are made at the European level.

Chapter five examines negotiations over the terms of monetary union and the structure of the European Central Bank, focusing on disputes that emerged after the initial agreement in the Maastricht Treaty. This chapter also exposes the linkage between voter opinion and specific proposals, or their rejection. Chapter six examines the degree of fit between the model presented in Chapter one and the evidence presented in subsequent chapters, and draws conclusions about the influence of voter opinion and institutional actors on government attitudes toward a European Central Bank.

2 Germany

> *"Convergence comes before the schedule. According to unequivocal terms of the Treaty, only those countries that meet the convergence criteria will enter the third stage of monetary union. No schedule can circumvent these requirements or render them invalid."*
>
> - Theo Waigel, Finance Minister, 1996

Germany consistently supported EMU after signing the Maastricht Treaty in September 1992 and acted to protect and promote its stability-oriented character. From that point onward, the center-right Kohl government reiterated the conditions of its continued support and began stressing them to German voters and foreign governments. The central bank had to be independent from political control and have a clear mission to promote a stable currency. In addition, member states had to support the ECB's mission by limiting their debts and deficits. As European Union governments hammered out the finer details of monetary union, Germany devoted most of its energy to ensuring the central bank's independence, restricting membership to countries that met the Maastricht Treaty's convergence criteria before the launch of EMU, and establishing fines for members that failed after entry to hold to the criteria. Germany viewed the willingness of foreign governments to commit to budgetary rules and accept economic sanctions for overshooting pre-set limits in particular as a confidence-building measure, despite the difficulties it would be bound to create during future European recessions.

Despite high and rising unemployment levels through 1998, the Social Democratic opposition could not attract a political majority without committing itself to a gatekeeper policy at the European level. When its leadership chose to ignore this principle, as chancellor candidate Oskar Lafontaine did in 1996, voters refused to rally around the party, despite the government's sagging popularity. When party centrists promised to adopt a gatekeeper policy at the European level, voters responded with enthusiasm. In the 1998 general elections, German voters elected as chancellor an SPD state governor who had promised, unlike the party's previous top candidate, to support the stability-enhancing aspects of monetary union.

Voters who valued stability above growth continued to form the majority in Germany, if a smaller one than in the west before reunification. Most westerners retained their preference for stability and modest government spending commitments. The last demand proved to be particularly pronounced in the German case: western voters not only wanted government to balance the budget; they wanted spending reduced to the point where taxes could be ratcheted back to pre-reunification levels. Politicians from all three center-right parties were able to mobilize this latent group in the fight to cut spending and taxes. These voters were also the most skeptical about EMU membership in principle.

In contrast, reunification and recession increased the percentage of voters who expected government to directly stimulate growth and economic welfare. East Germans in particular saw social transfers and equalization payments as non-negotiable, given their impoverishment relative to the West. The number of unemployed grew explosively during this period, creating a new cohort of voters in favor of growth and welfare. In contrast to the stability camp, which was concerned about the effects of EMU membership on stability, this group supported a delay in EMU as a means of avoiding government cutbacks.

The growing force of the growth-and-welfare camp in the east and in declining areas of the west weakened the commitment of the country's two large catch-all parties to wage stability and fiscal austerity in comparison to the pre-reunification period. In particular, strategies to attract support from both East and West split the parties from within and generated ambivalent social and economic policies. Between 1990 and 1994, the government chose to stimulate the economy directly, while assuring conservatives that rebuilding the east would unleash an economic boom large enough to pay for the investment. By 1994, conservatives had isolated the government's eastern wing and pushed for deep spending cuts. SPD attempts to attract these voters led to similar internal divisions and equally damaged their election prospects.

Reunification damaged the country's capacity to pay for its spending commitments. After reunification, spending institutions that had been compatible with balanced budgets while embedded in the West German economy threatened public finances once embedded in the reunified German economy. Entitlements to social transfers and requirements for public investment in infrastructure outweighed the ability to pay, given the serious inadequacies of the eastern economy and the sensitivity of west German employment to tax increases. By 1994, once it became clear that spending programs had generated a structural government budget deficit in the reunified economy (that is, once the hope of an East German economic miracle like the West had experienced in the 1950s had evaporated), the government began paring down entitlements. The savings were intended to meet the western demand for lower taxes and social insurance premiums (in hope of recovering their competitive positions from before reunification).

Reunification brought with it a threat to the central bank's independence, which the Kohl government and the Bundesbank successfully resisted. The central bank actively promoted the country's gatekeeper role abroad, and pushed the government to reform the nation's spending commitments. It raised interest rates and squeezed the money supply in the early 1990s to counteract the government's growth-and-welfare-oriented spending program for the East. It waged a public relations campaign to mobilize voter support for its policy of low inflation, a stable mark, and balanced budgets, strengthening its allies within government. These methods allowed the central bank to wield decisive influence over government policy during the years of ambivalence following reunification, and legitimated its frequent comments on the government's commitment to a gatekeeping role.

This chapter's work is divided into four broad tasks. Section one examines the German economy to shed light on the country's economic interests and how well they match the government's demands for a stability-oriented monetary union. Section two outlines societal demands on economic policy from business groups, unions and voters, to identify the political environment in which the German government is making European policy decisions. Section three considers the impact of institutions on the relative commitment to growth and stability in the government's economic policy, focusing on social insurance spending commitments and the Bundesbank. Section four examines how political parties transmitted societal pressures into institutional reform packages at the national level, and into a stance on EMU at the European level.

2.1 Economy: Performance and Structure

A nation's economic strength and stability determines its capacity to provide employment and to pay for spending without deficits or inflation. Countries with relatively strong and stable economic activity should have relatively low unemployment levels and a strong tax base capable of supporting extensive spending commitments without resorting to extensive borrowing or risking high inflation levels. Conversely, countries with relatively weak and unstable economic activity should be faced with a more frequent disruptions, the prospect of higher unemployment, and a weaker tax base. In these cases, price stability and strict budget discipline should be less attractive than a more growth-oriented monetary policy and willingness to borrow to smooth out the impact of negative economic shocks.

Despite making demands on its European partners, Germany did not fulfill the entrance criteria for monetary union until 1997. Unlike many other European countries, however, Germany's surge in inflation and deficits were new in the 1990s, a result of reunification. The Kohl administration focused between 1990 and 1994 on dealing with widespread poverty and economic collapse in the east with an increase in transfers, investment and tax expenditures, and accepted temporarily, if uneasily, the consequence of large budget deficits. From 1990 onward, the federal government borrowed to develop economic infrastructure in the new states and to improve links between them and the old federal republic. It also incurred greater costs through its unemployment insurance and pension programs as the recession of 1993 worsened, particularly in the new states.

In its 1994-1998 term, in contrast, the Kohl government sought to re-establish a pattern of low budget deficits once the initial program of eastern aid had been completed. Two characteristics of the government's savings program stand out in contrast to many other European countries: cuts to government programs generated less opposition, and had a solid base of internal majority support. Entitlement programs were cut over this period, but not deeply enough by 1996 to keep borrowing within the three percent limit of the Maastricht

Treaty. The deficit drove Germany's government debt over the Maastricht limit of 60% of GDP in 1996. Economic recovery in the latter half of 1997 helped government to increase revenues and reduce the debt in time for membership selection in early 1998.

Relatively high inflation rates between 1990 and 1993 reflect the determination of government, businesses and workers to raise the standard of living in the East. Income transfers and wage increases fueled a consumption boom, while investment in infrastructure drove up input. The Bundesbank then raised interest rates to counter the inflationary effects. By late 1993, inflation had been slowed by rising unemployment, a rise in payroll taxes, and an income tax surcharge to finance public investment that dampened consumer spending. Eastern wages continued to rise at a faster rate than productivity increases in 1996, but should become less significant as eastern and western wages become more similar.[37]

Table 2.1 EMU Convergence Criteria, Germany†

	1991	1992	1993	1994	1995	1996	1997
Inflation°	3.6	5.1	4.5	2.7	1.8	1.5	1.8
Deficit*	3.3	2.6	3.2	2.4	3.3	3.4	2.7
Debt*	41.5	44.1	48.0	50.2	58.0	60.4	61.3

Source: European Monetary Institute, *Convergence Report*. Frankfurt, 1998.
† Reunified Germany from 1992, old Federal Republic for 1991.
° Consumer Price Index. * Federal and state government, percent of GDP.

The German mark remained one of the European Union's strongest currencies throughout the 1990s. Although government borrowing, high unemployment and the 1993 economic recession could have weakened the mark, the Bundesbank used interest rates and a tight monetary policy to contain domestic inflation, which in turn ensured a strong exchange rate. The mark remained high against the US dollar because of interest rates, but

[37] For an overview, see Hans Tietmeyer, "German monetary, economic and social union--two years later," *Auszüge aus Presseartikeln der Deutschen Bundesbank*, June 11, 1992.

solid against European currencies in its own right.[38] It was revalued 3.5% within the ERM in 1992 following interest rate increases by the Bundesbank.

Unit labor costs illustrate the impact of wages and payroll taxes on a nation's inflation rate, and identifies an incentive for cost-conscious employers to replace employees with machinery, thereby increasing unemployment. Unit labor costs refer to the cost of labor that businesses incur when producing a product. When unit labor costs do not grow, productivity remains constant. When unit labor costs grow, productivity deteriorates. Wage hikes in the east and payroll taxes across the country hurt national productivity in the first years after reunification and then leveled off after 1993.

Table 2.2 Productivity and Unit Labor Cost Growth: Change over Previous Year*

	1991	1992	1993	1994	1995	1996
Prod.	2.5	4.1	0.6	3.4	2.2	2.7
ULC	3.3	6.2	3.7	0.2	1.6	-0.2

Source: European Monetary Institute, *Convergence Report*. Frankfurt, 1996.
*Reunified Germany from 1992, old Federal Republic for 1991.

Structure

An economic profile illustrates which sectors of the economy are paying for the country's expenses, how productive those businesses are, whether they are becoming more competitive, and what kinds of bills they have to pay. Ideally, the country should produce enough income to pay for the expenses it incurs on an ongoing basis.

Reunification weakened the German economy in two ways. First, the economy of the former GDR was in such poor condition that it could not contribute to national productivity in a meaningful way. Many industries were closed after rehabilitation was

[38] For statistics, see International Monetary Fund, *Balance of Payments Yearbook*, Washington, D.C. 1998.

considered hopeless. As a result, unemployment rose and tax receipts remained low in the new states. About 70 per cent of this region's domestic product came in the form of income transferred by the federal government, compared with about 30 per cent in the West.[39]

Reunification also weakened western firms as government raised payroll taxes to help pay for investment and social assistance costs in the new states. Capital-intensive, large manufacturers were able to adapt by shedding workers, increasing the capital component of their German operations, and moving some operations abroad. Small and medium-sized businesses, particularly those that provided parts to larger firms, suffered heavy and permanent damage as their clients began purchasing components abroad. Unemployment skyrocketed in both types of industry beginning in 1993, leading to lower tax revenues and higher social assistance payments in the West.

The overall effect of reunification was a weaker and less diversified economy than had existed in 1990 in the eleven western states. What was left of Germany's economy had become more capital intensive. Those who remained at work became more productive, but increasing structural unemployment (unemployment lasting for more than a year) became an increasingly chronic burden on workers and business. For the government, these structural changes in the nation's industrial and labor markets resulted in a new income and expenditure pattern. The number of taxpayers declined, and the number of social assistance recipients increased, including unemployment insurance and pension recipients.

This change can be demonstrated by observing trends in economic activity, employment and productivity, for which figures are presented in Table 2.3, as well as in the appendix. The country produced less and less of its income from agriculture and manufacturing. The businesses that survived produced goods more efficiently. The drop in manufacturing production and employment reflects both the closure of many east German businesses, as well as dropping production in the West. Despite this decline, Germany continued to generate more GDP in this sector than many other European countries. The shift toward the service sector is particularly prominent in the new states. Private businesses

[39] "Für soziale Zwecke wurden 1992 mehr als 1 000 Mrd. DM ausgegeben." *Handelsblatt*, June 16,1993.

have dominated the increase in service sector growth.[40] The distribution of employment in primary, secondary and service industries followed the same trend as GDP, but employment itself declined from 1991 onward.

Table 2.3 Share of GDP and (Share of Employment) by Kind of Activity°

	1991	1992	1993	1994	1995
P*	1.4 (4.2)	1.3 (3.7)	1.2 (3.4)	1.1 (3.3)	1.1
S	37.7 (40.3)	36.3 (39.0)	34.2 (38.1)	33.9 (37.1)	33.5
T	57.7 (55.5)	59.3 (57.3)	61.5 (58.4)	61.4 (59.6)	62.1

Source: OECD, *National Accounts*, 1996; ILO Yearbook of Labour Statistics, 1995.
*P=Primary; S=Secondary (including mining, utilities); T=Tertiary (service) industry. Sectoral data omit import duties or non-deductible turnover taxes, which count as GDP, nor imputed bank service charges, which are deducted from the total figure. °Older, but more complete data than in appendix.

Productivity, measured as GDP per employed person, remained lower in the primary and secondary sectors than in the service industry.[41] The strongest improvement was in agriculture, followed by manufacturing and utilities, but were bought at the price of higher unemployment. Market services increased productivity at just above the average rate, while government services produced only modest gains. On balance, the capacity of the economy to generate wealth was improving, but not necessarily the capacity to generate income for individuals.

Table 2.4 Unemployment Rate, Germany*

1991	1992	1993	1994	1995	1996
5.7	7.7	8.9	9.6	9.4	10.4

Source: EMI, *Convergence Report*. Frankfurt, 1998. *Reunified Germany since 1992.

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[40] Data on employment by kind of activity are available from OECD *National Accounts*, Volume II. Paris, 1998.

[41] See appendix for figures, Table 2.9.

The unemployment rate and the participation rate have an important impact on government finances, since they largely determine the number of taxpayers in the economy, and the demand on public income transfers such as unemployment insurance. Table 2.4 shows that the German unemployment rate doubled as a result of reunification. Despite this, German participation rates, which reflect the portion of working-age residents who are employed or looking for work, were significantly higher in 1997 at 48.4 percent than in either France or Spain.[42]

The exchange rate[43] depends in part on the economy's position against the rest of the world. Reunification shook Germany's economic position against the rest of the world as strongly as it had the domestic economy. The current account illustrates a country's ability to pay for the goods and services it imports without taking on debts. A surplus indicates that the country is accumulating capital that can be used either for investment or consumption. A deficit indicates that the country is assuming debts to pay for imported goods and services. In addition to goods and services, money transfers to and from a country may take the form of non-investment payments to individuals from private or government sources, such as pensions or other forms of aid.

Before 1990, Germany relied on investment income and export surpluses to pay for services it imports.[44] With reunification, Germany's net income from exports dropped as goods were diverted into the German economy, and as more heavily taxed products became more difficult to sell in difficult markets. While Germany's gross investment income remained strong, it was unable to compensate for an increased withdrawal of foreign investment from the German economy after 1989, that turned into a hemorrhage after 1992. As these surpluses dwindled, the German demand for foreign services rose dramatically after

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[42] Figures by age and sex available from the International Labour Office (ILO) in the *Yearbook of Labour Statistics*. Paris, 1998.

[43] The deutsche mark was one of the exchange rate mechanism's stronger currencies. For parities against other participating currencies, see EMI *Convergence Report*. Frankfurt, 1998.

[44] This account follows from data published by the IMF in the *Balance of Payments Yearbook*, Washington D.C. 1998.

1989, particularly in the transportation, construction and business service sectors.

Table 2.5 **Current Account, Germany**, Billion US Dollars

	1991	1992	1993	1994	1995	1996
G*	19.44	28.20	41.19	50.47	65.11	71.21
S	-21.18	-30.68	-27.06	-39.69	-45.48	-43.54
I	21.69	17.99	13.28	6.83	-1.15	-5.12
T	-37.62	-34.66	-35.29	-38.99	-41.04	-36.34
Sum	-17.67	-19.14	-13.87	-20.94	-22.56	-13.78

Source: IMF, *Balance of Payments Statistics Yearbook*, 1998.
* G=goods; S=services; I=investment income; T=transfers.

Table 2.6 **Financial Account, Germany**, Billion US Dollars

	1991	1992	1993	1994	1995	1996
DI°	-19.61	-17.03	-13.21	-17.32	-25.43	-33.18
Out	(-23.72)	(-19.67)	(-15.26)	(-17.26)	(-38.84)	(-29.52)
In	(4.11)	(2.64)	(1.95)	(1.94)	(13.41)	(-2.66)
Port~	24.28	32.94	119.73	-30.29	33.92	58.25
Assets	(-17.96)	(-48.06)	(-32.66)	(-52.18)	(-23.08)	(-36.03)
Liab.	(42.24)	(80.00)	(152.39)	(21.89)	(57.00)	(94.28)
Total*	5.22	51.80	16.21	30.43	44.93	18.96

Source: IMF, *Balance of Payments Statistics Yearbook*, 1998.
°DI= direct investment (outward from and inward to Germany) ~ Portfolio investments (debt and equity securities as assets held abroad and liabilities to foreign investors). * Includes other investment (including bank sector), reserve assets and capital account. Positive figures reflect liabilities (foreign loans entering the national economy), while negative figures reflect assets (money loaned abroad).

A country's financial account reflects its foreign investment assets and liabilities. It illustrates a country's future capacity to draw on investment income, or its responsibility to pay back loans. Despite the fact that Germany remained a net exporter of direct investment, large government deficits from 1991 onward turned the country into a net importer of capital.[45] Overall, German direct investment abroad remained historically high over the study period while foreign investors stayed away. Germans were much more likely, however, to invest in portfolios (stocks, bonds, equities and other money market instruments), particularly after 1991. Particularly large government deficits in 1991, 1992 and 1993 managed to dwarf private investment abroad, a rare occurrence.

Being a net importer of capital is compatible with price stability if the borrowed money is invested in productive assets that can generate future income rather than current consumption. In accordance with the constitution, the German government directed a significant portion of the money borrowed into productive assets and infrastructure. Table 2.10 (see appendix) shows that investment grew significantly, but not as strongly as private consumption.

On balance, Germany's post-reunification economy was less uniformly capable of supporting strong, stable economic growth with high levels of employment than the West German economy had been for its population. Productivity increases throughout the 1990s demonstrate that the country was beginning to rebound economically. Meanwhile, rising and persistent unemployment levels meant that measures to control inflation had been bought at the cost of a dual labor market, which strained attempts to balance the national budget.

On the basis of national aggregates, it is difficult to see why the country's voters and government remained so strongly attached to balancing budgets and controlling inflation after reunification. However, the economic picture contrasts starkly between west and east, with continuing relative strength of employment and economic activity in the west, and weakness in the east.

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[45] Ibid.

2.2 Society: Business, Labor and Voter Interests

Societal pressure can refer either to relatively privileged access to and influence over the policy-making process, or to public opinion and electoral pressure that political parties consider when forming and carrying out policy decisions. In the realm of economic and EMU policy, the former refer to business and organized labor groups, while the latter refer to voters, and from time to time, specific constituencies. The relative influence of interest groups versus that of voter opinion is of crucial importance to deciding government policy on EMU and related economic policies. This section presents those concerns, which set the background for section four, which deals with how the parties managed them. We are also looking for evidence that societal actors are likely to prefer stability and a stability-oriented monetary union more strongly if they are situated in highly-competitive, capital intensive industries complemented by strong financial income interests.

Three observations about business positions on economic policy and the European Central Bank stand out. First, the business community was too concerned with the economic challenge of reunification to pay much attention to EMU during the first half of the 1990s.

The German Chamber of Industry and Commerce (Deutscher Industrie- und Handelstag, or DIHT), which represents the nation's large, capital-intensive, export-oriented industries, persistently pressed the government after 1991 to reduce taxes and social insurance premiums as an incentive for job creation and economic recovery. The DIHT stressed that the higher cost of labor after 1991 had led German employers to lay off workers, invest in more capital-intensive production methods, and to move more of their operations abroad. This hurt workers in the west and prevented economic recovery in the east. It suggested that the tax cuts would allow firms to hire more employees, leading to higher tax revenues for government. Meanwhile the government would spend less on unemployment insurance and early government pensions. In addition, the DIHT demanded that the government reduce the deficit, so that future tax increases could be ruled out, and so that the value of the mark would be ensured.

The force of the DIHT's demands was redoubled as its members continued to lay off workers as they restructured their German operations. As late as 1996, when unemployment was nearing an unprecedented four million, the DIHT revealed that 28% of its members were planning to move even more of their operations out of the country, following the example of Daimler Benz, Gründig, and BMW. The DIHT also pointed out to government that these increased costs were deterring foreign companies from investing in the country.[46]

In addition to advocating lower payroll taxes, the DIHT supported the Bundesbank's tight monetary policy as a balancing force against the government. Unlike the central bank, which began to loosen the money supply toward the end of 1992, and the banking community, which shared the Bundesbank's view that inflation was less of a danger from that point onward, the DIHT preferred high interest rates and a tight money supply in order to rule out inflation, regardless of the effect on growth and employment.[47] It remained the more skeptical than the entire banking industry about the effect on inflation when the Bundesbank began lowering interest rates until autumn 1995.[48]

The Federation of German Industry (Bundesverband deutscher Industrie, or BDI) represents small and medium-sized businesses, particularly those that manufacture components for larger exporters, and that compete with imports in this market. It supported the DIHT's call for a rollback of payroll taxes, and pushed government even harder to cut social programs in order to balance the budget.[49] Its greater zeal can be attributed to the fact that its members were less able to adjust to tax hikes by shifting production abroad. Another factor that falls into consideration, however, is that a large percentage of German small and

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[46] Some of the policy impact was reduced by the expectation that tax reductions would not bring back jobs that had been sacrificed to new technology and foreign outsourcing. The Kiel Institute for World Economics and the Bundesbank conducted studies demonstrating that German firms were in fact adopting structures similar to those found in Japan, the US and other West European countries. See Dietmar Petersen, "Die Zeit der Bestandsgarantien für Standorte ist vorbei," *Handelsblatt*, January 6, 1997.

[47] "Neues Geldmengenziel wird der Lage gerecht," *Börsen-Zeitung*, December 11, 1992.

[48] "ZBR setzt Stabilitätsorientierte Politik fort," April 3, 1995 and "Zinsen: Reaktionen der Spitzenverbände," August 28, 1995 *Auszüge aus Presseartikeln der Deutschen Bundesbank*.

[49] "Henkel: Weitere soziale Einschnitte unvermeidbar," *Frankfurter Allgemeine Zeitung*, September 21, 1996.

medium-sized enterprises (SMEs) are linked to their larger counterparts through cross-holdings that give the latter decisive influence over company policy.[50]

The BDI and the DIHT were at odds, however, on whether Germany's eroding economic situation could be remedied by a devaluation of the mark, or whether only changes to domestic economic practices (i.e. tax and wage policies) could restore the country's economic competitiveness. The BDI argued in 1996 that the high exchange rate was responsible for two-thirds of Germany's lost competitiveness since reunification. Since its members' best export markets (in Asia) reacted sensitively to prices, it preferred a lower exchange rate for the mark, and for the euro. These additional claims put the BDI in closer company with the IG Metall union, which promoted the same exchange rate policy, than the DIHT, which attacked the BDI for softening its line on the domestic economic policies of the government.[51]

The cross-sectoral Federation of German Employer Associations (Bundesvereinigung der Deutschen Arbeitgeberverbände, or BDA) emphasized the business community's overwhelming preoccupation with payroll taxes and business costs. The BDA was concerned with monetary union to the extent that it influenced these two factors. It not only fought for lower payroll taxes, but pushed for employers to have more say in setting work schedules and pay rates. Without these changes, the BDA argued that German industry would continue to lose competitiveness and workers would remain unemployed.[52]

These examples demonstrate that peak organizations that might have otherwise assumed opposing economic policy preferences showed clear and surprising unity on their policy focus and position. All these organizations pleaded for the elimination of payroll tax

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[50] For a survey of the relationships between SMEs and large businesses in Baden-Württemberg, one of Germany's most productive industrial provinces, see Gary Herrigel, "Large Firms, Small Firms and the Governance of Flexible Specialization: The Case of Baden-Württemberg and Socialized Risk," in Bruce Kogut, *Country Competitiveness: Technology and the Organizing of Work*. Oxford University Press, 1993, p. 15-35.

[51] "BDI-Argumente sind schädlich," *Handelsblatt*, July 8, 1996.

[52] Hundt, Dieter, "Warnung vor der Transferunion," *Handelsblatt*, December 31, 1996. Hundt is the President of the BDA.

increases that had affected them both. Government, however, remained unresponsive.

Second, business lobbying directly on EMU came after the terms of EMU had been set, and focused on whether Germany should participate. While all sectors supported the establishment of a hard currency monetary union as a first choice, business split into two groups on how to respond if some potential participants in monetary union did not meet the criteria.

With the ECB's independence secured in the Maastricht Treaty, the DIHT lobbied the government to resist any alteration that could challenge the bank's stability-oriented mission. As a result, the DIHT argued that membership should be limited to a hard core of countries that met the entrance criteria set down in the Maastricht Treaty. These countries' economies and voters would adapt best to a monetary union focused on price stability. They would also set a good example for other countries making progress toward meeting the criteria, but which had not yet achieved them.[53]

The DIHT also rejected arguments that the future common currency should be devalued to boost economic growth through the trade income of member states. It also warned politicians against selling monetary union as the solution to high unemployment and stagnant growth, although politicians had not attempted to do so. DIHT president Dieter Hundt called on government to resist (domestic French) pressure by the end of 1996 to devalue the euro against the dollar, since it would divert attention from necessary domestic economic reforms to promote growth and employment while locking in price stability. He emphasized that income and payroll taxes, not the exchange rate, were causing stagnant growth by widening the gap between what employers pay for labor and what workers receive, and called on monetary union's supporters in government to overhaul the tax system before promoting a weaker European currency. In return, the DIHT offered the brighter employment prospects. It maintained that countries with a stabler monetary policy had better long-term employment patterns. Its studies claimed that businesses that had experienced short term gains from devaluation of the national currency soon lost them as domestic prices

[53] Stihl, Hans-Peter, "Wirtschaft plädiert für Stabilität." *Handelsblatt*, December 31, 1996. Stihl is the President of the DIHT.

rose to destroy the advantage.[54]

Among exporters, however, splits developed in the run-up to EMU membership. The CEOs of Daimler Benz, Siemens and BMW all expressed concern that a delay in switching to the euro would cause the mark to appreciate and hurt their exports. All of the advantages they had gained by improving productivity would be lost (Bernd Pietschrieder, BMW), and the pressure on costs could lead firms to move even more jobs abroad (Jürgen Schrempp, Daimler Benz) While all three supported a stable euro, Heinrich von Pierer of Siemens was the only one to insist on prior convergence, and support automatic punishments for governments that borrow more than 3% of GDP in a fiscal year. He also pointed out that once the euro was in place, government spending policy would have a greater impact on the competitiveness of national firms. In particular, consumption policy, lower business taxes and non-wage labor costs would become key elements of national competitiveness and would have to be kept to a minimum.[55]

The BDA expressed concern that the Stability Pact would not force governments to respect the fiscal rules of the Maastricht Treaty after the euro had been introduced and pushed for measures that would tighten control of national budgets and restrict membership even further. It wanted the German government to press for each member of the future monetary union to conclude an internal stability pact between levels of government that would prohibit government borrowing in excess of the convergence criteria. It also considered stability to be more important than a larger membership. Still, simple membership criteria would not be enough to satisfy the organization.[56]

In contrast, the BDI took a tactical approach to EMU. The BDI feared that a delay of monetary union would cause the mark to appreciate and hurt its members' exports. BDI President Hans-Olaf Henkel was particularly worried that the successful anti-inflation

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[54] Ibid.

[55] "Umfrage: Wann kommt der Euro--welche Länder sind dabei?" *Handelsblatt*, December 31, 1996.

[56] Hundt, Dieter. "Warnung vor der Transferunion." *Handelsblatt*, December 31, 1996.

policies of other European governments would amplify their competitive gains against German exports if the mark appreciated. Furthermore, he expected not only that imports would flow from other countries, but that German investment capital would flow outward as well. He estimated that currency appreciation had caused two thirds of Germany's labor unit cost deterioration since 1989. In contrast to the bleak scenario of a delayed monetary union, Henkel claimed that an early start would ensure that small and medium sized firms supplying parts to larger companies could continue to do so competitively. The BDI would even support a small group of initial members, since it would set a precedent for others to eventually follow. Henkel emphasized that this was a second best strategy, and that a two speed monetary union was preferable to weakening the entrance criteria for membership.[57]

The Federation of German Wholesalers and Exporters (Bundesverband Groß- und Außenhändler,or BGA), also preferred a timely introduction of monetary union to delay. Another currency appreciation would have hurt its membership. At the same time, it demanded deep budget cuts at home and supported deficit restrictions that were far more constraining than those contained in the TEU, even supporting subsidy cuts to make this happen. The answer, however, seems to lie in the effect that monetary union would have on trade patterns within euroland. Like the big automotive and electronics firms, they expected the single currency to reduce price differentials across Europe, which in turn would give an advantage to countries that could contain tax rates.[58] The BGA was looking ahead to the increased importance of price competition within EMU.

Germany's large banks, in contrast to the BDI and BGA, consistently favored strategies that would ensure the value of the mark. In April 1991, the Dresdner Bank was already expressing support for a two-speed EMU rather than a broad membership. Anticipating that some countries would not meet the criteria, it believed that a hard core of stability-oriented members would have a lasting disciplinary effect on other countries with

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[57] Henkel, Hans-Olaf. "Der Wettbewerb wird noch härter werden." *Handelsblatt*, December 31, 1996. Henkel is the President of the BDI.

[58] "Außenhandel fordert das nächste Sparpaket." *Süddeutsche Zeitung*, September 18, 1996.

less impressive economic records.[59] Just as important, however, was the length of the transition period in 2002, during which banks would have to deal both in euros and marks. Martin Kohlhaussen, speaking for Commerzbank, criticized the transition period during which both national currencies and the euro would circulate on account of the costs it would impose on banks.[60]

After EU governments had signed an agreement to limit deficit spending at the end of 1996, representatives of the nation's smaller banks began commenting on the government's plans for monetary union, underlining the importance of EMU guaranteeing stability for small savers and investors. Moreover, they specifically desired a small membership that posed the smallest risk to inflation, and even more certain sanctions against deficit spending members of EMU than those agreed to at the 1996 Dublin summit.[61]

Service industries, including retailers, focused squarely on the transition period from the mark to the euro as the most important impact on their revenues, rather than its stability, or on the structure of the ECB or the terms of membership. The DIHT's forum for business on the modalities of introducing the euro revealed that businesses were either concerned about the increased cost of doing business with two currencies for six months in 2002, or with the effect that translating costs into euros would have on prices as consumers expected prices to be rounded (downward).[62]

Third, as sections 2.3 and 2.4 demonstrate, government met some business demands, but it was focused on independent domestic and foreign policies, leaving most groups

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[59] Röller, Wolfgang, "Die Währungsintegration eines kleines kerns," *Frankfurter Allgemeine Zeitung*, April 5, 1991.

[60] "Umfrage: Wann kommt der Euro--welche Länder sind dabei?" *Handelsblatt*, December 31, 1996.

[61] Both Michael Heitmüller of the Federation of German Savings and Chequing Banks and Wolfgang Grüger of the Federal Association of German Popular Banks and Raiffeisenbanks underlined the importance of maintaining public confidence in the stability-enhancing terms of monetary union. See "Umfrage: Wann kommt der Euro-welche Länder sind dabei?" *Handelsblatt*, December 31, 1996.

[62] "Counting cost of paying in euros," *Financial Times*, December 10, 1996.

dissatisfied. It placed a balanced budget in front of lower payroll taxes, though the latter was clearly more important to most business owners. Instead, it attempted to help employers roll back other wage-related costs like sick pay. Therefore, there is no reason to argue that business has had a decisive influence on monetary policy or government policy toward the European Central Bank, either on its creation, or on what terms. Nevertheless, the government's policy of strict adherence to the Maastricht criteria for potential members, a system of semiautomatic punishments for future deficit spenders, and a strong defense against attempts to attack the independence of the ECB reflected most business sector wishes. Still, business tended to avoid the EMU debate until it was forced upon them by the increasing likelihood that it would actually take place. By then, however, in 1997, all of the decisions to be taken in EMU had been taken, with the exception of membership and the choice of the ECB's president.

Labor

Organized labor in Germany is represented collectively by the German Union Federation (Deutscher Gewerkshaftsbund, or DGB). Like business, the DGB was too concerned with the impact of reunification to pay much attention to monetary union, except where their requirements of EMU membership came into conflict with their goals. Its economic policy focused on defending wages and social insurance entitlements that the Kohl government had targeted for reduction in the wake of reunification. The DGB and its member unions concentrated on fighting cutbacks in pensions, sick pay and wages that were designed to pay for reunification, directly or indirectly.

Its response to the proposed central bank and to the entrance criteria was twofold. It led a campaign to protest government spending cuts intended to prepare Germany for entrance into the final stage of Economic and Monetary Union. In addition to strikes and demonstrations, the DGB placed considerable pressure on the Social Democrats to resist the Kohl government's austerity program. This secondary tactic proved the least fruitful through 1996, as the federal SPD lacked control of parliament, and as state SPD governments embarked on austerity programs similar to those of the federal Christian Democrats. The DGB's only concrete, but impressive, success was to prevent employers from taking advantage of changes to federal sick pay legislation passed in 1996. Between 1996 and 1998, however, SPD obstruction of federal government savings proposals took the effect that the DGB desired, preventing some of the more drastic cuts which the Christian Democrats had planned.

The DGB's delegates often opposed cuts in the welfare state more fiercely than the leadership itself. As early as 1993, DGB leadership had already endorsed a plan to protect social benefits for workers with stable jobs while loosening protection for other Germans as a way of controlling the cost of payroll taxes.[63] The DGB's delegates gave the union a new policy platform at its 1996 Dresden congress. They opted for total opposition to the government's budget balancing efforts rather than proposing an alternative means of reducing the country's borrowing needs. They demanded not only the maintenance but the expansion of the welfare state. The delegates also rejected an attempt by the DGB's policy committee to develop a formula saying when the financial limits of the social state had been reached.[64]

Next to supporting social spending as an imperative of moral conduct, the DGB championed the position that government social spending provided the best support for economic growth, and consequently, blamed poor growth on government cutbacks.[65] In conjunction with the German Salaried Workers Union (Deutsche Angestelltengewerkschaft, or DAG),[66] it led protests in June 1996 against cuts to unemployment insurance, pensions and

[63] "Gewerkschaften sehen Spielraum für Ausbau des Sozialstaates," *Frankfurter Rundschau*, May 7, 1993.

[64] "DGB versteht sich als Verteidiger des Sozialstaats," *Frankfurter Rundschau*, November 18, 1996.

[65] *Handelsblatt*, December 6, 1996.

[66] Deutsche Angestelltengewerkschaft

health insurance and claimed that 250,000 participated country-wide.[67] These appeals had no meaningful influence on the Kohl government's determination to cut spending.

By the end of 1996, the DGB had again adopted a proposal calling for the government to end the practice of paying for non-contributory pensions with pension premiums (see section on pensions below). This measure was designed to protect pension entitlements for the core of the labor force (and the core of its membership), while reducing its tax burden by up to three percentage points.[68] While the DGB continued to support high social spending that would continue to pay for non-insurance pensions, the shift in policy committed the union confederation to serving the core of the labor force at the expense of the underemployed, the disabled, and working mothers.

Unions also vigorously opposed calls from business and the FDP to allow greater wage flexibility between firms and industries that businesses demanded to control wage costs and inflation. IG Chemie president Hubertus Schmoldt demanded full legal protection for the wage-setting authority of peak union organizations in Germany. Without this precondition, he would oppose union participation in a proposed tripartite talks on stimulating economic growth.[69]

Having had no visible effect on government social and budgetary policy, the DGB kept up pressure on the SPD and Alliance 90/Green parties to support their cause at the federal and state levels. They demanded that SPD state governments retaliate against the federal government by obstructing budget negotiations, since they had veto power in the Bundesrat.[70] While the Alliance 90/Greens refused, state governments responded with opposition against government plans for drastic tax reductions, but not against modest

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67 "Erneut Proteste gegen Sparpaket." *Handelsblatt*. June 28, 1996.

68 "Streit um Senkung des Rentenniveaus." *Handelsblatt*. January 29, 1997.

69 "Hände weg vom Tarifgesetz." *Handelsblatt*. January 3, 1997.

70 "Nun werden SPD und Grüne stärker in die Pflicht genommen." *Frankfurter Rundschau*. September 14, 1996.

modifications to the nation's social security net.[71]

Toward 1996, the DGB feared that exports and jobs would suffer if EMU were delayed and the mark appreciated. It used this argument to attack the Kohl government's determination in 1996 to negotiate a Stability Pact of budgetary rules for EMU members that was expected to keep the number of participants small. Instead, DGB Chairman Dieter Schulte promoted as wide a membership as possible for the European Central Bank, though he recognized that EU governments would have to set aside the entrance criteria in order to do so.[72]

Schulte advocated instead of budget criteria a focus on exchange rate stability, followed by price stability, and harmonized interest rate levels. Exchange rate stability, he argued, would demonstrate an ability to deal with economic shocks internally. Cuts designed to meet the entrance criteria, in contrast, would spark recession, lower government tax revenues, higher social security payments and higher deficits. Instead, Schulte supported EMS II to stabilize exchange rates, and he pleaded for a European employment and growth policy to stand alongside the stability pact. He also questioned why Germany was pushing the stability pact so strongly when it couldn't meet the criteria itself.[73]

At the same time, one of the DGB's largest members, IG Metall, called for a lower exchange rate to promote growth. This call was explicitly represented as an alternative to wage restraint. The union complained that wage restraints in the past had brought union members nothing, and that they would not continue to restrain their demands.[74]

In sum, on the one hand, the DGB was like business in focusing late on EMU, when most issues, except membership, and the final go-ahead had been decided. It was more

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[71] Schulte also expected that currency markets would lead to an overappreciation, which would destroy jobs before it was corrected. Since two thirds of German exports were sold to other EU countries, the exporting sector would be hard hit. See Dieter Schulte, "Währungsunion nicht verschieben," *Handelsblatt*, December 31, 1996.

[72] Ibid.

[73] Ibid.

[74] "Rolle Rückwärts im Arbeitgeberlager," *Handelsblatt*, July 11, 1996.

concerned with the effects of reunification on social benefits, employment and union power in general. On the other hand, the DGB had a more unified voice for labor, which in contrast to business, was explicitly organized on a cross-sectoral basis. They successfully resisted business pressure to separate their bargaining terms by sector as an attack on their overall bargaining power, and retained their capacity to resist cuts to sick pay and wages that business had been demanding within the government's economic policy framework.

Voters

The German economy started to feel the effects of Bundesbank restraints on the economy in 1991, so it will be interesting to know how people saw the downturn. Particularly important is the "jobless recovery" of 1994, which hit the new states in the east harder than the old federal republic. With these figures, we should get an impression of how much demand there might be for government to take a more aggressive approach to combating joblessness and economic stagnation. Did the public blame the government, and did the recession have an impact on the public's attitude toward EMU?

After 1991, Germans lost confidence that their financial situation would improve from year to year.[75] Some pared down their expectations to maintaining the status quo, and even more began to believe that they would be worse off. They also believed that their job prospects had little hope of improving. Despite these trends, Germans generally expected to have better job and financial prospects than the country at large. Germans were also concerned about their own finances more than their own jobs.

East Germans tended to be more optimistic than west Germans about their personal finances through 1994, though they also tended to be more polarized as a group than their western counterparts. Unlike westerners they saw a relationship between their job prospects

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[75] This information is based on survey data from Eurostat's Eurobarometer Surveys 36, 38, 40, 42, 44 and 46, which were taken between 1991 and 1996, and presented in Table 2.14 through Table 2.19, for both West and East Germany, in the appendix.

and their financial prospects through 1994. From 1995, however, easterners had fully adopted the western opinion pattern of strong pessimism about job and financial prospects for the country at large, milder pessimism about their own prospects, and a tendency to evaluate personal financial prospects more pessimistically than job prospects. Overall, eastern confidence in the health of the German economy evaporated after 1991, and remained strongly pessimistic through 1996, as did confidence in the west. Easterners also had less hope of holding or keeping a job than did Germans living in the west of the country.

Two aspects of German attitudes toward EMU and the ECB are particularly interesting. The first, as the tables below demonstrate, is that Germans had confidence in the central bank as it had been constituted, since it had been modeled on the Bundesbank, but not in the currency it was supposed to manage. This reflects the widespread German fear that the ECB could come under pressure from national governments with weak economic growth to reflate the European economy, at the expense of the currency's value. Another aspect this divergent pattern reflects, though less strongly, was the growing German conviction as the 1997 deadline for meeting the convergence criteria approached that the country simply needed more time to work through the effects of reunification before entering EMU. This was a repeated theme of the unofficial SPD chancellor candidate, Gerhard Schröder, as early as 1996.

Table 2.7 European Central Bank: German Support / Opposition

	1991	**1992**	**1993**	**1994**
Germany	55 / 23	51 / 33	56 / 33	63 / 30
. West	--	51 / 34	56 / 33	63 / 30
. East	--	54 / 29	59 / 31	63 / 28

Source: Eurostat, *Eurobarometer* 36, 38, 40, 42.

Table 2.8 Single Currency: German Support / Opposition

	1991	1992	1993	1994	1995	1996
Germany	45 / 32	38 / 48	32 / 58	34 / 45	34 / 45	38 / 50
. West	--	37 / 49	31 / 58	34 / 44	34 / 44	39 / 49
. East	--	41 / 45	34 / 58	34 / 47	34 / 47	34 / 51

Source: Eurostat, *Eurobarometer* 36, 38, 40, 42, 44, 46.

In the spring of 1998, when members were being chosen for EMU, and after the Kohl government had taken measures to reassure voters that monetary union would be stability-oriented (see Section 2.4 and Chapter 5), German voters moved to support the single currency, with 51 percent in favor and only 34 percent against.[76] This put approval far behind approval of French and Spanish voters, but represented a striking turnabout in the last year in the run-up to launch EMU. Overall, these figures show that concerns about the effect of monetary union on the national economy had alleviated by early 1998.

2.3 Institutions: Spending Commitments and the Central Bank

Spending Commitments

Germany's most important social spending institutions--old age pensions, health insurance, and unemployment insurance--are funded principally by premiums rather than general tax revenues. Since the premiums that employers and employees pay into the funds can be adjusted regularly to meet insurance liabilities, these institutions have a built-in mechanism for covering commitments that can protect the government from pressure to

[76] Eurostat, *Eurobarometer Survey 49* (Spring 1998). Brussels, 1998, p. 45.

borrow money over long periods of time to fund these projects. In contrast, if government so wishes, it can capitalize on the relatively rapid increase in payroll taxes to generate support for spending cuts. As a consequence, social institutions should have only a limited capacity to create a structural budget deficit. However, government is responsible for setting premiums, entitlement criteria, and for topping up the funds when premiums are insufficient to cover liabilities. Thus, the mechanism only promotes spending adjustments when combined with a political commitment to do so.

After reunification, the Kohl government paid for increased claims on pension and unemployment insurance with a series of payroll tax increases, supplemented with money from general tax revenues to cover shortfalls that proved difficult to contain. The political importance of the funding mechanism was underlined by the government's attachment to it despite evidence that it was exacerbating unemployment and funding shortfalls. Many SMEs reacted to premium hikes by going out of business, while larger companies replaced a portion of their workforces with machinery or replaced them with cheaper labor abroad. As a result of its lasting impact on the federal budget, social spending became the focal point of conflict between the majority in favor of stability, and the minority in favor of continued social transfers, particularly from 1994 onward, when cuts set in.

Instead of addressing the connection between premiums and unemployment, the Kohl government attempted to reduce the budget deficit by *extending* the principle of premium-based social insurance to increase revenues, while restricting access to benefits from social insurance funds. In 1996, the government tabled a plan to introduce home care insurance for the infirm, which had been placing an increasing burden on the government's welfare budget. It cut the duration and value of unemployment insurance benefits, raised the age at which workers could retire with a full pension, and cut back some eligible health insurance services to prevent premiums from rising quickly. The overall purpose of these changes was to reduce the spending of social insurance institutions so that injections of money from general tax revenues could be reduced. The government expected that this would ease pressure on the deficit, and eventually, stabilize the payroll taxes which paid the premiums.

Despite some progress in containing the cost of social insurance, government tax revenues were still financing a substantial share of payouts by the end of 1996. Table 2.17 shows the cost of transfers to the social security funds up to 1996. High and rising unemployment kept payouts of unemployment insurance and pensions high, while health insurance and an aging population kept pension and health insurance costs high. The government also did not attempt to charge unemployment or pension insurance premiums to the nation's public servants, who do not pay into the regular plans, and whose pension benefits are paid out of general tax revenues.

Table 2.9 General Revenue Transfers as Social Security Receipts, Million DM

1991	1992	1993	1994	1995	1996
74,110	80,600	100,200	94,780	95,360	107,110

Source: OECD, *National Accounts*, Volume II, Table 6.4. Paris, 1998.

Pension Insurance

The core of Germany's public pension system is a premium-based insurance plan that uses incoming premiums from employers, employees and the self-employed to cover the cost of current pensions. In addition, the government calculates premium credits for a variety of groups considered too poor to contribute to the system. Students and new mothers, for example, are exempted from premiums without any reduction in the value of the pension they will later receive. These non-contributory pension credits are paid for through the premiums of other contributors, but also by top-ups from the federal budget. Due to the large number of 'social,' or non-contributory benefits available to Germans, the country's pension system imposes more spending on government than any other single program.[77]

[77] See, for example, "Für soziale Zwecke wurden 1992 mehr als 1.000 DM ausgegeben," *Handelsblatt*, June 16, 1993 and "Etat für 1997 sinkt auf 440 Milliarden Mark," *Die Welt*, July 9, 1996.

Three main challenges confronted the German pension system during the Kohl administration. As in many developed countries, Germany's aging population threatened to bankrupt the pay-as-you-go system in the medium term. More immediately, Eastern pension entitlements grew much more quickly than either regional or national wage rates. Third, and most relevant--unemployment after 1992 hurt the solvency of the pension fund by reducing the number of contributors country-wide and by driving large numbers of older workers into early retirement. Together, these factors drove pension entitlements, payroll taxes (premiums) and budget expenditures rapidly upward. After 1992, exploding costs hindered the finance ministry's need to control expenditures in preparation for the third stage of monetary union.

The balance of payments in the pension fund deteriorated as the federal government made uniform access to social benefits an issue of national unity.[78] According to the terms of the Treaty on Unification of 1990, pension entitlements from the GDR were credited in the West German pension system. Shortly after reunification, the fairly low initial cost of the pensions (relative to Western pensions) began to rise as the government sought to equalize conditions in east and west. The low initial costs reflected low wages in the GDR. However, the government instituted significant pension increases twice per year in the East (see table). Retired East Germans also had accumulated more pension credits than the average West German, due to a longer average work life (earlier labor force entry and retirement at age 65).

From 1991, the government also made special pensions available to unemployed workers in East Germany over the age of 55 that would support them until they became eligible for the standard old age pension at age 60. This was considered a temporary measure, and was eventually extended to easterners reaching 55 by June 30, 1992 as a means of capping unemployment.[79]

After 1992, the number of unemployed Germans taking an early pension increased

[78] "Blüm kämpft weiter für die Pflegeversicherung." *Süddeutsche Zeitung*, January 25, 1991.

[79] "Neues im Sozialrecht." *Frankfurter Rundschau*, December 28, 1991.

drastically. Government responded with an offer of partial rents from the age of 58, based on a forfeit of 3.6% per early year of retirement.[80]

The pension system responded slowly to the medium-term demographic challenge. In 1991, Germans could retire on a full pension at age 65 (men) or 60 (women). Unemployed Germans 60 years and older were entitled to early retirement benefits as an alternative to unemployment insurance.[81] Pensions were indexed to the growth of net wages in the workforce, on a regional basis. This formula, adopted in 1989, made it possible that pensions could shrink if payroll taxes, for example, ate into workers wages.[82]

Throughout the Kohl administration, the government trimmed pension spending on the periphery, but left core entitlements intact. At the end of 1991, the government cut back its future pension liabilities with two measures. First, it placed a seven-year time limit on the period for which students, draftees and trainees would be credited with pension payments without having made any. It also tabled plans to raise the retirement age to 65 from 60 and 63, beginning in 2001.[83] The final changes were introduced far later, however, in summer 1996.[84]

Significantly, the pension fund and its premiums were designed to cover non-insurance expenditures, such as benefits for individuals who had not paid premiums, at least for some time. In 1996, the cost of these programs was about 120 billion DM per year, including the cost of special early retirement plans in the early 1990s for older victims of layoffs, who became more numerous as the recession continued.[85]

Workers and employers pay equal premiums into the country's unemployment

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[80] "Rente wird Nettoeinkommen weiter folgen," *Die Welt*, November 2, 1995.

[81] "Umstellung der Ost-Renten kostet Milliarden," *Frankfurter Rundschau*, February 8, 1991.

[82] Blüm, Norbert, "Alt und jung sitzen in einem Boot," *Das Parlament*, February 9, 1996.

[83] "In ganz Deutschland gilt seit dem 1. Januar ein einheitliches Rentenrecht," *Handelsblatt*, January 6, 1992

[84] "Rentenspargesetz beschlossen," *Das Parlament*, July 12, 1996.

[85] "Bergwacht in Not," *Der Spiegel*, February 5, 1996.

insurance fund. In return, claimants are entitled to a pay-related benefit and a secondary entitlement that provides more modest coverage once the core entitlement expires. The government sets premiums, but the administering agency independently assesses what premiums must be levied in order for the fund to break even without government top-ups. The public insurance provider helps to keep the fund solvent and to justify rate increases by making the link between premiums and benefits as clear as possible.

The unemployment insurance fund also pays for passive and active labor market programs that constitute about 25% of its payments.[86] Premiums pay for training programs, as well as partial benefits to workers who are employed part time as an alternative to being dismissed. As unemployment rose during the 1990s, premiums rose dramatically and sparked a fight over whether insurance premiums should continue to pay for non-insurance programs.

Conservatives defended the practice as a means of containing the cost of unemployment on the federal budget. They tried to direct outrage over higher premiums into support for lower benefits for the insured. Social welfare advocates, in contrast, demanded that the government leave insurance coverage intact, and reduce premiums by paying for labor market programs with general revenues. The finance minister, supported by the government's conservatives, successfully fought off a campaign led by the labor minister to pay for labor market programs through general revenues. By 1996, the two groups reached a compromise. The labor ministry reduced unemployment insurance benefits marginally and continued to pay for labor market programs, but gained an increase in the national value added tax to pay for them.

Premiums could not pay for both insurance claims and labor market programs, despite a 58 percent increase in premiums that the finance minister had demanded in 1991.[87] Tax revenues topped up the insurance fund throughout the 1990s. This fact empowered the finance minister to press for spending cuts to unemployment insurance. Early efforts focused

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86 1995 figures. See "Umschulung aus Steuern finanzieren," *Süddeutsche Zeitung*, July 13, 1996.

87 "Beitrag zur Arbeitslosenversicherung wird angehoben," *Handelsblatt*, January 11, 1991.

on fighting abuse. In 1994, it cut the ability of older workers to collect unemployment insurance until they became eligible for a full pension.[88]

Other savings measures adjusted the compensation formula rather than touching eligibility itself. The government attempted, and sometimes succeeded in delaying or reducing individual benefits to account for other sources of income, or savings.[89] In addition, it attempted to cut down on eligibility periods. In 1994, it introduced a 12 week ineligibility period for workers who quit their jobs.[90] The government also introduced time limits to entitlements to secondary unemployment insurance for the first time.[91] Further savings were attempted by subjecting benefits to income tax surcharges and home care insurance premiums.[92]

In 1996,the labor minister cut the core entitlement by three per cent per year in the attempt to realize a structural change in the fund's capacity to pay for itself through premiums.[93] He rebuffed criticism against the cuts from within his own party's Social Committee by noting that social spending kept growing in defiance of his efforts to control

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[88] "Bei Frühverrentung kürzerer Bezug von Arbeitslosengeld," *Handelsblatt*, December 23, 1994.

[89] In 1992, the government reduced benefits for claimants with a common law spouse, though not for married claimants, to reflect the partner's income. See "Wer nicht heiraten will, muß büßen," *Tageszeitung*, June 24, 1992. In 1995, the same principle was extended to life partners in same sex relationships. See "Arbeitslose: Jetzt geht es ans Sparbuch," *Tageszeitung*, August 1, 1995. In 1994, the government attempted, unsuccessfully, to demand that claimants cash in their life insurance policies before being eligible. See 'Arbeitslose ohne Alterschutz," *Frankfurter Rundschau*, January 6, 1994.

[90] "Weniger Geld," *Handelsblatt*, December 9, 1994. The measure was struck down by the Federal Social Court, which set the maximum penalty period at two weeks. "Gericht kürzt Sperrzeiten," *Frankfurter Rundschau*, February 11, 1995.

[91] "Blüm verteidigt die Kürzung der Arbeitslosenhilfe," *Frankfurter Allgemeine Zeitung*, July 18, 1994 and "Waigel will die Arbeitslosenhilfe befristen," *Frankfurter Allgemeine Zeitung*, July 15, 1994.

[92] "Kürzung des Arbeitslosengeldes um Solidarzuschlag zulässig," *Handelsblatt*, August 4, 1995.

[93] "Arbeitslosenhilfe sinkt jährlich," *Handelsblatt*, February 12, 1996.

costs. He estimated that outlays had increased by 76.3 bn for pensioners, 40.3 bn for the unemployed, and 13.5 bn for war victims in the preceding years, of which 46.5 billion were related to reunification.[94]

The government also ensured that special unemployment insurance rules for the eastern states were short-lived. For the first year of reunification, the government made wage top-ups available to workers in eastern firms that adopted short work weeks, whether or not the firm saved jobs as it did so. After that time, the government made the funds conditional on firms saving jobs, as is customary in the west.[95] It also made special money available to ease the impact of unemployment for older workers, particularly in the east, and extended it through the end of 1992.[96]

Overall, the temporary rules to ease eastern unemployment and adjust the fund maintained the principle of premium-funded insurance, if not the reality. The formula helped the government to force entitlement cutbacks, but the government's economic conservatism was essential to making the principle of cutbacks a reality.

Health Insurance

German law requires residents to have health insurance, and more than 90 per cent are insured through public enterprises that operate on a not-for-profit basis. The responsibilities of the insurers are regulated by law, and services are funded principally by premiums linked to the salary of the insured. Nevertheless, government provides top-ups from general tax revenues that make health spending second only to pension spending in the government's social budget.

As in the unemployment and pension systems, health insurance premiums are

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[94] Ibid.

[95] "Neues im Sozialrecht," *Frankfurter Rundschau*, December 28, 1991. Originally available to a recipient for six months, the entitlement was extended to 15 months in 1992. "Kurzarbeitergeld für mehr als sechs Monate," *Frankfurter Allgemeine Zeitung*, March 23, 1992.

[96] "Der Bund hat kein Geld für eine gesetzliche Regelung," *Handelsblatt*, June 11, 1992.

recommended by the organization of independent public health providers according to costs, but set by the government. During the 1990s, debates over health insurance spending were prompted by rising premiums, which in turn were prompted by Germany's aging population. Unlike pensions and unemployment insurance, however, the state of the German economy placed little extra demand on the federal budget.

Health care spending generated a focus on payroll taxes in the same way that unemployment insurance and pension premiums had done. Again, the finance ministry focused on improving the state of the national budget, which meant two things. First, it wanted to prevent social insurance programs from making many demands on the national budget. Second, (and secondary in importance) it wanted to prevent social insurance premiums (that do not flow into general revenues) from crowding out income taxes (that do.) The finance ministry promoted more austere benefits as a means of keeping expenses and premiums down. The health ministry went along with promoting less generous benefits, but with much less vigor and success than in the other two cases, [97] resulting in persistent funding shortfalls.[98]

The government's most drastic move, and spectacular blunder, was to pass a law allowing employers and their health providers to pay only 80% of workers' wages when they were sick. This led to protracted conflict between unions and employers in 1995 and 1996, after which government and employers backed down, and premiums stayed up.

Overall, reunification-related increases in social spending commitments contributed heavily to Germany's uncharacterisitically high budget deficit after 1990. Existing pension, unemployment and health insurance benefits became available to the entire population of the reunified Germany without consideration for the lower per capita tax base available to pay

[97] The CSU wanted higher premiums, but were blocked by the CDU, and its employees' committee, the CDA. See "Schwerer Konflikt über Gesundheitsreform," *Frankfurter Allgemeine Zeitung*, February 22, 1997. On changing rules, "Fielder: Wir sollen für Seehofer die Drecksarbeit machen," *Handelsblatt*, January 9, 1997.

[98] "Krankenkasse trotzt Sparerfolgen mit Defizit im Milliardenhöhe," *Süddeutsche Zeitung*, June 6, 1997.

premiums. When the imbalance between benefits and revenues became clear the government responded first by protecting entitlements and raising payroll taxes. As businesses fired workers to contain the rising cost of labor, social insurance accounts worsened even further, and the cycle of premium increases and unemployment repeated itself. By 1997, unemployment had reached a record level in the Federal Republic's history, and kept pressure high on reforming spending commitments.

Thus, the premium system of paying for social spending commitments was useful for *initiating* a response to changes in payouts (and avoiding a budget deficit), but not necessarily for restoring balance in a manner that either government or voters would find acceptable. In particular, the premium system holds the danger of magnifying the negative impact of a strong blow to the national economy as described above. In order to avoid magnifying a negative shock, a premium system must be combined with either a political commitment to cut spending, or at least a temporary suspension of the link between payroll taxes and spending levels.

After premium increases failed to balance the accounts and the 1994 election was past, the Kohl government began to cut benefits. The strategy it employed was made possible by a core of voters who could benefit from a policy of stable prices and remain relatively unharmed by cuts to spending commitments. Where cuts were made across the board that affected them, as in pensions, the government balanced sacrifices between recipients and payers to minimize the political fallout, while stressing that the balance of premiums and payouts had to be restored if the deficit was to be contained. In this way, the premium-based system proved effective at justifying cutbacks to mainstream German voters.

Those on the periphery of the labor market, experiencing more frequent unemployment or underemployment, increasingly lost guarantees of entitlement to insurance benefits. Not only did they have more limited access to unemployment insurance in the short term, but the Kohl government increasingly differentiated between spending commitments that had been 'earned' through premiums, and 'unearned' benefits, particularly in pension insurance, that should be paid for out of general tax revenues rather than a guaranteed insurance benefit. This in turn meant that Germans on the periphery of the labor market would be more vulnerable to annual rounds of budget cutting over the long term as well than their counterparts with stable employment.

On balance, then, the German case shows that premium-funded spending commitments are capable of initiating adjustments that strive toward balancing the budget. At the same time, the pay-as-you-go system tends to exacerbate unemployment during deep recessions or other shocks which dramatically increase spending commitments through the social insurance system. Finally, the easiest political solution for the Kohl government, to adjust spending to the disadvantage of those on the periphery of the labor market, exacerbated the social consequences of the economic difficulties that followed reunification. While the Bundesbank's efforts to fight inflation led to a dramatic increase in the number of chronically unemployed and underemployed (see below), the Kohl government's adjustment of spending commitments hit precisely this group hardest.

The Bundesbank

During and after reunification, the Bundesbank fought to protect its independence from political control and its mission to promote price stability in the face of concerted attempts to weaken its influence. The Bundesbank's leadership focused its efforts in four areas after 1990: reforming its own institutional structure; promoting spending reform; controlling reunification-related inflation; and shaping the terms of EMU. The latter included the structure of the ECB, the conditions for membership, and a variety of institutional measures designed to ensure the stability of the new European currency.

Structural Reform

After reunification, the Bundesbank pushed the Kohl government to revise its structure. The proposal was designed to protect the bank's independence from attempts by state governments to undermine its mission to promote price stability. Federal law before reunification specified that each state in the federation have its own state central bank, and that each have a seat on the 16-member central bank council in Frankfurt. Immediately after reunification, the State Central Bank for Berlin assumed temporary responsibility for the new states.[99] Extending the one-state-one-bank principle would have led to a council of 23 members. More importantly, Social Democratic state governments were appointing political partisans to head their state central banks more frequently. If the new states followed suit, a majority of the central bank council could favor loosening the Bundesbank's traditional focus on price stability in favor of a more growth-friendly and inflation-tolerant monetary policy.

Instead of maintaining a central bank for each and every state, the Bundesbank proposed that eight regional banks represent the nation's various economic regions, much like US Federal Reserve Banks in the United States. The Bundesbank pointed out that eight instead of 16 regional bank governors would allow the Bundesbank Council to retain a manageable size.

The Bundesbank's plans for a geographical division of labor among regional banks increased the chances that conservative regions favorable to price stability would maintain the upper hand. The conservative strongholds of Bavaria and Baden-Wurttemberg would retain their own state banks, along with the Social Democratic stronghold of North-Rhine Westfalia. Brandenburg would be fused with Berlin, Schleswig-Holstein and Mecklenburg-Vorpommern with Hamburg, Saxony-Anhalt with Lower Saxony, and Saarland with Rhineland-Pfalz. The eastern, but conservative state of Saxony would also have its own bank.[100]

Social Democratic state governments fought the proposals most vigorously in favor of the one-state-one-bank principle, supported less fervently by governments in the eastern states. The Social Democratic stronghold of Rheinland-Pfalz led the opposition in the upper

[99] "Bundesbankstruktur weiter kontrovers," *Börsen-Zeitung*, January 3, 1991.

[100] "Pöhl-Modell gegen das Rheinland-Pfalz Modell," *Handelsblatt*, April 18, 1991.

house of the federal parliament.[101] Berlin's SPD finance minister Norbert Meisner linked the one-bank principle to the federal principle of government in Germany, and this linkage between political representation and monetary policy became the rallying point for opponents to the government's plans to restructure the Bundesbank according to the latter's wishes.[102]

After a long fight, the Kohl government pushed through the Bundesbank's restructuring plan with a minor modification: eight or nine regional banks would be established, and Thüringen and Sachsen would be given the option of forming a common regional bank. Once it was clear that Thüringen would not be locked into the more conservative circle of Hessen's Frankfurt-dominated regional bank, it dropped its opposition to the government's plans and deserted the Social Democratic camp.[103] SPD state governments complained bitterly that the government was deliberately attacking SPD influence over the government, and managed to impose a suspensive veto on the restructuring legislation, which the Bundestag subsequently overrode.[104]

The government's support of the Bundesbank's proposal for structural change ensured the primacy of the Bank's president over the bank council. This aided the

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101 Ibid.

102 "Bundesbankstruktur weiter kontrovers," *Börsen-Zeitung*, January 3, 1991.

103 For the terms of the original agreement, see "Statt elf nur noch neun Landeszentralbanken," *Handelsblatt*, June 5, 1992.

104 Bremen mayor Klaus Wedemeier justified the Bundesrat's suspensive veto on the government's restructuring legislation as a means of fighting for political control over the Bundesbank's management of the economy. See "Der Bundesrat erhebt Einspruch," *Süddeutsche Zeitung*, June 6, 1992. The most notable fight between the Bundesbank and a state SPD government over the leadership of a state central bank had begun a year earlier in the state of Saarland. There, Premier Oskar Lafontaine insisted on appointing a party loyalist whose credentials were in question to the head of the state central bank, while the Bundesbank refused to accept the appointee. See "Eklat zwischen Bundesbank und Lafontaine," *Süddeutsche Zeitung*, April 6, 1991. Edgar Meister, the SPD Premier of Rhineland-Pfalz, underlined the determination to retain political influence when he offered the government to agree to 12 regional banks, but retain a vote for each state on the Bundesbank council. The government rejected this plan, which would have not only have neutralized the goals of the Bundesbank and the government, but allowed more state representatives to be appointed without having the qualifications of a state central bank president. See "Statt elf nur noch neun Landeszentralbanken," *Handelsblatt*, June 5, 1992.

independence and conservatism of the bank in two ways: it strengthened the ability of the president to rebuff nominations of growth-oriented candidates to the leadership posts of regional banks: and it helped ensure a more conservative group of regional bank presidents than would have come together under the one-state-one-bank principle.

Economic Policy

Between 1990 and 1994. the Bundesbank and the government clashed on both the principle and the substance of economic policy. On principle. government intended to raise the eastern standard of living as quickly possible while keeping taxes as low as they could be. On principle. the Bundesbank expected easterners to raise their own standard of living by working more productively and accepting fewer social benefits. which would keep inflation and deficits low.

The Bundesbank clashed with the government on three substantive issues. First. the Bundesbank was at odds with the government over the terms of the 1990 German Monetary. Economic and Social Union (GMES). First. the two parties disagreed most strongly with the government over the terms of converting the savings of east Germans into western marks. In negotiations between east and west over the terms of GMES. the government approved the exchange of most savings on a 1:1 basis. despite the Bundesbank's opposition. The Bundesbank warned that creating such a large sum of money would fuel inflation and advocated a 2:1 exchange ratio. When the government pushed through the 1:1 rate. the Bundesbank unleashed higher interest rates designed to prevent the new money supply from driving German prices up.[105] As a result. the external value of the mark rose against all other European currencies. hurting exporters. while domestic industry suffered from higher interest rates. The Bundesbank's concern for domestic inflation above the government's political agenda and the stability of the European Exchange Rate Mechanism kept interest rates high

[105] For an in-depth account of the Bundesbank's view on GEMS. see Hans Tietmeyer. "German monetary. economic and social union--two years later." *Auszüge aus Presseartikeln der Deutschen Bundesbank*. June 11. 1992.

until they began dropping in October. 1993.

The Bundesbank followed up its defense of its anti-inflation stance by deflecting concerns about the impact of its policies on the exchange rate. Tietmeyer maintained that a strong. stable currency would be compatible with strong exports and healthy economic growth as long as taxes remained low enough to keep the price of exports competitive. Looking back on the rise of the mark after reunification. along with unemployment and worsening government finances. he stressed that the strong mark would not have generated unemployment after reunification if government. businesses and labor had contained their costs. Instead. government spending increased. leading to higher interest rates from the Bundesbank to controi inflation. while higher taxes increased the cost of labor. and consequently. the price of manufactured products. Consequently. he admitted that the overvaluation of the mark which followed the 1992 currency crisis deepened the recession of 1993 and hurt exporters. but were not the root of the problem. For this reason. he dismissed suggestions to devalue the mark (and accept a higher inflation rate). expecting that doing so would have destroyed its value and credibility as a reserve currency without generating real advantages for exporters. Similarly. a weak European currency would bring no advantage to the German economy. nor for any other competitive exporting country.[106]

Second. the Bundesbank fought the government's policy of borrowing to finance the costs of reunification. Not only were government deficits a source of concern. but the shortfalls of government corporations like the rail and postal services led the Bundesbank to call for more spending cuts.[107]

Third. the Bundesbank made it clear that limiting public spending would be preferable to higher taxes and spending. Large government payments. tax exemptions and interest subsidies were increasing the money supply and endangering the value of the mark.[108] Bundesbank President Pöhl expressed particular concern after reunification that

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[106] "Der Termin steht im Vertrag." *Der Spiegel*. December 2. 1996.

[107] "Schlesinger für maßvolle Abschlüsse der Tarifpartner." *Handelsblatt*. November 4. 1992.

[108] "Hochzinskurs zeigt bisher keinerlei Bremswirkungen." *Handelsblatt*. April 10. 1992.

emergency help for the new states might entrench itself into permanent transfers from the public purse.[109] It was particularly concerned that the bulk of money flowing into the new states was coming in the form of social security transfers to individuals, rather than in the form of investment in infrastructure. This had two effects that displeased the Bundesbank. Since most of the money sent east came through the social security system, the money promoted temporary consumption rather than lasting improvements in the productive structure of the local economy. This was particularly worrisome since transfers from the west constituted two thirds of eastern GDP, pointing to a permanent drain on the western economy of six per cent of its GDP unless changes were made. In addition, the tax increases required to pay for these transfers would damage western businesses by hurting their competitiveness and by justifying inflationary wage hikes.[110] This was particularly bad in the east, where unions were demanding wage hikes in excess of 10 per cent, without productivity increases.[111]

The Bundesbank's interest rate and monetary policies restricted the range of economic options that the government could employ to bring its accounts back into balance. The bank's policy of high interest rates, plus supporting the exchange rates of the dollar and yen forced Germany to take an export-led approach to economic recovery. Lower real income meant lower domestic demand, and a corresponding need for producers to sell their products elsewhere or go out of business. At the same time, the Bundesbank told the government to cut back its spending, particularly in social insurance, and demand higher contributions.[112]

After October 1993, the Bundesbank began to gradually but significantly relax its

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[109] "Transferleistungen nicht als Dauersubventionen." *Börsen-Zeitung*, June 28, 1991.

[110] Tietmeyer, Hans. "German monetary, economic and social union--two years later." *Deutsche Bundesbank Auszüge aus Presseartikeln*, June 11, 1992.

[111] "Bundesbank tritt kräftig auf geldpolitische Bremse." *Frankfurter Rundschau*, February 1, 1991. Schlesinger, Pöhl's successor, made a point of repeating the criticism. See "Bundesbank Head Defends Tight Credit." *Wall Street Journal*, February 6, 1992.

[112] "Bundesbank: Sparkurs mit Nachdruck verfolgen." *Handelsblatt*, September 13, 1996.

hold on the economy, once inflation was less of a concern, and the economy needed stimulating. Overall, it helped push the government to decisions about reforming institutions to suit the new German economy. Its public relations campaign directed at taxpayers and employers proved somewhat effective at stimulating institutional reform.

Economic and Monetary Union

The Bundesbank's policy on Economic and Monetary Union focused on three aspects of developing the European Central Bank: ensuring the ECB's independence from political control, enforcing the membership criteria for monetary union, and committing member governments to economic conservatism after assuming membership. Taken together, these measures were intended to deter the European Union's weaker economies from attempting to seek membership in monetary union. Successful deterrence would prevent political confrontations from arising between a central bank devoted to fighting inflation and countries who could not achieve acceptable growth and employment levels in a low inflation environment. This in turn, was designed to minimize the probability that political pressure to weaken the central bank's independence could become irresistible after monetary union had begun.

In pursuing these goals, the Bundesbank both advised the Kohl government on each of the three issues and waged a public relations campaign to solicit public support for its stand on the ECB. In this capacity, it served as a counterweight to pressure from foreign governments and domestic interest groups seeking a pro-growth policy in Germany. It began pressing its point to government shortly after the Maastricht Treaty was signed.[113]

In 1991, while the TEU was being negotiated, the Bundesbank focused principally on limiting membership to countries that were serious about committing themselves to stable

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[113] Schlesinger, speaking on behalf of the Bundesbank, underlined the Bank's determination to maximize its impact on the government's foreign economic policy and the structure of the ECB in a speech to the American Institute for Contemporary German Studies in Washington, D.C. entitled "The Challenges to German Monetary Policy." See *Auszüge aus Presseartikeln der Deutschen Bundesbank*, June 1, 1992.

prices and modest budget deficits. Hans Tietmeyer, Vice President of the Bundesbank at the time, publicly advised the government to resist pressure from EU governments to participate without meeting the criteria. The government had a responsibility to Germans, who currently enjoyed "one of the most successful and best monetary constitutions in the world," and could lose from a poor arrangement. It also had a responsibility to the European Community, since the mark was the anchor currency of the EMS and a model for a stable European currency. This was doubly true in the Bundesbank's eyes, since most national central banks remained politically dependent.[114]

In December 1996, while EU governments were negotiating the Stability Pact at the Dublin Conference, the Bundesbank had to defend its position again, this time against demands by German proponents of EMU to weaken or eliminate the entrance criteria. Helmut Schmidt, who had established the European Monetary System with France in 1979, accused the Bundesbank of sabotaging the central bank project by lying about the binding nature of the criteria, and disputing the need for the criteria as a prerequisite.[115] The opposition Social Democratic Party began supporting this position during the course of the year.

Bundesbank President Hans Tietmeyer responded by reiterating his support for a "stability-oriented currency union," and his "hope that it will be a success." More importantly, he underlined that federal courts and both houses of the German legislature had chosen to support the same position as the Bundesbank. Both Bundestag and Bundesrat had demanded strict adherence to the convergence criteria when they passed the enabling legislation, and required an additional vote before adhering to membership. The Federal Constitutional Court had reinforced these conditions. Tietmeyer emphasized that the Bundesbank was defending terms of membership that the legislative and judicial branches of government, not the Bundesbank, had established and confirmed. On this basis, he

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[114] Marsh, David, "Bundesbank warns over speed of move to single currency," *Financial Times*, June 12, 1991.

[115] See reference in "Der Termin steht im Vertrag," *Der Spiegel*, December 2, 1996.

dismissed the accusation that the Bundesbank was acting as a "state within a state."[116]

Tietmeyer added that national governments had subsequently negotiated and agreed upon the membership criteria, and then entrenched them in an international treaty. While he judged the criteria to be too tolerant of inflation and borrowing, (he would have preferred a two per cent limit on deficits), the Maastricht Treaty bound the Bundesbank to comply with the decisions of elected European Union governments. Therefore, he considered it was unreasonable to accuse the Bundesbank of unilaterally creating and imposing membership criteria that the Treaty did not contain. In addition, Tietmeyer reminded his critics that the governments of France and Holland, not the Bundesbank, and not the German government, had proposed the membership criteria to which EU governments had finally agreed. The Bundesbank had no intention to kill or undermine the Treaty, but was determined to oppose backsliding.[117]

Bundesbank officials stressed first and foremost that European voters had to accept the ECB and the euro if they were to succeed. Without consensus across national electorates over monetary policy, politicians would transform irreconcilable differences of national interest into bitter conflict that could destroy the ECB's independence, or even the new central bank itself.

The Bundesbank consequently promoted the view that a central bank was ultimately only as independent as political consensus allowed. This position allowed the German central bank to oppose membership for countries which failed to meet the Maastricht criteria while leaving the door open to future membership, even in the near future. Tietmeyer observed that strikes in France, Italy and Spain demonstrated a lack of popular support for EMU. Furthermore, he suggested that voters in these countries were already turning against the planned central bank because the government justified spending cuts and high interest rates on the upcoming deadline for membership in monetary union. Political opposition would intensify and be directed at the ECB itself if these countries assumed membership

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[116] "Der Termin steht im Vertrag," *Der Spiegel*, December 2, 1996.

[117] Ibid.

before developing the ability to live under its terms.[118]

Tietmeyer emphasized that the modest scale of economic transfers to poor regions within the European Union made it doubly important to ensure that countries with weak economies delay entry to monetary union. Without the possibility of devaluing the currency, or depending on transfers to buoy the economy, countries that lost competitiveness through economic shocks would have to regain it through reducing costs or by winning investors for more competitive goods and services.[119] In either case, the majority of voters would have to be firmly committed to accepting a lower standard of living in the short term in order to turn their economy around.

Overall, Tietmeyer emphasized the importance of the euro and the ECB being insulated from political conflict. Fiscal policies and wage policies had to be nested within the requirements of monetary policy in the new currency union. In addition, the ability of countries to prosper in a stability-oriented monetary union would depend heavily on their competitiveness, since the exchange rate could no longer be used to balance out the effects of the shock.[120]

The Bundesbank also showed concern that governments having difficulty with the entrance criteria would try to qualify dishonestly on the deficit criteria and pressure gatekeepers to overlook the fact. The Convergence Report of the European Monetary Institute in early 1998 reflected the Bundesbank's demand that accounting tricks and one-shot measures not be considered when determining convergence with entrance criteria. Tietmeyer expected that central bank presidents would have to pressure governments to avoid assessing the entrance criteria loosely. He explained that the Bundesbank would advise the government on which countries had fulfilled the criteria properly, to address such concerns during the final stage of decision-making on EMU members.

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118 Ibid.

119 Ibid.

120 Tietmeyer, Hans. "Der Euro kann kein Allheilsmittel sein." *Handelsblatt*, December 31, 1996, p. 10.

Consequently, the Bundesbank also supported Finance minister Theo Waigel's stability pact proposal as a useful tool for constructing a political consensus on the long-term budgetary implications of monetary union. It would also establish when there might be exceptions. Just as important, Tietmeyer pointed out that the stability pact could provide some insurance against future political coalitions less inclined to follow the criteria. While sanctions for overspenders could meet resistance in the Council of Ministers, the European Courts of Justice would also have the competence to rule on sanctions, compelling national governments to comply. The Bundesbank, in short saw the stability pact as a means of deterring potential overspending. He expected painful penalties to be necessary for effectiveness.[121]

The Bundesbank demonstrated a sustained impact on the German economy, and on economic policy as well that proved decisive in moving the country from a state of structural budget deficits toward renewed balance. That task proved to be more difficult than at any other time in Germany's history, however, and was not complete by the time EMU was launched. The Bundesbank's attempt to reinforce economic conservatism give some crucial new evidence about the foundations of effective central bank independence, and its limits that suggest a modification of the model in chapter one. The evidence also points to serious problems in establishing an independent central bank that must be considered in the French and Spanish cases.

The Bundesbank was able to raise the pressure on the Kohl government between 1990 and 1994 to modify its reunification-related economic policies by restricting the money supply as the government began transferring money eastward. By increasing the cost of spending decisions through interest rates, unemployment and subsequently increasingly higher deficits, the Bundesbank was able to initiate both a reduction of inflation by 1993 and a reduction of deficits beginning in 1995. Public support was essential to protecting the Bundesbank in its determination to keep control of the economy.

Most important, the Bundesbank case demonstrates that a central bank's political

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[121] Ibid.

independence depends more on public support than formal institutional rules. The German central bank's ability to force economic conservatism on the federal government depended ultimately on the economic conservatism of the electorate. Yet even that conservatism would have been meaningless had the Bundesbank not carried out a dual strategy to protect itself against more growth-oriented influences both from within the country and from other European Union member states.

At the European level, the Bundesbank focused on securing institutional features for the ECB and membership criteria for EMU that guaranteed the ECB's economic conservatism before it became a matter of public debate. With these provisions secured in international treaty, the Bundesbank could present central bank independence and concrete limits on public deficits as an untouchable under international law. As a result, the Bundesbank had a position on membership in EMU that was unassailable in Germany, but the object of derision in countries unlikely to meet the Maastricht criteria. While the German government was conservative enough that it never publicly considered loosening the entrance criteria to EMU, the Bundesbank used its legal position to ward off foreign pressure on Bonn to treat the entrance criteria lightly.

At home, the Bundesbank waged a sophisticated public relations campaign to mobilize economic conservatives against government policies or proposals that could have hurt their interests, and the Bundesbank's independence as well. This is the most important finding, since it points to the fact that central bank independence rests on a combination of an underlying majority of conservative economic interests, and an activist central bank that mobilizes public opinion against individual government policies that could contribute to structural budget deficits or inflation. In effect, central bank independence must depend on more than a transaction cost defense against political manipulation, which is all institutional independence supplies. It must rest on an activist body sophisticated enough to mobilize a political majority in its defense.

2.4 Parties

Germany's political parties reflected the divergent interests of their respective supporters when making decisions about cutting spending and stimulating the economy. The parties with the narrowest and most stable bases of support also had the most consistent policies. The Christian Social Union (Christliche Sozialunion, or CSU), which represents the prosperous state of Bavaria, and the Free Democratic Party (Freie Demokratische Partei, or FDP), which represents a narrow section of the middle and upper classes, fought hard within government to cut the budget deficit which had grown in the wake of reunification. They were also the most vocal opponents of foreign attempts to weaken the entrance criteria to EMU, or to undermine the ECB's independence. The Alliance 90/Greens, which primarily represents the ecological movement, promoted hikes in environmental taxes to pay for social programs, but had no well-developed position on monetary union. The Party of Democratic Socialism (Partei des demokratischen Sozialismus, or PDS), which represents former communists in the new states, opposed the government's savings plans in principle and served as a mirror image of the CSU and the FDP.

The two mainstream parties, CDU and SPD, were torn between the desire to support the unemployed during an economic downturn, and the fear that Germans had for the inflationary effects of high, persistent, deficits. This unenthusiastic commitment to price stability reflected an electoral base centered on a core of pro-stability voters, but increasingly squeezed by a rapidly growing army of unemployed and underemployed Germans. The Christian Democratic Union, which led the government, carried out a policy of spending cuts in order to reduce budget deficits, but did so with more internal division and with less enthusiasm than the CSU and the FDP, and with considerably less vigor than it demonstrated in the mid-1980s, before the number of CDU voters requiring social assistance skyrocketed. Despite the internal unrest, the CDU promoted stability internally and with respect to monetary union.

Voters supported the government over the opposition social democrats throughout the study period, but only at the national level. The CDU/CSU won a comfortable majority in 1990 and a very thin one in 1994, but only led two of 16 state governments--in Bavaria and Saxony. While the party made gains in state elections between 1994 and 1996, it did little to weaken the SPD stranglehold at the state level.[122] SPD state governments made it difficult for the government to get economic policy changes past the upper house of the federal legislature, which the state governments dominate.

The Governing Coalition and National Economic Policy

Germany's governing coalition of three center-right parties--the CDU, the CSU, and the FDP won the 1990 and 1994 elections with support from both economic conservatives and social welfare advocates. The FDP fought consistently for a balanced budget, low taxes, and reduced government spending. The CSU also pushed for deep spending cuts, but not so deep that the government could cut taxes. Economic conservatives had kept both parties in office since 1984, and this ensured that their economic preferences remained firm and unambiguous.

The CDU cemented the coalition from 1990 onward by uniting its traditional base of middle class and pensioned voters from the west with poorer and pensioned voters in the east. Economic conservatives from the middle class continued to form the core of its clientele, but growth-oriented voters from the east moved the party's center of gravity away from its commitment to price stability and conservative borrowing policies. Easterners expected the CDU to guarantee economic solidarity between east and west, while westerners expected the party to keep the budget balanced, taxes moderate and inflation low. After the 1994 election, the tension between these two goals led to conflict within the party and open warfare within the coalition over social spending and budget cuts that nearly destroyed the government.

The CSU and FDP controlled spending from the finance and economics ministries

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[122] *Country Report: Germany*. London: Economist Intelligence Unit, 1994 (4th Quarter), 1995 (3rd Quarter); 1996 (2nd Quarter).

respectively, while the CDU managed spending through line departments and entitlement programs. Their respective bases of support made this division of labor the most bearable for the three parties. More likely to pay taxes and less likely to require social transfers than the average German, CSU and FDP voters supported the decision to eliminate the deficit by cutting spending and keeping taxes low. The FPD, with the narrowest base of support, frequently attacked the CDU for being too "soft on cutbacks and tax reductions."[123]

In contrast, the CDU's success at uniting west and east gave it the political capital required to increase spending through line departments and entitlement programs in 1990. In doing so, the party assured easterners that it was socially responsible while assuring westerners that it would manage the economy in an economically responsible way. Between 1990 and 1994, economic policy focused on improving the standard of living in the east with investment and income transfers designed to stimulate the economy.[124] Most tangibly, the government committed itself to fully extending western social entitlements eastward without reducing benefit formulas. After hopes for an economic upswing evaporated, and the party's left wing took heavy losses in the 1994 election, conservatives reasserted their focus on dismantling the country's structural budget deficit. By 1995, the government had begun cutting entitlements to the elderly and the unemployed, despite internal opposition from the remainder of the CDU's left wing.

Cuts to social entitlement programs met more opposition and took more time to undertake than other budget items, but the government eventually implemented them. There were serious, but short-lived disagreements over cutting expenses on construction and defense investments,[125] but these were resolved within the course of a few months. In

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[123] See, for example, Möllemann's critique of the CDU in "Politiker predigen neue Bescheidenheit," *Frankfurter Rundschau*, March 9, 1992.

[124] This position was adopted in the CDU's 1991 Dresden Manifesto. In 1994, the party's platform changed to one of responsibility. See Otto Model et al, *Staatsbürger-Taschenbuch*, 28th ed. Munich: C.H. Beck'sche Verlagsbuchhandlung, 1995.

[125] See, for example, claims made on the budget by the respective ministers in July, 1996 in "Waigels Sparkurs stoßt auf heftigen Widerstand," *Süddeutsche Zeitung*, July 1, 1996.

contrast, entitlement reforms were only seriously tackled in 1995, and only completed in 1997.

Three groups of voters pressed the government to reflect their interests as it attempted to close the spending gap that grew after 1990. Germany's older voters wanted the government to leave pension entitlements intact. They also formed a considerable base of support for the governing coalition.[126] Some showed room for compromise, though easterners opposed pension reductions much more strongly.[127]

Easterners deserve distinction for their tenacious defense of pension spending. The lower standard of living generated pressure to close the gap between eastern and western pensions. Government and opposition parties responded by supporting a 15 per cent rise in eastern pensions for the 1991-92 year, with subsequent increases through 1994 between 10 and 12 per cent. In 1994, Kohl emphasized the gains that the CDU had brought to eastern pensioners, despite criticism from conservatives within his own party over the bill that came with the spending. Those conservatives did not dare make a concerted move against the increases until after the election, however.[128]

The coalition's desire to demonstrate financial responsibility imposed some limits on pension spending. It rejected calls to immediately reduce the eastern retirement age by three to five years to meet western guidelines. This proposal was designed to reduce unemployment, but would have created 200,000 new pension recipients from the unemployment lines.[129] Instead, the government made some limited offers of early retirement in the east and raised the western age to the eastern age in order to save money. Blüm emphasized that in contrast to FDP demands for deep cuts to the system, that he would

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[126] Survey results from late 1996 reported in Dr. Renate Koecher, "Denken im Generationverbund," *Frankfurter Allgemeine Zeitung*, January 15, 1997.

[127] See, for example, "Wo könnte gespart werden?" *Die Welt*, January 12, 1993.

[128] "Streit um Renten gärt in der Bonner Koalition," *Die Welt*, January 3, 1994.

[129] "Einigkeit über die Erhöhung der Ost-Renten zum 1. Juli," *Frankfurter Allgemeine Zeitung*, March 22, 1991.

only fine-tune it [130] Blüm also emphasized that the east was not losing money from the changes.[131] Within the framework of federal eligibility rules, eastern pensioners would continue to benefit from pension increases that followed the eastern rate of wage inflation. At the time, wage increases were considerably stronger in the east than in the rest of the country.

Germans with stable jobs and far from retirement increasingly demanded that the government roll back taxes and insurance premiums to pre-reunification levels and that it reduce the deficit.[132] They found support from the conservative camp of the CDU, the CSU, and the FDP. The FDP proposed a deep reduction in income tax rates to 15.25, and 35%, offering to support a higher VAT in return. It also pushed the government to lower wages in government work programs to encourage more employers to create permanent jobs. Neither of these proposals were considered seriously, however.[133]

Furthermore, the FDP stressed that EMU would make budget reform even more pressing than before. FDP economics minister Günther Rexrodt argued that budget cuts required by the Maastricht Treaty were good in themselves, since Germany's deficit was structural, not cyclical in nature, meaning that it would persist until spending commitments were adjusted downward.[134]

CDU deputies representing the party's core constituency presented their demands for lower spending and social security commitments at policy congresses and cabinet meetings,

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[130] "Koalition plant angeblich weitere Sozialkürzungen," *Frankfurter Allgemeine Zeitung*, October 14, 1996.

[131] "Blüm: Die Milliarde sparen wir nicht im Osten," *Frankfurter Allgemeine Zeitung*, November 14, 1996.

[132] Survey results from late 1996 reported in Dr. Renate Koecher, "Denken im Generationverbund," *Frankfurter Allgemeine Zeitung*, January 15, 1997.

[133] Make-work projects pay participants at 90% of the industry standard wage. "Kaum Aussichten für eine Steuerreform schon 1998. Verwirklichung in Stufen?" *Frankfurter Allgemeine Zeitung*, August 2, 1996.

[134] Rexrodt, Günther, "Die Wirtschaftspolitik muß weiter in nationaler Verantwortung bleiben," *Handelsblatt*, December 31, 1996.

and in conjunction with the FDP. In 1993, the CDU's economic committee called for cutbacks to the social security system so that payroll taxes and budget deficits could be contained. In place of current benefits, it called for the state to provide less while allowing individuals to choose what additional coverage they would like.[135] By 1996, budget policy speakers Adolf Roth (CDU) and Wolfgang Weng, (FDP) used this group's support to press the finance minister for budget cuts that would reliably cap the deficit at 56.5 billion DM.[136]

Without a definitive political commitment from the Chancellor to make deeper cuts where they would have a lasting effect on the budget deficit, finance minister Theo Waigel remained constrained to searching for savings where they would have the least durable impact. By 1996, he was applying privatization receipts of 9 billion DM against the deficit,[137] and relying on spending freezes within government departments to reduce the year-end balance, with only minor effect.

Waigel moved the CSU into a political position that emphasized economic responsibility through lower entitlement spending, but which also allowed for open negotiations with the rest of cabinet over the kinds of cuts to be made. This strategy proved suitable for an electorate which was a net payer into the German tax and social insurance system, but which wanted the government to consider the social implications of its strategy. In 1993, he demonstrated this position after proposing a cut in the rate of wage replacement for unemployment insurance in 1993. He wanted a 1% cut for parents, and 3% for others. He also pushed the government to end the universality of housing subsidies and baby bonuses by calling for the introduction of means tests, combining savings and social

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[135] "CDU Mittelstand: Sozialsystem vom Arbeitsvertrag abkoppeln." *Frankfurter Allgemeine Zeitung*, April 23, 1993; "Für Einschnitte ins soziale Netz." *Frankfurter Rundschau*, May 12, 1993.

[136] "Die Koalition kündigt weitere Sparmaßnahmen an Kürzungen in allen Ressorts." *Frankfurter Allgemeine Zeitung*, September 10, 1996.

[137] "Waigel droht mit schärferer Sparpolitik." *Süddeutsche Zeitung*, September 11, 1996.

protection.[138] Waigel followed up these measures with plans to save 20 billion DM in peripheral spending, which included eliminating inflation adjustments to welfare payments. He argued that this change would not only save money, but reduce unemployment by increasing the gap between the income of welfare recipients and the working poor.[139]

Waigel's demands for deep cuts allowed the CDU to position itself as the force that balanced economic and social responsibility. Social Minister Hannelore Roensch justified social assistance cuts to families of five members and more in 1993 as more social than Waigel's proposals would have allowed for. The same went for cuts to baby bonuses and home nursing care budgets.[140] Waigel also left a door open to the government to prevent deeper cuts in return for an anti-abuse program in social services that would allow the government to portray itself to voters as a protector of the social state. With savings of 16%, or 6-7 billion DM, the program neutralized opposition from the SPD and from within the CDU.[141]

The government attempted to equalize the burden of adjustment between recipients and premium payers when cutbacks hit across its supporters, thereby holding their support. In 1996, government decided that pensioners would receive the equivalent of 64% of their working income rather than 70%. It raised the full-pension retirement age from 60 (for women) and 63 (for men) to 65 -- early retirees would forfeit a portion of their pension payment.[142] Since the eastern retirement age was already 65, this adjustment did not hurt the party's eastern base of support. Premiums would remain high, but ratepayers could expect gradual and increasing relief over time. The changes were designed to bring the pension

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[138] "Soziales Netz wirkt grobmaschig," *Tageszeitung*, January 20, 1993; "Sozialhilfe und Arbeitslosengeld als Sparschweine?" *Neue Zeit*, January 20, 1993.

[139] "Ein radikaler Umbau des deutschen Sozialleistungssystems," *Frankfurter Rundschau*, May 27, 1993.

[140] "Kabinett billigt Kürzungen der Sozialhilfe," *Süddeutsche Zeitung*, March 6, 1993.

[141] See *Tageszeitung*, January 20, 1993 and "An die kurze Leine gelegt," *Handelsblatt*, March 15, 1993.

[142] "Abschied von der Frührente," *Handelsblatt*, December 30, 1996.

fund's liabilities and premiums back into balance, so that pressure on the national budget could be permanently contained. Blüm explicitly rejected SPD calls to pay for pensions from general revenues, arguing that the premium system was the only real defense against future attacks on the pension fund by cash-strapped governments.

The cutbacks also followed a political calculus that avoided a regional concentration of cuts (particularly in the new states) or cuts to mainstream voters. While the government attempted to gain the support of all premium payers, it weakened the pension coverage of citizens on the periphery of the labor market. Social Minister Norbert Blüm promoted a controversial plan to restrict payments from the national pension plan to individuals who had made contributions during their working lives, and to tie their pensions to the actual contributions they had made into the program, thereby cutting out pension benefits based on credits for periods of unemployment. By doing so, he sought to consolidate support for the government from Germans with stable, secure employment. They would receive the largest, most secure pensions and be spared premium increases. With this base of support secured, the government could afford to weaken the pension claims of Germans on the periphery of the labor market, who would pay less over their working lives. Students, mothers on maternity leave (up to three years under German law), and the underemployed would not receive credits to their pension plans for periods of time outside the labor market.[143]

Pension top-ups and pensions for citizens who had not paid premiums (e.g. the disabled) would have been paid out of general tax revenues under the plan, where they would be more vulnerable to attack by the finance minister's efforts to balance the budget. Blüm repeatedly described payments that were not directly linked to premium payments as a "burden" on the pension system and those who paid into it. In order to accord the social provisions for marginal groups in the pension system more protection, many CDU politicians added to this proposal by suggesting the creation of a special "Family Plan" to handle other pension obligations.[144]

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[143] "Auf Kosten der Jungen," *Der Spiegel*, February 3, 1997.

[144] "Unionspolitiker fordern Familienkasse," *Die Welt*, January 23, 1997.

Blüm also proposed the establishment of Nursing Care Insurance in 1991, which would impose premiums on workers to pay for services that had previously cost the welfare system a great deal of money. The FDP opposed the plan, preferring a deduction for premiums paid to private companies. The plan was estimated to cost the government 25 billion per year, or two per cent of social payments.[145] Blüm also used the plan to counter claims that the government was dismantling the welfare state. He estimated that it would help 1.65 million elderly and handicapped people who needed help. The insurance plan would be the "fifth pillar" of the welfare state, alongside pensions, unemployment, accident and health insurance,[146] strengthening the country's reliance on the adjustment-promoting premium system.

Within the CDU, a block of easterners and blue collar workers opposed the spending cuts the CSU and FDP were pushing through. CDU speaker Geißler called on the government to ensure a minimum social standard in the country. The CDA, or workers' wing of the CDU, called for higher taxes that would finance higher transfers into the East.[147] The cabinet's most socially minded minister, Blüm, rejected this during the 1994 campaign, arguing that it was more important to leave money in workers' pockets.[148]

CDU state governors in the east made it politically difficult for their federal counterparts to cut spending on regional make-work projects. During budget talks in the Bundesrat, Sachsen Premier Kurt Biedenkopf called on the federal government to link such spending to unemployment levels, which were high in the east. He also warned the west against jetisoning its financial commitment to the east as it prepared for EMU.[149]

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[145] "Schwindender Optimismus," *Süddeutsche Zeitung*, January 2, 1991.

[146] "Bonn seeks to patch up an ailing social state," *Financial Times* November 19, 1993; "Blüm: Nennen Sie mir ein Land, das seinen Sozialstaat so ausgebaut hat," *Handelsblatt*, November 26, 1993.

[147] "Front gegen Sozial-Sparpaket," *Die Welt*, July 12, 1993.

[148] "Blüm spricht sich für Familiensplitting aus," *Handelsblatt*, September 22, 1994.

[149] " Biedenkopf: Zustimmung zum Haushalt ist keine Selbstverständlichkeit," *Frankfurter Allgemeine Zeitung*, November 11, 1996.

Mecklenburg-Vorpommern Premier Berndt Seite (CDU) criticized cuts even more strongly, underlining the special vulnerability of the east to unemployment, despite intensive training in the labor market.[150]

Kohl's handling of the government's deficit-cutting measures indicate the difficulty of keeping both wings of the coalition together. In 1992, he used support from the east to consolidate the government's commitment to promoting welfare and employment, despite criticism from western conservatives. He gave the budget balancers a partial commitment by promising to raise taxes after the 1994 election to pay for for the costs of reunification. This did not placate die-hard conservatives in the CDU and FDP, however, who feared that with or without a balanced budget, spending entitlements would entrench themselves at a higher level.[151]

In 1995, he warned both camps that they would have to compromise by focusing on a balanced budget. He praised the CDA as the "social conscience and social regulator of the union," and promised not to dismantle the welfare state. At the same time, he made it clear that the government would to focus on cutting spending. In the same speech, however, he warned the conservative camp of the party to back off from demands for a much smaller social welfare system.[152]

Kohl reflected the undetermined nature of the compromise by allowing line ministries and the finance minister to publicly fight out the strategy for reducing the national deficit, while minimizing his own intervention. He did not become publicly involved in the social minister's efforts to raise payroll taxes and reduce entitlements to Germans on the periphery of the labor market. On the other hand, when these changes failed to bring the deficit under the three percent Maastricht limit, the finance minister was left to fight line ministries alone until negotiations reached a public impasse.

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150 "Seite: Sparpaket der Koalition verbessern," *Handelsblatt*, August 28, 1996.

151 *Country Report: Germany*, (Fourth Quarter, 1992) London: Economist Intelligence Unit, 1992.

152 "Ganz schimmerig," *Wirtschaftswoche*, June 22, 1995.

In 1996. Waigel continued searching for savings in politically insensitive areas. which would limit the extent of cutbacks in the run-up to the 1998 election. Suffering from a continuing need for top-ups to the unemployment insurance fund and slumping revenues in 1996. Waigel leaned on most of the cabinet to compensate for borrowing far in excess of budget forecasts that had drawn criticism from the SPD finance critic.[153] In September Waigel found 12.5 billion in savings to pay for higher unemployment insurance claims.[154] In November. he needed to come up with three billion marks to plug a shortfall and finally got help from Kohl. who said that Waigel "shouldn't have to go begging to the ministers." Yet several discretionary. high-profile items such as the Eurofighter. Franco-German military units and coal subsidies were successfully defended.[155] Waigel eventually decided to take back a billion DM that he had allotted for the unemployment agency and spread the other 2 billion among the other ministries. [156] For the following year. he pushed through cuts in defense. research and transport programs as well as more across-the-board cuts amounting to another 10 billion.[157]

Overall. the politics of reducing the federal budget deficit reveal a pattern of controversial and politically excruciating cuts. but. In contrast to the French and Spanish cases. conservative forces within the government not only demanded budget and entitlement cuts. but got them. Nevertheless. the economic structure of the country and the political

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153 SPD critic Karl Diller criticized that 75.8% of the year's forecast borrowing had been reached by the end of June. due to lower-than-expected revenues. See "Finanzressort weist SPD-Kritik zurück." *Handelsblatt*. August 1. 1996.

154 "Der Haushalt 1997 soll neu berechnet werden." *Handelsblatt*. September 9. 1996.

155 "Waigel will nicht mehr bei Ministern 'betteln gehen.'" *Handelsblatt*. November 7.1996.

156 "Waigel will allein von Arbeitsminister Blüm eine Milliarde." *Süddeutsche Zeitung*. November 8. 1996.

157 Cuts amounted to 200 million for defense. which was much less than the two billion originally planned. To compensate. transportation lost 450 million. research lost 166 million. Across-the-board cuts would bring the total to 10 billion in cuts. See "Rühe-Etat erneut mit rund 2 Mrd. DM belastet." *Handelsblatt*. November 8. 1996: "Rühe muß weniger streichen als erwartet." *Süddeutsche Zeitung*. November 9. 1996.

transmission of voter interests made balancing the budget much more difficult than one would have expected in a gatekeeper country, as described in chapter one. With east and west joined, a greater percentage of the population required social assistance and expected their governments to deliver. They did not form the majority, as the continuing support for conservatism illustrates, but their demands made the politics of cutting expenditures a more timid and precarious exercise than it had been for the same coalition in 1984.

So in the German case, electoral interests played an important role in shifting the balance of economic policy priorities between price stability and promoting growth and welfare. The CDU, which was the principal party in the governing coalition, was in the best position to shift from a platform of stability and budget restraint in the old Federal Republic to pursue more growth and welfare in the first term of all-German government between 1990 and 1994. The CSU and FDP, in contrast, retained the same supporters and interests. Consequently, they also played an important role in cajoling the coalition to recommit itself more strongly to budget discipline from 1994 onward, particularly through their control of the finance and economics ministries respectively.

Social Democrats

The Social Democratic Party, or SPD, led the opposition until 1998. It's candidate for Chancellor in 1990 was Oskar Lafontaine, who represented the party's most committed advocates of a higher priority for economic growth and government spending to enhance social welfare. Rudolph Scharping, who gave more credence to mainstream concerns for stability, replaced Lafontaine after the 1990 election, only to be switch places again in late 1995. With the party's decision to support Gerhard Schröder before the 1998 election, the party's economic policy shifted back toward the center.

After opposing reunification in 1990, the SPD supported measures that transferred money from wes to east, but which also ensured that Germans on the periphery of the labor market had equal access to social insurance entitlements. For this reason, it opposed the Kohl government's strategy to control costs through extensive reliance on the premium system of paying for social spending commitments and marginalizing beneficiaries on the edge of the labor market.

In 1991, the SPD weighed in on the side of government and eastern pensioners in the new states in 1991 by advocating large increases in pension payments. As was the case with other costs tied to reunification, the SPD criticized the government's plans for paying these bills. It preferred paying for pensions from general revenues to prevent premiums in the west from rising.[158] The SPD staked its position on keeping the core entitlements intact.[159]

After the initial agreement, the SPD campaigned for the highest pension increases possible, particularly for easterners, higher minimum rates, and for expanding entitlement to benefits. When leading SPD deputy Björn Engholm suggested that pensions be indexed below the wage increase rate to avoid massive premium increases, the party's Bundestag chief, Ottmar Schreiner, marginalized him quickly and decisively.[160] The party also argued that the government's policy of linking benefits to contributions unfairly penalized eastern women, who remained in the labor force for an average nine years less than eastern men.[161]

The SPD commitment to defending steady and substantial pension increases sharpened in 1994, when payment increases in the east not only began to level off, but threatened to decline as net wages stagnated. (In 1989, both parties supported tying pension benefits to after-tax wage growth.) The stand unequivocally placed growth and welfare ahead of stability and restraint, and sought to bring the SPD in favor with eastern CDU

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158 "Einigkeit über die Erhöhung der Ost-Renten zum 1. Juli," *Frankfurter Allgemeine Zeitung*, March 22, 1991.

159 "Schäuble schließt Einschnitte bei sozialen Regelleistungen nicht aus," *Handelsblatt*, March 26, 1993.

160 "Engholm rüttelt an Grundfesten," *Frankfurter Rundschau*, September 13, 1991.

161 "Harte auseinandersetzung über die Rentenpolitik im vereinigten Deutschland," *Frankfurter Allgemeine Zeitung*, April 27, 1991; "Ostrente liegt bei 864 Mark im Monat," *Die Welt*, August 7, 1991.

supporters, who strongly opposed the outcome.[162] The issue died by the end of the year, when the social minister announced that eastern wages had risen about five per cent, and that pensions would also.[163] The SPD criticized the government's pension policy again in 1995, when it planned to start reducing the top-ups from the federal budget on eastern pensions. While the government maintained that pensions had reached the point where the change would have little impact, the SPD complained that the measures would hit eastern women hard.[164]

The SPD embraced Norbert Blüm's view, if not the government's, that a variety of payments made with pension premiums were "plundering" the pension fund. SPD leader Oskar Lafontaine argued that the federal budget should be responsible for those outside of or on the periphery of the labor market, while Germans with stable jobs had the stronger guarantee of a premium-based fund.[165] Later, the party added early retirement pensions to the list of extra payments as well, while making its general commitment to the benefits clear.[166] Finally, it took the controversial stand of criticizing the government's decision to grant pensions to ethnic Germans emigrating from eastern Europe after the end of the cold war.[167]

The SPD also embraced the introduction of nursing care insurance. In the 1994 campaign, the party's social affairs critic, Rudolf Dreßler, promised that the party would introduce the plan if elected.[168]

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162 "Erstmals droht Senkung der Renten," *Die Welt*, February 18, 1994; "Widerstand gegen Rentenregelung," *Neue Zeit*, January 29, 1994.

163 "Ostdeutsche Renten steigen 1995 in zwei Stufen um zusammen 5%," *Handelsblatt*, September 29, 1994.

164 "Keine Anpassungen für Millionen Ost-Rentner," *Handelsblatt*, July 17, 1995.

165 "Dreßler fordert Krisengespräch," *Handelsblatt*, January 30, 1996.

166 Dreßler, Rudolf, "Koalition zersört Rentenkonsens," *Das Parlament*, February 9, 1996.

167 Ibid.

168 "Pflegekompromiß wieder vertagt," *Frankfurter Rundschau*, February 3, 1994.

SPD deputy and finance critic Ingrid Matthäus-Meier criticized social spending cuts in general in 1996, arguing that unemployment and not the welfare state was to blame for flat economic growth and large budget deficits. She argued that the budget was socially unjust and would create no jobs. Higher taxes on the rich and energy taxes were an SPD alternative. More spending on future-oriented industries were necessary, as well as lower interest rates.[169] This approach was in unison with the extraparliamentary party's social policy released in conjunction with the country's trade union confederation, the DGB. That paper called for an expansion of benefits, of employment, and to realize savings in social welfare programs through efficiency.[170]

The SPD was able to use its majority in the Bundesrat to curtail government efforts to cut the duration of entitlement to secondary unemployment insurance benefits. It successfully fought government freeze of social assistance payments, and partially reversed cuts to an income replacement plan for construction workers.[171] In 1996, it also held up approval of the budget to press for changes to cuts in child tax credits, a higher retirement age and research and development funding, which it expected to exacerbate unemployment.[172]

In addition to demanding different spending priorities, the SPD pushed the government to apply payroll taxes differently. In 1994, Sharping proposed that the government exempt poorer Germans from the country's 7.5% income tax surcharge, or "Solidarity Tax" and replace it with a 10% tax on higher-earning Germans. The government pointed out that unless the 10% tax were applied to people and families with modest incomes, it would amount to a deficit-increasing tax cut.[173] It also proposed that public

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169 "Waigel erwartet für 1996 mehr Wirtschaftswachstum." *Handelsblatt*, September 11, 1996.

170 "Die soziale Sicherung soll effizienter werden." *Handelsblatt*, September 7, 1995.

171 "Bonn makes spending compromise." *Financial Times*, December 9, 1993.

172 "Zusammengeschustert, getrickst, gepfuscht." *Süddeutsche Zeitung*, July 10, 1996; "SPD-Länder wollen Sparpaket ablehnen." *Handelsblatt*, July 12, 1996.

173 *Country Report: Germany* London: Economist Intelligence Unit, 1994 (2nd Quarter).

servants and the self-employed pay payroll taxes like everyone else.[174] The government did not act on these proposals.

The SPD's economic strategy of redistributing tax burdens away from payroll taxes allowed the party to criticize the government's difficulties controlling the national budget deficit without proposing cuts that could cost them support. During Lafontaine's leadership, however, the party went even further to praise the value of budget deficits as an investment in the economy,[175] particularly in technology. In addition, the party's economic critic supported bringing eastern wages up to western levels, and forcing interest rates down,[176] which could have led to a lower exchange rate. Frequently, party members accused the government of "taxing the economy to death," in its attempt to pay for current programs.

At the same time, the SPD took advantage of a government proposal to reduce spending and taxes in 1997. The SPD admitted the need for cuts, but suggested that the government cut defense spending, fight tax evasion, and scrap plans to move the seat of government to Berlin. It fought plans to cut housing subsidies, unemployment insurance, training budgets and social assistance as socially irresponsible.[177]

The SPD and the DGB worked together to complement parliamentary pressure with strikes and street demonstrations. The SPD successfully appealed to the DGB to protest in September 1996 against budget cuts before the reconciliation committee between the Bundestag and Bundesrat met on Sept. 13.[178] A quarter of a million union protesters showed up across the country[179] The government eventually passed its pared-down budget with 341

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[174] "Bonn seeks to patch up an ailing social state," *Financial Times*, November 19, 1993.

[175] "CDU: Höhere Neuverschuldung nicht notwendig," *Frankfurter Allgemeine Zeitung*, May 21, 1996.

[176] "SPD: Etat ohne Zukunftsimpulse," *Süddeutsche Zeitung*, July 21, 1996.

[177] "Arbeitnehmerverbände nennen Bonner Sparpläne Horrorkatalog," *Frankfurter Rundschau*, May 27, 1993.

[178] "SPD und DGB rufen zu Protestaktionen auf," *Handelsblatt*, August 28, 1996.

[179] "Massenproteste gegen Bonner Sparpaket," *Frankfurter Rundschau*, September 9, 1996.

votes (it needed 337) to override the Bundesrat's rejection of the August 30 law.[180]

Two changes to the party's economic policy under Lafontaine further undermined confidence in the SPD's commitment to low inflation and deficits. First, he chose to end Sharping's policy of shunning the Party of Democratic Socialism, the successor organization to the East German communist party as a possible coalition partner. This was surprising, because in 1994, the government had successfully exploited a de facto coalition between the SPD, the PDS and the Greens in the state of Saxony-Anhalt to scare swing voters away from the SPD in the federal election. This attempt to burden the SPD with the moral stigma and anti-stability orientation of the PDS worked, despite the fact that Sharping had publicly shunned the former communists.[181] While Mr. Lafontaine's more popular rival would have continued to reject cooperation with the PDS, the new leader accepted the risk that came with the attempt to forge an unambiguous alternative to government policy.

Second, the party chose to support EMU membership for countries that had not met the membership criteria set in the Maastricht Treaty. The SPD's economic critic, Ernst Schwanhold, argued for an interpretation of the EMU membership criteria to allow for as broad a membership as possible.[182] This was a radical change from Scharping's policy, which proposed that monetary union be postponed until Germany and other countries could make an economic recovery and meet the criteria.[183]

Positions on EMU

In 1992, both government and mainstream opposition parties united to support strict membership criteria for entry into EMU. Both CDU and SPD unequivocally committed

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[180] "Koalition geschlossen für Sozialabbau," *Frankfurter Rundschau*, September 14, 1996.

[181] *Country Report: Germany*. London: Economist Intelligence Unit, 1994 (3rd Quarter, p.9.)

[182] "SPD: Etat ohne Zukunftsimpulse," *Süddeutsche Zeitung*, July 21, 1996.

[183] Münchnau, Wolfgang, "German opposition leader urges single currency delay," *Financial Times*, October 30, 1995.

themselves to putting the criteria in front of the timetable. For the government, this meant assuring the public that the European Central Bank would be at least as conservative as the Bundesbank, and that the euro would be as stable as the mark. This meant restricting membership to countries that had met the Maastricht criteria.

The test of this policy came later, when more and more foreign and domestic commentators suggested that entrance criteria could be overlooked for country's demonstrating an unspecified pattern of "good progress" toward the criteria. The CDU, with the most ambiguous base of support, simply assured the public that the criteria would ensure the bank's conservative nature and the euro's stability. Within that party, only conservatives under the leadership of Wolfgang Schäuble promoted the hard-line position. The CSU, however, was allowed to spearhead the government's policy of total opposition to fudging the criteria. From time to time, the FDP took the boldest stand by threatening to abandon the coalition unless the government assumed a strict gatekeeper role in its negotiations with other governments over the terms of membership.[184] This did not mean a rejection of monetary union in principle, however. Foreign minister Klaus Kinkel of the FDP did not hesitate to warn that EMU's failure late in the game could drive the German currency up, and hurt the economy.[185]

For the SPD, supporting the Maastricht Treaty's membership criteria for monetary union demanded little, but allowed opportunities to criticize the finance minister on a regular basis for failing to balance the budget, or at least reduce the deficit to the limits he had himself insisted upon in the Maastricht Treaty.

In 1996, the SPD reversed its strategy on monetary union and placed the timetable ahead of the entrance criteria. As Germany and most other countries were set to fail the entrance criteria for EMU membership, the Lafontaine camp saw an opportunity to weaken both the Bundesbank and the conservative nature of the ECB. The party expected that it

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[184] Linke, Thomas, "FDP erklärt Währungsunion zur Koalitionsfrage," *Handelsblatt*, February 8, 1996.

[185] Kinkel, Klaus, "Mit dem Euro Behäbigkeit und Kleinmut überwinden," *Handelsblatt*, December 31, 1996.

could widen support for a political "Growth Council" that would limit the ECB's independence to restrict the economy. The party's expert on monetary union, Christa Randzio-Plath, endorsed the prospect of as wide a membership in EMU as possible, a liberal interpretation of the membership criteria, votes for all EU governments on the ECB's board of directors, and a pact on growth to replace the negotiated stability pact.[186]

Lafontaine began selling EMU as an opportunity to stimulate growth, if modifications were made to the institutional structure, if the timetable for monetary union took precedence over the entrance criteria, and if the participating governments made a political commitment to make jobs a European priority. Lafontaine played heavily on the government's failure to reduce unemployment while preparing for EMU by adopting the name of a failed government campaign to promote private sector jobs. The SPD's Alliance for Jobs called on EU governments to collectively stimulate their economies to balance the contractionary effects of introducing the euro under the management of the ECB. Even more important, Lafontaine saw EMU as an opportunity to unite European governments in the task of keeping wages, taxes and social spending high by mutual agreement. Lafontaine assured the public that he would promote this end if voters elected an SPD government.[187]

Lafontaine's strategy alienated the party from supporters in more prosperous parts of the country who supported a delay of monetary union. This group, with strong support in Baden-Wurttemberg, Bavaria and Lower Saxony, preferred to achieve economic recovery before pursuing the convergence criteria. They also feared that a growth-oriented EMU would never be able to achieve economic stability.[188] The counterattack by the Lafontaine camp was both economic and value-laden. First, it pointed out that if European governments

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[186] Interview conducted in Hamburg, Germany, December 1996.

[187] Lafontaine, Oskar, "Die Einführung des Euros macht ein Bündis für Arbeit notwendig," *Handelsblatt*, December 31, 1996.

[188] "Kohls Europakurs in der Anfechtung," *Neue Zürcher Zeitung*, February 17, 1996. For details on the split between the SPD's national and European leadership on the one side and the party's broader support base, see "Im europäischen Musterland wachsen Zweifel am Euro," *Handelsblatt*, January 29, 1996.

delayed monetary union, money markets would push the DM up against other EU currencies, hurting exporters and the people who work for them. Tourists would also continue to lose money to banks as they exchanged currencies while on vacation.[189] Just as important, however, the Lafontaine camp argued that the collapse of such an important common European project would unleash nationalism--and war--on the continent. Incidentally, this was the only common point on EMU policy which government and opposition shared during 1996.[190]

The government, mindful of retaining its base of support, refused to water down its commitment to enforcing the membership criteria. This even meant hinting at Germany's own temporary exclusion when it failed to reach the criteria in 1997. Despite the government's striking unpopularity in other fields, this stand helped the government to retain a majority of public support, and gave some peace of mind to the party's conservative elements.

Rivalry over the EMU issue within the SPD underlined the controversy's central importance in deciding the country's leadership. While internal SPD politics presented voters with a candidate in 1996 who wanted to put growth and welfare ahead of stability, the public demonstrated an impressive lack of confidence, and an unwillingness to change governments. Meanwhile, they never failed to express support in 1996 and 1997 for an SPD candidate who promised to stick to the criteria, whatever the consequences.

At the SPD Congress in Mannheim in November 1995, Lower Saxony Premier Gerhard Schröder introduced his critical position on EMU, igniting a controversy waged within the party for some time. DGB chief Schulte said that he had "no worries about EMU or the European Union. SDP Member of the European Parliament Christa Randzio-Plath believed that the entrance criteria were sufficient protection.[191]

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[189] Madhouse-May, Ingrid, "Die gemeinsame Währung ist ein Gewinn für alle." *Frankfurter Rundschau*, November 2, 1995.

[190] "Kohls Europakurs in der Anfechtung." *Neue Zürcher Zeitung*, February 17, 1996.

[191] Norman, Peter, "SPD fails to find one voice on Emu." *Financial Times*, November 15, 1995.

Finally, the parties demonstrated the extent of their commitment to an independent central bank and a stable currency through their policies on measures designed to ensure these goals over the medium and long term. The government demonstrated its concern for the long-term performance of EMU by demanding a parallel agreement that punished deficit spending exceeding a pre-set limit, and despite concerns that it could hurt the chances of a transition to EMU. As Germany negotiated a so-called Stability Pact with France and other countries at the Dublin Conference of EU States in December 1996. Kohl emphasized to the Bundestag that the public had to have confidence in the euro's stability if it were to succeed.[192]

Kohl explained that the stability pact reached in Dublin on December 14, 1996 ensured that the euro would be a hard currency. In a public statement at year's end, he declared that the criteria would be held "without ifs or buts," and be held durably. This was the sole goal of the stability pact that Theo Waigel had been pushing for a year. He noted that all finance ministers had committed themselves to a durable financial stability policy. He singled out workers, pensioners, savers and investors as groups that would benefit from the measures. He also expressed the goal to include as many countries as could fulfil the criteria.[193]

Theo Waigel made a great effort to build public confidence in the government's provisions for central bank independence, restricted membership in EMU, and tough ongoing membership standards. To underline the country's internal safeguards against membership in a "soft" monetary union. He pointed out that the government's proposals on EMU had the support of both houses of parliament and the Federal Constitutional Court. In addition, the Stability Pact would support stability in three ways. First, the independence of the European Central Bank would be maintained, as would its sole obligation to ensure price stability. Second, the pact confirmed the entrance criteria for membership in the bank, and made durable economic performance an explicit goal. Third, the deterrent factor of semi-automatic

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192 "Germany sets hard terms for EMU deal," *Financial Times*, December 13, 1996.

193 Kohl, Helmut, "Der Euro wird eine Hartwährung," *Handelsblatt*, December 31, 1996.

sanctions and keeping the three percent limit on national borrowing had been victories for Germany. Furthermore, the future obligation of the European Commission to report on offenders raised the believability of the pact.[194]

The key to the Stability Pact for Germany was to impose automatic sanctions against countries with public deficits exceeding three percent of GDP. The automatic nature of the sanctions was crucial, since it would reinforce the independence of the institutional mechanisms punishing liberal financial behavior. The early terms of the proposed stability pact showed participants wide apart. The German government wanted a non-interest-bearing deposit of 0.25% of GDP for every percentage point of the excess deficit. The European Commission suggested a 0.2% maximum plus a small variable amount. Secretary of state for finance Jürgen Stark confirmed that setting an automatic mechanism was the main goal.[195]

Negotiations on the Stability Pact defied public opinion in many other countries, and the fact that the government acted so provocatively in its relations with other EU governments underlines the desperation of the German government to meet voter concerns at home. In the end, the German government settled for sanctions that could only be imposed by a vote of the European Council, and which could not be applied during "severe recessions," eventually defined as an economic downturn of two per cent or more over the course of a year.[196]

This concession was coupled with a parallel attempt for the first time to direct less likely candidates for the hard core of EMU into EMS II. This new institution would provide an institutional context in which second-string countries would continue to bring deficits, inflation rates, interest and exchange rates in line with the hare core of the union, without the pressure of becoming immediate (and unstable) members of the central bank itself.

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[194] Waigel, Theo. "Das Gipfeltreffen von Dublin hat den Durchbruch gebracht." *Handelsblatt* December 31, 1996.

[195] "Der Streit um den Stabilitätspakt geht weiter," *Süddeutsche Zeitung*, October 12, 1996.

[196] "In den Keller," *Wirtschaftswoche*, December 19, 1996.

According to unnamed sources, the German government was concerned about letting in Belgium and Austria, whose debts were considered too high, and even more so about Italy, Spain and Portugal. Germany tried to convince Italy to willingly stay out of the first round of EMU in exchange for membership by 2002 instead, but without success. [197]

The German government's profound fear that voters could reject the ECB as a poor substitute for the Bundesbank is demonstrated further by a controversial foreign policy initiative to locate the ECB in Frankfurt. In October 1993, the German government sought to quash a Dutch proposal to locate the European Monetary Institute and the future European Central Bank in Amsterdam and win Dutch endorsement of Frankfurt as the future site. Helmut Kohl's aide Joachim Bitterlich, was sent at least twice to meet with the Dutch Secretary of State Piet Dankert, to press the issue. The German government promised to block the expected election of the Dutch Prime Minister, Ruud Lubbers, as the next President of the European Commission if the Dutch government did not submit to Kohl's wishes. Dankert's report to the foreign ministry recounted Bitterlich's repeated message that Kohl was afraid that German voters would stop EMU in its tracks if he could not provide the symbolic reassurance of locating the central bank in Frankfurt.. In the end, the Dutch government refused to bend and Lubbers was taken out of consideration. By October 1993, Frankfurt had been chosen after all. Helmut Kohl's office denies that the exchange ever happened, but Dankert, a Member of European Parliament at the time of publication, confirmed both the German government's threats and motivation.[198] That the ECB's location had no impact on its composition, independence or operation, and that the Netherlands was normally one of Germany's closest allies on gatekeeping the EMU project emphasizes the German government's desperation to quell voter fears.

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[197] Ibid.

[198] Dankert pointed out that written accounts of informal meetings would be out of the ordinary, but that the extraordinary nature of the demands required it. The documents were broadcast by KRO-TV's show, "Brandpunkt." See "Kohl soll Lubbers erpreßt haben," *Süddeutsche Zeitung*, October 24, 1994; also "Der Kanzler-ein Erpresser," *Frankfurter Rundschau*, October 25, 1994; and "How Kohl linked EMI choice to Delors succession," *Financial Times*, October 26, 1994.

2.5 Conclusions

Germany acted as a gatekeeper to membership in the European Central Bank project. It insisted on membership criteria compatible with price stability, ensured that EU governments would not qualify with one-year measures or non-standard accounting procedures, and fought vigorously to make the membership criteria permanent with a system of automatic sanctions against governments with high budget deficits.

Germany's domestic economic policy after reunification was more equivocal. The government made economic growth and social welfare in the new states its first priority during negotiations with the German Democratic Republic over the terms of German Monetary, Economic and Social Union, and during all-German elections in 1990, while downplaying the risk of inflation and budget deficits to westerners. The Bundesbank's attempts to tie the hands of government did not induce a movement to restrict spending drastically until 1993. Even then, its attempts to restrict spending were hesitant, reluctant and slow.

The difficulty of reducing spending commitments to sustainable levels reflects a division within the government between its traditional core of western conservative voters and a new base of impoverished voters from the new states. That deficit spending could be defended at all is a testament to the weakened power of economic conservatives in the unified republic. Those who had controlled the party through the cost-cutting years of the mid-1980s lost their control over the government's economic policy and only won it back with both tremendous effort and a strain on the coalition that almost destroyed it. Overall, the parallel between Germany's foreign policy and its domestic economic policy is tenuous for most of the study period. Since this does not fully reflect the ideal type, a review of the variables can lead to more important insights.

Despite the tenuous relationship between domestic and foreign economic policy, some observations can be made about how voters and institutions influence domestic economic policy and foreign policy. The first conclusion is that voters were able to project their economic interests onto party platforms in a meaningful way. Party leaders and backbenchers alike adopted policies intended to appeal to the public's basic economic interests. For the governing coalition, these policies reflected the economic disparities of a reunified country. Three quarters of the electorate represented the old federal republic, with its relative prosperity, economic vigor and commitment to economic conservatism. One quarter represented the new states, with their relative poverty, economic paralysis and tendency to view economic and social improvement policies as inseparable. Beyond the first few years of reunification, national and foreign economic policy reflected the continued but weakened dominance of economic conservatism.

The governing CDU, CSU and FDP reflected the new constellation of economic interests by pursuing a balance between social welfare and economic conservatism. What makes this commitment so striking is that it persisted despite record unemployment levels in 1995 and 1996. Voters and government parted paths mainly on the schedule for finding a balance between these two goals. Because the country had not yet worked out the effects of reunification on the economy and because unemployment remained so high as a result, voters wanted membership in the central bank delayed until renewed economic growth could bring the deficit down less painfully. This was the single point on which government economic policy was driven more strongly by its European commitments than the voice of the people.

Voters demonstrated their medium-term conservative outlook by their response to two alternatives provided by the opposition Social Democrats. They responded enthusiastically to an inofficial candidate for chancellor seeking to assemble a center-left coalition closely resembling that held by the government. He promised to continue fiscal reforms and rebuild the economy, but on Germany's timetable, not Europe's. Not only was this seen as a way to put Germany's house in order, but also as a way to resist foreign influences that could weaken Germany's economy, and her ability to play a gatekeeper role permanently. This, incidentally, continued the policy of the SPD's previous leader until late 1995.

Voters rejected the SPD's official candidate for chancellor in 1996 when he tried to construct a majority coalition of depressed regions that would support an end to economic conservatism at home and a monetary union that would weaken it at the European level. It does not contradict the model's assertion that a major opposition should propose a policy that is at odds with the national majority, unless it forms the government. In Lafontaine's defense, he expected that as unemployment rose further, the critical mass for a major electoral realignment would form. Given the failure of the attempt, and the public's fierce hostility to an ECB that would be less conservative than the Bundesbank or a euro that would be less stable than the mark, the role of voters in driving the government's tenacity as a gatekeeper can be confirmed.

The Bundesbank's ability to tie the hands of government on both national and foreign economic policy was aided by its institutional independence, but depended heavily on the underlying support of the German public and its ability to wage a sophisticated public relations campaign to mobilize it. This was particularly important in the Bundesbank's campaign to compel the government to undertake painful corrective measures to entitlement programs, and to help it stay on course. In this way, the interaction of voter pressure and the efforts of an activist, independent central bank proved an important impetus to domestic economic reforms, and as a consequence, to the credibility of Germany's gatekeeping role.

The Bundesbank's independence as a political actor with broad voter support also gave it the ability to strengthen the government's commitment to gatekeeper behavior in the face of contrary foreign pressure. The most crucial, however, proved to be the Bundesbank's participation in the drafting of the Maastricht Treaty's provisions for EMU in the first place. From this point onward, the Bundesbank was able to mobilize conservative voters in defense of the terms of an international treaty. This stance inoculated both the bank and conservatives against criticism that they were out to undermine the Treaty, or Europe itself.

On the other side of the institutional spectrum, the premium system of funding social spending commitments did not always keep borrowing under control, but it helped the German government to draw attention to spending cuts that were necessary to restrain government borrowing. From that point onward, the political preference among mainstream voters for ratcheting down borrowing, aided by the control of the finance and economics ministries through the CSU and FDP, was decisive.

The structure of the German economy influenced more than political demands. It also influenced the kinds of social welfare programs that the country could retain without damaging the commitment to price stability. Institutions that placed little or no pressure on the federal budget while embedded in the west German economy suddenly drove structural deficits when embedded in the unified German economy.

Two structural attributes (sectoral diversity, capital investment in infrastructure) of the western, eastern and combined German economies had a decisive impact on the country's ability to balance stability with growth and social welfare. First, the much wider economic disparity between regions in the unified Germany than had existed in the west before 1990 meant that corporations and working individuals had to pay significantly higher taxes or accept the impact of a long-term structural deficit. As long as voters remained committed to price stability, higher premiums for health, pension and unemployment insurance, and higher income surtaxes targeted at investment in the east were the price to be paid for a stable currency in a unified country. Western taxpayers, who carried the burden of this increase, showed a remarkable willingness to accept cutbacks to their own social insurance benefits as a sacrifice that would ensure lower government deficits and price stability.

One last observation about the relationship between economic structure and voter conservatism needs to be added, since it differs from Frieden's expectations about which societal groups support a strong currency. The prevalence of intra-industry trade in Germany between large, capital-intensive, export-oriented manufacturers and medium-sized, import-competing enterprises created an alliance in favor of economic conservatism that differs from Frieden's expectations. Medium-sized producers were more conservative about the entire spectrum of economic issues than even their larger counterparts, since they were the first to be priced out of competition to supply big firms when taxes rose to pay for social spending. Furthermore, many of these SMEs are owned in part by their larger counterparts to form conglomerates, though the firms officially retain an independent voice. Overall voter conservatism compared to many other countries reinforces the connection. Therefore, the relatively large amount of intra-industry trade within the country (and hence the very high sectoral diversification of the economy) had a decisive impact on conservatism holding in Germany. This points to the need to examine the impact of economic structure on political preferences as closely as capital intensity and income from investment alone.

Two conclusions can be reached from this. First, the underlying economic interests of the conservative majority are capable of reforming spending institutions that generate structural deficits. Second, the dominance of intra-industry trade that ties the interests and jobs of medium-sized, import-competing industries to large, capital-intensive industries is an important aspect of the conservative alliance in Germany weathering great adversity.[199] Third, the difficulties Germany has experienced containing its spending are linked to the task of rebuilding the economies of the new states, and should be considered transitional in nature, given Bundesbank independence and voter conservatism.

199 See Bruce Kogut, ed., *Country Competitiveness: Technology and the Organizing of Work*, Oxford University Press, 1993, pp. 15-20.

3 France

France led the drive to establish the European Central Bank. Nevertheless, French governments displayed ambivalence toward the institution's economic priorities. President Mitterand's vision of monetary union rested on a central bank that would allow governments to determine interest, inflation and exchange rates. The common European currency would protect the EU's weaker economies. Investors and speculators would no longer be able to favor national currencies for transactions or savings. In this way, a common currency would insulate national governments from financial pressure to balance budgets and restructure the economic base on a competitive basis. This vision drew on the Werner Report of 1970 and on the European Monetary System of 1979, neither of which required more than exchange rate stability as a standard of membership. Enough politicians and voters found this proposal appealing to keep its discussion alive at the national level up through the second stage of monetary union, but before Lionel Jospin's electoral victory in 1997, this position remained in the minority, and governments did not propose it at the European level.

Instead, successive French governments from the mid-1980s onward committed the country to stability-oriented economic policies at both the national and European levels. Governments matched relatively new restrictive monetary and fiscal policies at the national level with a willingness to commit to an ECB that would entrench this policy program in an international institution anchored in an international treaty.

Voter support for a strong national currency required government commitments to stability- oriented policies. In the wake of the 1982-83 currency crisis, candidates for national government were forced to place the value of the franc on an equal footing with the battle against unemployment. The *franc fort* policy, as the first half of this compromise came to be known, required tight monetary policies to combat inflation and spending restraint to balance the budget, even at the cost of high unemployment. With the launch of monetary union, it also required establishing independence for the Banque de France.

However, the country's high number of unemployed and the political popularity of social spending programs made it difficult to lock in a low-inflation policy by ensuring low debt and deficit levels. Monetary policy achieved low inflation at the cost of high unemployment levels, which dampened government revenues, raised spending and increased the budget deficit. Given the economic hardship that caused the deficits, fiscal policy was committed to balanced budgets in theory more than reality.

Difficulty reducing the government deficit to three percent of GDP was matched by reluctance to accept rules that would impose penalties for exceeding the limit as a member of the ECB. French governments committed the country to economic policies that were relatively new, and not fully consolidated at the national level. The French proposal and commitment to the ECB served to consolidate an internal attempt at an economic and political sea-change.

When the ECB project came into discussion, economic conservatives seized the opportunity to tie the country's fiscal and monetary policy hands. Its establishment would have strengthened the priorities of conservatives in national economic institutions and institutionally protected the relatively new commitment to the *franc fort*. As governments failed to either make low inflation compatible with low unemployment (by promoting labor market reforms), or make high unemployment compatible with balanced budgets (by reducing unemployment insurance benefits and reducing other social insurance benefits financed by payroll taxes), conservatives began to link proposals for domestic institutional reform to the requirements of membership in EMU. Commitment to EMU came to be part of continuing the commitment to the relatively new *franc fort* policy. This connection became doubly important once it became clear that the stalemate between spending and stabilizing institutions was threatening to scuttle the *franc fort* policy.

The slow pace of institutional reform reflected a weak commitment to spending cuts, and increasingly, to price stability, in the major political parties, in the Elysée, and in the Matignon.[200] This ambiguity reflected in part the divided state of the French electorate, which collectively demanded both the *franc fort* and measures to combat unemployment.

[200] These two terms refer respectively to the official residences and offices of the French President and the Prime Minister. They are commonly used to distinguish policy positions coming from each office.

It also reflected the massive resistance of organized labor in defense of social entitlements, particularly pensions, that were driving government deficits.

France has an economic structure that is somewhat less wealthy and structurally diversified than Germany's, but counts among the EU's stronger economies. Capital intensive production and financial services stand alongside a broad range of medium-sized exporting and import-competing firms and domestic service industries, including several within the public enterprise sector. Unemployment is chronic, pervasive, particularly for youth and older workers, and historically higher than in Germany. Under these conditions, social spending commitments have a larger impact on the deficit than they would otherwise have. In both society and politics, the battle within France over the relative gains of spending and stability is far sharper than in Germany or in other gatekeeping countries that have achieved some sort of equilibrium. Conservatives were determined to push through an economic and institutional revolution based on clearly defined political preferences. They failed under the weight of adjustment-related unemployment in 1997, and the capacity of spending institutions and their allies to block institutional reform.

Section one presents France's economic performance and characteristics. Section two reviews societal demands on domestic and foreign economic policy. Section three investigates the impact of institutions on government behavior, and section four considers the impact of electoral politics on domestic and foreign economic policies.

3.1 Economy: Performance and Characteristics

France experienced low *inflation* from the mid-1980s onward, long before the Banque de France became independent. During the 1990s, a combination of high unemployment, high interest rates and a determination not to devalue the franc within the ERM kept pressure on prices constant. The wage and pension increases which followed the strikes of 1995 and 1996 did not push inflation anywhere close to the limit for membership. However, these increases compelled the Banque de France to ensure price stability with persistently high unemployment levels.

France's *budget deficit* did not reach the reference target of 3 percent of GDP until 1997, and remained significantly higher until then. The country's persistently high unemployment rate was the most important contributing factor to the deficit. It's severity worsened with the 1992 recession and receded only as economic activity improved. Revenues declined, social insurance payments increased, and tax expenditures (targeted tax relief) designed to boost entry-level employment reduced government income further.

Table 3.1 French Convergence with EMU Membership Criteria

	1991	1992	1993	1994	1995	1996	1997
Inflation Rate°	3.2	2.4	2.1	1.7	1.8	2.0	1.2
Deficit*	-2.1	-3.9	-5.8	-5.8	-4.9	-4.1	-3.0
Debt*	35.8	39.8	45.3	48.5	52.7	55.7	58.0

Source: EMI, *Convergence Report*, Frankfurt, 1998.
° Consumer Price Index *Percent of GDP

Cutbacks to fixed spending commitments contained the deficit's growth somewhat. Pension reforms undertaken during the Balladur administration and wide-reaching cuts after 1995 reduced the state's spending commitments significantly. France's total government debt remained within the 60 percent limit of GDP by the time it qualified for EMU in 1997.

The franc's *exchange rate* vis a vis other European currencies faltered in 1992, 1993, and 1995. In 1992, the franc was only able to remain in the Exchange Rate Mechanism after massive intervention by the German central bank to support the rate, and after European governments agreed to abandon the established ERM fluctuation bands to allow 15 percent fluctuation up or down (i.e. a 30 percent fluctuation corridor).[201]

Economic Structure

The structure of the economy determines its overall potential to generate sustainable and high

[201] For exchange rate information, see EMI, *Convergence Report*, Table 8. Frankfurt, 1998.

levels of income. An economy's structure also determines its sensitivity and vulnerability to external economic shocks. To the extent that shocks can generate inflation, disrupt or halt economic activity, or cause large and permanent budget deficits, they can destabilize the exchange rate, the internationally recognized value of the currency. Since national economies differ structurally, the relative competitiveness of national economies has an important impact on national income, the value of the currency, and finally, the exchange rate. The capacity to generate income with minimal disruption depends on a widely diversified economic structure, including competitive capital intensive industries.

France's economy in the early 1990s was fairly well-diversified and competitive by European standards, as was its national income average. Economic activity was compatible with a policy of low inflation and a strong exchange rate, but not without tensions. The economy was characterized by a strong service sector oriented to both the domestic and European market, manufacturing for both domestic and export markets, a smaller but significant agricultural sector, and increasingly, outward foreign investment.

Exports were a fairly reliable source of foreign income, and were concentrated in high value-added sectors such as electronics, chemicals and machinery, but remained highly sensitive to the franc's exchange rate against the dollar.[202] In the private sector, France was a net investor in the world, but had not begun relying on income from foreign investments to contribute to the balance of payments. In contrast, the central government's deficits in the early 1990s were large enough to turn France into a net debtor on a year-for-year basis. In sum, the French economy was relying more heavily on capital investment and investment returns than in the past.

The Juppé government of 1995-1997 introduced the most significant structural change in the economy when it reprivatized numerous enterprises nationalized by Mitterand in the 1980s, primarily as joint-stock companies.(See section 2.4) This structural change after 1995 aided deficit reduction by pushing liability and pension costs into the private sector, and boosted the number of shareholders in the economy, with a direct interest in low

[202] These comments are based on statistics derived from the International Monetary Fund's Balance of Payments Statistics, 1998.

inflation.

On the other side of the economic policy divide, high and long-term unemployment persisted throughout the 1990s, as employers continued to lay off workers, send others into early retirement, and restrict hiring of regular staff. Where firms created new jobs, they often did so in conjunction with state subsidies that favored poorly paid employment free of social insurance premiums for both employers and employees.(See section 2.4) None of these trends relieved the French government's budget situation before 1997.

Production in France were dominated by the service sector. Public job-creation projects had a significant impact on this category, as reflected in productivity and employment figures. Overall, the service sector accounted for an ever-increasing share of the country's GDP from 1991 to 1996, without generating a corresponding increase in value for the economy, while manufacturing and agricultural employment shrank.

Measures for 1991 to 1996 show that France did not yet begin to generate the kind of service sector productivity that Germany depends on to generate economic growth. This weakness meant that manufacturing (and exports) continued to play an important role in economic performance.

Table 3.2 French Share of GDP (& Employment) by Kind of Activity (Percent)°

	1991	1992	1993	1994	1995
P	3.8 (5.3)	3.5 (5.2)	3.0 (5.0)	3.0 (4.8)	3.0
S	35.9 (29.1)	35.1 (28.3)	34.6 (27.3)	33.7 (25.9)	33.9
T	60.4 (65.5)	61.4 (66.5)	62.4 (67.7)	63.2 (69.3)	63.1

Source: OECD, *National Accounts*, Paris, 1996. ILO, *Yearbook of Labour Statistics*, Geneva, 1995.
°Older, but more accurate data than in appendix.

Employment dropped steadily in almost every economic sector, except various sorts of public service jobs. Hotels, restaurants, and banking experienced some fluctuations within the downward trend. The drop in primary and secondary industry employment was accompanied by increases in productivity, while productivity growth in the service sector remained flat, meaning that service industries were unable to offer employment to many of those losing jobs in manufacturing and agriculture. This imbalance not only generated chronic unemployment, but also a relatively strong tendency for residents to stop looking for work altogether. This phenomenon is revealed by the relatively low participation rate of workers in the labor market of 45 percent in 1995, meaning that only 45 percent of the entire population was either working or looking for work. Only 50.6 percent of men fell into this category, and only 39.8 percent of women.[203]

National productivity growth rates provide an indication of how well the country is able to improve its competitiveness. The productivity growth rate says less about prospects for future employment than it does about the chances for avoiding layoffs in the future as firms compete for markets. Also note that productivity increases can represent a realized reduction in employment.

Table 3.3 French Productivity and Unit Labor Cost Growth

	1991	1992	1993	1994	1995	1996
Prod.	1.3	2.3	1.8	2.7	1.1	0.8
ULC	8.1	8.0	4.9	0.0	1.9	2.9

Source: EMI, *Convergence Report*, Table 2. Frankfurt, 1998.

Unit labor costs indicate the role that wages play in eroding or improving price competitiveness, and are calculated by dividing production by labor costs. In France, unit labor costs grew strongly at the beginning of the 1990s, meaning lower productivity, stalled in 1994, and moderated thereafter. This points to a significant shift in wage agreements toward long-term price stability.

[203] International Labour Office, *Yearbook of Labour Statistics*, Table 1A. Geneva, 1998.

Table 3.4 French Unemployment Rate

1991	1992	1993	1994	1995	1996
9.5	10.4	11.7	12.3	11.6	12.3

Source. EMI. *Convergence Report*. Table 2. Frankfurt. 1998.

The current account measures a country's net income from investment sources, the sale of goods and the provision of services abroad. The balance, surplus, or deficit contributes to the value of the national currency. Since current account figures are normally listed by economic activity, it is also possible to get an overview of the country's strengths and weaknesses, and of trends in economic success.

France turned a significant trade deficit into a trade surplus after 1991. The economy was dominated by domestic services and trade, with investment becoming more important. Imports increased, but exports grew even more strongly. Modest growth of the nation's surplus in exported services continued, particularly in travel (but not transportation) and business services. On the other hand, the French economy did not receive enough income from investments to compensate for foreign investments being withdrawn. This gap widened sharply after 1990, more than tripling by 1994. Current transfers also were a significant burden on the country's current account.

The financial account measures net wealth (or indebtedness) vis a vis the rest of the world. The most important subcategories are foreign direct investment (in production facilities), and portfolio investment (stocks and bonds), both in the private and public sectors.

France's financial account turned from an exceptionally strong surplus in 1989 and 1990 to a large deficit after 1991.[204] This reflects a surge of French investment abroad in 1992 that transformed the country from a net investment recipient into a net investor in the

[204] See IMF. *Balance of Statistics Yearbook*. Washington. D.C. 1998.

outside world. The net flow of direct investment abroad was very strong in 1991 and 1992, and moderate in 1994. The more interesting story, however, lies in government debt assumed to prop up the franc's exchange rate. Large government debt exploded in 1992, as the Banque de France borrowed huge sums of money to support the exchange rate of the franc. Money kept moving into France until 1994, when investment capital began leaving the country, some in direct investment, but more in portfolio investments. This change was made in large part by a large pay-down of money that the French central bank had borrowed in 1992 to support the franc's exchange rate. In sum, private investment interests are on the verge of taking on a new importance for the French economy, both in an absolute sense, based on investment income, and based on the size of its activity in comparison to government borrowing.

Table 3.5 Current Account, France, Billion US Dollars

	1991	1992	1993	1994	1995	1996
G°	-9.71	2.37	7.52	7.25	11.0	14.94
S	36.41	19.12	16.84	17.85	17.97	16.25
I	-5.73	-8.61	-9.17	-6.76	-8.97	-2.70
Total*	-6.52	3.89	8.99	7.42	10.84	20.56

Source: IMF, Balance of Payments Statistics Yearbook, Table 1. Washington, 1998.
° G=goods; S=services; I=investment income. * Includes an adjustment for current transfers.

Table 3.6 Financial Account, France, Billion US Dollars

	1991	1992	1993	1994	1995	1996
DI°						
(Out)	-23.93	-31.27	-20.60	-24.44	-15.82	-30.36
(In)	15.15	21.84	20.75	15.80	23.73	21.97
Port.~						
Assets	-15.72	-18.46	-31.50	-21.96	-6.42	-53.10
Liab.	29.54	52.50	34.52	-27.90	13.08	-7.55
Total*	-3.07	-8.04	-16.67	-4.78	-7.33	-22.34

Source: IMF, *Balance of Payments Statistics Yearbook*, Table 1 Washington, 1998.
°DI=direct investment (outward and into France). ~Portfolio assets abroad and liabilities to foreigners. * Includes an adjustment for other investment assets.

3.2 Society: Business, Labor and Voter Interests

French society had to make tough choices in economic and social policy during the 1990s. First, its members had to decide on how to deal with the consequences of a successful fight against inflation during the 1980s. French unemployment was already high at the beginning of the decade, state finances were deteriorating accordingly, and the decision to remain in the EMS to preserve the exchange rate against the German mark only hurt the domestic economy. The strain forced an increasingly tense dispute over whether the shift to stability was worth the price it was extracting on the country.

Business

Business is represented principally by the National Council of French Employers

(*Conseil National du Patronat Français*, or CNPF). Throughout the 1990s, both business representatives and the CNPF lobbied the government chiefly for legislation that would reduce labor costs. The most important of these were social security contributions. In their capacity as co-managers of the various social insurance funds, they promoted the restriction of benefits that individuals were entitled to receive, so that increased demand would lead to higher premiums. This position was most pronounced in pension policy, in which the *patronat*, as the CNPF is often called, vigorously fought pension premium hikes. By 1993, it also pushed for the legalization of private pension plans as part of a broader strategy to reduce the burden of pension premium contributions. In 1995, it renewed its pressure and maintained it until the Juppé government legalized the plans later that year.[205]

In contrast to cutting individual benefits, employers often approved of extending access to benefits to more individuals if doing so would allow them to reduce their payrolls more easily, particularly through early retirement. For this reason, the CNPF never came out in favor of controlling spending by increasing the retirement age upward from 60, and even began promoting even earlier retirement at reduced rates in 1995. Meanwhile, the Balladur government had practically raised the retirement age before then (see sections 2.3 and 2.4), demonstrating a stronger priority for budget restraint.

The contradictory position of the *patronat* and individual firms on pension policy had less of an impact on public sector pension spending than the increasingly generous pension agreements struck in public sector enterprises. In 1996, generous pension agreements in the wake of the 1995 strikes were negotiated at France Télécom, the national railway system SNCF, and the utility company EDF-GDF.[206] So the strong presence of the French state as employer, coupled with the relative weakness of French governments in imposing reform policies, weakened the call among the business community for restraint.

The CNPF also lobbied the government to reduce the payroll-related costs of health

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[205] Ridding, John, "Grey on top, thinning below," *Financial Times*, July 27, 1998; "Le gouvernement relance prudemment le projet de fonds de pension," *Le Monde*, July 2, 1995.

[206] "Lemaitre, Frédéric, "Les contradictions de l'Etat face aux préretraites," *Le Monde*, October 12, 1996.

care, but not until 1993. Then it challenged the popular support health care as an unlimited, universal entitlement, arguing that individuals should take more responsibility for their health care choices. The existing system, as the CNPF underlined in 1995, consisted of three tiers: "national solidarity," for the unemployed and others without resources; a system of "obligatory collective insurance," for working people, and "individual" insurance providing complementary benefits. The CNPF advocated two measures to reduce health insurance premiums: additional funds from the general budget to allow a one percent drop in premiums, and fewer benefits in the first and second tiers.[207] Doctors provided stiff resistance to government plans to restrict their income. In early 1994, they threatened to strike against measures proposed by the Balladur government that would have limited income as a means of capping overall medical expenditure growth at 3.4 percent for the year.[208]

Business also clashed with unions over the prospect of legislation to reduce unemployment by regulating working hours and hiring practices. Business rejected labor proposals for the 35 hour work week (without salary cuts) from 1995 onward. Throughout the 1990s, they fought unions over the share of peripheral labor within firms. As industry wages remained high in the wake of the 1992 currency crisis, employers increasingly replaced segments of their core workforces with part time workers, minimum wage workers and government-subsidized trainees. While business was happy to exploit government back-to-work programs as a source of inexpensive labor, labor was not willing to accept the prospect of lower effective wages. Employers opposed the 35 hour week on account of the prospects for higher unit labor costs and inflation, and enjoyed government support until 1997 (see section 2.4).

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[207] Bezat, Jean-Michel and Alain Faujas, "Le CNPF veut plus de pouvoirs pour reformer l'assurance-maladie," *Le Monde*, June 14, 1995.

[208] Normand, Jean-Michel, "Les dépenses de santé devront être réduites," *Le Monde*, January 22, 1994. For a broader overview of the resistance of doctors to cost expenditure measures, see David Wilsford, "Reforming French Health Care Policy," in John Keeler and Martin Schain, eds., *Chirac's Challenge: Liberalization, Europeanization, and Malaise in France*. London: MacMillan, 1995, pp. 231-256.

In macroeconomic policy, the CNPF led a pragmatic exchange rate policy that reflected both the group's diverse membership and the country's economic fortunes. After the rupture of the European Monetary System in late 1992, employers complained increasingly that Italy, Spain and the UK were benefiting at France's expense from lower exchange rates. Not only had exchange rate devaluations dropped their competitors' costs up to 35 percent, subsequent devaluations were destroying the competitive value of productive investments or wage restraints in French industry. The loudest cries came from sectors which competed with counterparts in these countries, either in the French market, in Spanish, Italian and British markets, or in third markets that their competitors could suddenly supply more cheaply. The particularly strong collapse of the Italian lira, for example, had virtually shut French producers of textiles, machinery, chemical products and agricultural goods out of the Italian market.[209] In addition, car sales in regions bordering Italy shrank as consumers crossed the border for better bargains. Overall, the most sensitive and vulnerable sectors supplied goods that required only standard technology and processing techniques.

The real divide over devaluation or a strong currency rested on the degree of flexibility or product advancement that companies could rely on. A spokesman for the chemical industry, for example, explained that the more advanced the chemical processing a product required, the less likely that exchange rates would affect sales. Similarly, auto makers Renault and Peugot-Citroen were able to adjust by moving some of their production operations to Spain, taking advantage of the currency shift. The contrast with other exporters is striking, since these firms depended heavily on export earnings. Yet Aerospatiale, which demonstrated less production flexibility (i.e. less of an international structure) had gone so far as to calculate the exchange rate it needed from the government in order to compete against Boeing of the US.[210]

In 1995, after two major currency crises, the CNPF explicitly rejected a devaluation of the franc, arguing that it would not help the country solve many of its problems. Interest

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[209] Gallois, Dominique, and Martine Orange, "Les industriels français redoutent surtout la faiblesse du dollar." *Le Monde*, March 8, 1995.

[210] Ibid.

rates would not necessarily drop with a devaluation, as most businesses wanted. Nor would it aid repayment of debt or lead to a reduction of the government's deficit. It would also inject renewed instability into the European exchange rate system, and hurt France's interests further. A commitment to remaining within the hard core of the EMS was the only solution that the CNPF would consider.[211]

In conjunction with this stance on economic policy, the CNPF also criticized the government's tendency to pursue growth by promoting consumption. Denis Kessler, Vice President of the *patronat*, pointed out that people were saving because they were afraid of their financial prospects, and would not spend again until they regained confidence that their positions would be more secure. Therefore, raising the average income was unlikely to initiate an economic recovery. In addition, the savings themselves would help the country recover through investment if the money wasn't being funneled into public debt.[212]

In 1991, the CNPF welcomed both the Maastricht agreement on EMU and the establishment of an independent European Central Bank. Nevertheless, it criticized the establishment of the ECB without a corresponding political body that would carry ultimate political responsibility for the bank's policies. In addition, the CNPF suggested that representatives of industry, trade and banking participate as advisors of some kind. In contrast to German industry, the French business group also advocated an early start for the third stage of monetary union, in which exchange rates would be frozen and the common currency introduced.[213] An employers' peak organization, the Enterprise Institute (*Institut de l'Entreprise*), reinforced this stance in October 1996 by advocating a flexible interpretation of the entrance criteria for monetary union as the government prepared for negotiations with Germany over the Stability Pact at the Dublin intergovernmental conference.[214] This

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[211] Faujas, Alain. "«Il faut passer d'une économie axée sur le secteur public et social à une économie fondée sur le secteur productif.»" *Le Monde*, February 14, 1996.

[212] Ibid.

[213] "Frankreichs Patronat will Europa." *Börsen-Zeitung*, November 28, 1991.

[214] Bonse, Eric. "Paris sorgt sich um die politische Souveränität." *Handelsblatt*, December 31, 1996.

international commitment would lock in the national agenda to reform prices and spending to support stability.

The CNPF explicitly linked membership in the ECB to outside pressure on government and society to finally establish and maintain a culture of stability. It expected a single currency to increase the mobility of capital and labor, and put strong pressure on governments to harmonize their economic and financial policies. In addition to the pressure on governments to clean up their finances, the CNPF emphasized that the French model of a dual economy, in which large production sectors are state-owned or otherwise protected from competition, would have to give way to a market economy at last. In addition, it argued that France could no longer afford the competitive disadvantages of tax rates and social insurance premiums far above the European average,[215] and that these changes would have to be made to commit to EMU. Overall, French business saw ECB membership as a means to complete the changes toward a French economy that relied more on private enterprise, and toward an economic institutional structure that linked social spending and business taxes to the price components of France's export competitiveness.

In sum, the French business community remained divided on some of the key issues related to membership in the ECB. Collectively, it demonstrated significant support for a domestic economic policy reform oriented to price stability and modest government deficits. It also promoted a stability-oriented monetary union, but without the guarantees of prior stability which Germany sought. Through early membership before reforms were completed, price sensitive exporters and domestic market providers could be brought into a coalition with larger, less price sensitive sectors to promote a strong currency through a wave of privatizations, tax reductions and labor market reforms that would cheapen the price of labor, which could alleviate the concerns of the former group about the costs of a high exchange rate).

It is important to note that the French middle sectors are less likely to support a hard EMU and related policies than their German counterparts. This can be attributed to the lower

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[215] "Frankreichs Patronat will Europa," *Börsen-Zeitung*, November 28, 1991.

prevalence of small and medium-sized enterprises in manufacturing linked to large, productive enterprises as in Germany, and the higher importance of service industries, and in relatively less productive sectors in Germany.

Labor

Labor is represented both by unions which oppose macroeconomic and budgetary policy restraint and those that cooperated with a policy of spending reductions. More radical unions lost power to reformists between 1993 and 1996, but showed also through strikes as a force capable of frustrating government plans to reform spending commitments. More growth and spending-oriented labor in France is represented by the socialist Workers' Force (*Force Ouvrière*, or FO) and the communist General Labor Confederation (*Confédération Générale de Travail*, or CGT), which dominate public service and public enterprises; and in industrial manufacturing, particularly in the so-called 'protected sectors' dominated by state-owned industry. Most unions favor moderate interest rates, a growth-oriented monetary policy and a flexible exchange rate, but these are secondary issues in relation to their focus on wages and entitlements. Both macroeconomic policy and incomes policy were of interest to unions, both of them were the focus of direct confrontation with the Balladur and Juppé governments' plans to restrain public spending, and both were framed for members and the wider public as a matter of social justice. Despite the rhetoric of social justice, however, unions only mobilized their members against measures designed to hurt them directly, instead of in defense of broader social values that affected the entire public.

The CGT and the FO engaged in a systematic policy of total opposition to spending cuts during the 1990s. They also opposed the public sector savings necessary to qualify for EMU.[216] Both unions took critical stands on budget and social spending restraint policies. The FO successfully defended public sector pensions against cutbacks under the Juppé regime, where its own stake was the highest. Toward 1997, the FO was only able to exert

[216] See, for example, "Paris friert Ausgaben ein," *Handelsblatt*, August 8, 1996.

its influence by directly defending its members in the public service. In 1992, it had already lost its majority control over the unemployment insurance (UI) fund to the reformist Democratic Labor Confederation of France (*Confédération Française Démocratique du Travail*, or CFDT) and in 1996, its control over the national pension fund. Within the unemployment insurance fund the CFDT approved of measures in 1993 that reduced payments to benefit recipients in return for government subsidies that would limit premium pressures on their members. The FO remained unenthusiastic about this compromise and demanded unsuccessfully that civil servants pay unemployment insurance premiums in solidarity with the general society.[217] The CGT went even further than the FO by arguing that the UI fund insured less than half of the nation's unemployed, and had to be extended before any discussion of financing could be taken seriously.[218]

Pension reform also demonstrated that the FO and the CGT approved of only modest adjustments to entitlements, and while defending their own members' interests. The FO cooperated with pension reform in 1993, for example, in which complementary benefits were ratcheted down marginally. As discussed in section 2.3, however, these reforms kept benefits intact for workers with stable job histories (FO members fell into this category), while drastically reducing pension entitlements for those on the periphery of the labor market. Only the CGT spoke out for solidarity of all workers, and the maintenance of full pension rights.[219]

The FO only rabidly opposed a reform which threatened to reduce their pensions. Private pension plans proposed in 1993 involving tax deductions for premiums would have diverted premiums from the economy's more productive sectors away from the public plan, and forced pension cuts for the FO's membership. They fought proposals in 1993, and

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[217] Lebaube, Alain, "Le précedent accord sur l'assurance-chômage est mis en cause par les partenaires sociaux," *Le Monde*, June 17, 1992.

[218] Bezat, Jean-Michel, "L'Unedic table sur 72,000 chômeurs de moins en 1995," *Le Monde*, February 25, 1995.

[219] Seux, Dominique, "Important accord sur les retraites complémentaires," *Le Monde*, February 19, 1993; Francine Aizicovici, "Une situation incongrue," *Le Monde*, April 5, 1995.

eventually their introduction in 1995. In 1996, the CFTD replaced the FO at the head of the complementary pension system, and approved of the introduction of private pensions for the broad public for the first time. The FO became openly bitter about its own loss of institutional power in 1995 and 1996, began threatening the insurance boards with obstruction unless the FO regained control over the funds,[220] and eventually began threatening the government with protests when this last measure failed. The FO's greatest success came in conjunction with the CGT during the strikes of 1995. The unions fought to preserve wage increases and improve upon public service pension entitlements, and to express outrage over the government's introduction of private capital pensions. As section 2.4 demonstrates, the union was effective in blocking the adoption and implementation legislation that would allow the government to consolidate and control the growth of public sector pension entitlements.

Unlike the CGT, which focused heavily on wage demands, the FO paid considerable attention to demanding better working conditions and to reducing unemployment through the introduction of the 35 hour work week at the same pay. The FO even made a point of refusing to discuss measures to reduce youth unemployment until this demand had been met.[221]

The CGT's general economic policy stressed economic growth through higher wages and job creation through universal retirement at the age of 50. When the Juppé government initiated its savings program in 1995 by announcing a wage freeze for the public sector, they countered that if wages were raised high enough and enough jobs created through early

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[220] "Moderate Gewerkschaft gestärkt," *Frankfurter Allgemeine Zeitung*, June 14, 1996.

[221] The initiatives in question were pushed by Balladur's labor minister, Michel Giraud in concert with the economics minister to provide training positions (through a so-called Contrat d'Insertion Professionnel) and other jobs at 80 percent of the minimum wage. See Michel Noblecourt, "L'opposition au «SMIC-jeunes» rapproche les syndicats," *Le Monde*, March 17, 1994. The measures were repealed after protests led by the unions. The attempt to use youth unemployment to win a shorter working week for the same pay came a year later. Alain Beuve-Méry and Alain Faujas, "Le CNPF refuse de discuter de la réduction du temps du travail," *Le Monde*, March 30, 1995.

retirement, that economic growth would make government deficits disappear.[222] Due to their lesser importance on social insurance boards, the CGT took a back seat to the FO on entitlement policy. When the FO was forced out of the unemployment insurance and pension funds, it joined the CGT in its more fundamental criticism of cutbacks.

The CGT, as France's largest union and largest public sector labor group, helped to make the strikes of 1995 a success, as well as 1996 (see section 2.4). These strikes countered the savings policies of the Juppé government, ranging from wage freezes to privatization, and brought over a million strikers into the streets, representing teachers, Air France workers, transport workers, utility workers and civil servants. Meanwhile, the CGT's opposition to EMU rested not just on the savings policies it required, but the broader program of privatization it involved.[223]

The mirror side of the FO's decline has been the CFDT's rise in the union movement. This union, broadly based and somewhat internally divided, took leadership of both the unemployment insurance and health insurance boards, with a willingness to cooperate with the government on reform. It aided with the reform of unemployment, health. Reform-mindedness was short-lived, however. The CFTD lost many members as a result,[224] and showed a more radical face in 1996, when it led the truckers' strike for greatly improved pension entitlements.

The two week trucker strike in November and December of 1996 crippled the country and forced concessions from employers and government. From employers, they struck for better working conditions and higher pay. From the Juppé government, they struck for earlier retirement, as early as age 55, while the retirement age for other citizens was rising to 63. The Nouvel Economiste estimated that this measure would cost the government dearly at a time when it was attempting to constrain spending. The government tried to keep its

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[222] During the 1995 strikes, see "Le gouvernement aura cédé le premier," *Le Nouvel Economiste*, No. 1027, December 15, 1995.

[223] "Zerbrochenes Vertrauen," *Der Spiegel*, December 2, 1996.

[224] Webster, Paul, "Wage freeze unites unions," *Guardian*, September 13, 1995.

distance from the conflict, but the CGT and CFDT unions representing the truckers forced the government to mediate. By 1996, the tide of public opinion was with the unions. Nearly three quarters of the general population supported the truckers, while only 20% continued to have confidence in the prime minister.[225]

The FO had strong objections to cutbacks proposed for health care, particularly in 1995, after social affairs minister Simone Veil had attempted to restrain expenditures for the year. Marc Blondel, FO president, argued that savings measures would drive the wedge further between those relying on national solidarity for health care and being left behind, and those who could afford private supplementary insurance to make up for the shortfalls of the state.[226]

The union representing French doctors was successful until late 1996 at blocking reforms that would limit insurance coverage for residents seeing doctors. The Juppé government instituted reforms toward the tend of 1996 (see section 2.3). This measure was not intended to cut health spending, but curb its phenomenal growth, particularly in the 1990s. At the time of writing, figures on the programs impact were unavailable.

In addition to opposing cutbacks to social security entitlements, unions representing public sector workers also criticized the privatization of many publicly-owned enterprises. Throughout the 1990s, the prosperity gap between the public sector and the private sector grew significantly, meaning that privatization could lead to a lower standard of living for many employees over the long term.[227] Utilities, banks, insurance companies, Air France, computer manufacturers and defense firms, all had employees with a strong incentive to oppose the privatization plans as part of Maastricht. Even more telling of the public's final unwillingness to turn their backs on the unions, however, was the fact that the unemployed

[225] The new commitments were estimated to cost 500 million francs per year. See "Zerbrochenes Vertrauen," *Der Spiegel*, December 2, 1996.

[226] Bezat, Jean-Michel, and Alain Faujas, "Le CNPF veut plus de pouvoirs pour reformer l'assurance-maladie," *Le Monde*, June 14, 1995.

[227] "Public-privé: les deux France," *Le Nouvel Economiste*, No. 1017, October 13, 1997, p. 60.

were increasingly trying to get into these public sector jobs.[228]

The persistent growth of unemployment promoted more frequent attacks on the government's European policy. The CGT's leader, Louis Viannet, attacked integration into the European Union for the unemployment that it caused. He sax restrictive economic policies and privatizations driving businesses and people out of work. In addition to the decimation of well-paying jobs in the private sector, banks, Air France, and utility companies would shed jobs as they were privatize and forced to compete with non-French firms.[229]

Unions have been significant players in the EMU policy of successive French governments during the 1990s, but in an indirect manner. While unions represent a small portion of the French labor force, and while they demonstrate little direct interest in the concrete questions of membership in the European Central Bank, they are both active and important players in the social insurance spending policies of the French government. They are most active in defense of benefits for their own members. While the institutional importance of the FO waned in favor of the reformist CFDT, the FO, CGT, and in 1996, the CFDT employed non-institutional protest (i.e. strikes) in order to win fights against pension reform and wage restraint that they had lost institutionally or through government attempts at legislation. Because these pension funds place such a large burden on the federal budget, the strikes have proven to be an important non-democratic factor in the country's overall institutional deadlock and trouble reducing public expenditures.

Voters

French citizens were consistently pessimistic about their personal financial prospects, and even more pessimistic about the financial situation of the country at large.[230] They

[228] Ibid.

[229] Ibid.

[230] The following is based on information reported by Eurostat's Eurobarometer, Surveys 36, 38, 40, 42, 44 and 46, which cover 1991 through 1996. The relevant data is presented in the appendix in tables 3.14 and 3.15.

demonstrated surprising confidence in 1994, after electing a new conservative government with a large majority. Hopes not only faded quickly, however, but turned into deeper pessimism in 1995 and 1996. The one-time peak in optimism follows Balladur's campaign promise to promote economic growth and combat unemployment by restructuring both government and the economy. The pessimism in 1995 and 1996, in contrast, coincides with the spending cutbacks of both the Balladur and Juppé governments. These measures constituted the centerpiece of the conservative plan to attract private investment into the French economy by attempting to reduce the deficit. For the first time, social entitlements were cut significantly.

French public opinion was evenly split over whether job prospects were good or bad. Given the country's high unemployment rate, and the modest percentage of people who expected an improvement in either personal or national employment prospects, this demonstrates more resignation to the country's unemployment situation than anything else. The data for 1993 to 1996 suggest that most respondents believed that unemployment had at least bottomed out.

Support for a European Central Bank enjoyed majority support in France from 1991 to 1994, the years for which Eurobarometer published data on support for the institution. Support was particularly high in 1994, when French residents were also unusually optimistic about their own financial futures. The European Commission's decision to stop publishing support levels after 1994 obscures how French residents evaluated plans for the ECB in the context of two important policies that only came onto the policy agenda in 1995 and 1996. First, the unpopular savings policies of 1995 and 1996 under the Juppé government were linked to membership in the ECB. As noted above, these policies coincided with a sharp downturn in financial expectations both personally and for the country at large. Second, negotiations with Germany over the stability pact as part and parcel of ECB membership took place in 1996.

Table 3.7 French Support for the European Central Bank (+/-)

1991	1992	1993	1994
61 / 16	59 / 25	63 / 25	71 / 21

Source: *Eurobarometer* 36, 38, 40, 42.

A majority of French residents supported the introduction of a single European currency throughout the study period. Support remained stable, in contrast to support for the ECB, but also more modest.

Table 3.8 French Support for the Single Currency (+/-)

1991	1992	1993	1994	1995
64 / 18	57 / 32	59 / 31	60 / 32	58 / 23

Source: *Eurobarometer* 36, 38, 40, 42, 44.

Meanwhile, cleavages in France generally and over Maastricht in particular moved away from class conflict that had persisted until 1988, and toward a new set of criteria. The educated, professional, urban, centrist voter was most likely to demonstrate support for Maastricht and the reforms required to get there. Communist and Front Nationale supporters, the poor and marginalized, farmers and the small-business self-employed were most likely to oppose the change.[231]

In spring 1998, support for the single currency had increased to 68 percent of respondents, up 10 percent.[232]

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[231] This analysis is drawn from SOFRES data presented in Pascal Perrineau, "L'enjeu européen révélateur de la mutation des clivages politiques dans les années 1990," in François d'Arcy and Luc Rouban, eds., *De la Ve République à l'Europe*. Paris, Presses de la Fondation Nationale des Sciences Politiques, 1996.

[232] Eurostat. *Eurobarometer*, Survey 49, Questions 44-60. Brussels, 1998.

3.3 Institutions

Pension, health and unemployment insurance programs resisted spending adjustment in important ways, despite some successes at restraint. First, benefits were fragmented, meaning that the success the French government achieved in reducing social insurance spending in some pension plans in particular was balanced by increased spending commitments for pensions in professions with specialized funds and a particularly strong capacity to hurt the national economy with strikes. Transport and public service workers in particular proved capable of defending and extending spending commitments and increasing disposable income, in contrast to other sectors, which accepted by 1996. In 1997, the Jospin government demonstrated its unwillingness to touch this problem by focusing again on getting the French back to work instead.

Table 3.9 Social Security Receipts from General Government Revenues, Million French Francs (FF)

1991	1992	1993	1994	1995	1996
135.666	157.515	178.771	208.019	209.774	213.034

Source: OECD *National Accounts*, Volume II, Table 6.4. Paris, 1998.

Although in principle social security spending commitments are paid with insurance premiums, top-ups from general government revenues constituted a significant and growing expenditure, which made budget-balancing more difficult. Table 3.9 shows government transfers from the general budget to the social security funds.

Pension Insurance

The pension system began to place more and more pressure on the national budget in the 1990s as chronic unemployment and an aging population increased the ratio of claimants to ratepayers. Unemployment and public sector union demands reduced the effective retirement age in many sectors toward 50. At the same time, fewer people were paying into the fund. Many people who would otherwise contribute were unemployed, drawing an early pension as an alternative to unemployment, or working in poorly paid jobs exempt from social insurance contributions.

The French pension system is a network of public insurance funds that combines a universal old age security (OAS) pension, contribution-related benefits, and a number of complementary benefits for citizens unable to make contributions on their own.[233] According to French pension law, employers and employees to pay premiums into the pension funds, which are then managed by employer and union representatives. While the government sets some minimum standards, such as the official retirement age and the minimum OAS pension, the social partners, as the representatives are known, have the authority to reduce the retirement age or increase the benefits of their particular plan. Although most complementary pension plans are part of two major pension systems, ARCCO and AGIRC, which cover the broad base of employees and top management respectively, there are many different plans in France covering a variety of sectors and professions. Each, accordingly, has its own capacity to make an impact on the pattern of national entitlements.

In principle, the funds are responsible for balancing the flow of premiums and liabilities, and for borrowing money when the fund runs short. The government may provide aid in case of shortfalls, but refuses to assume responsibility for the fund as a matter of principle. In return for aid, the state demands that the social partners develop a plan to restore the balance of payments and premiums. The one exception to this pattern occurs when the government provides funds to cover the premiums of and liabilities for citizens unable to make contributions for some period of time.

The decentralized nature of the pension system makes it more difficult for the

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[233] For a brief but comprehensive view of the pension system and the challenges facing it at the beginning of the decade, see Jean-Michel Normand, "La fausse querelle des rétraites," *Le Monde*, February 5, 1991. See also Alice Rawthorn, "Some point of pride," *Financial Times*, June 24, 1993.

government to balance the budget, since the government tends to pay for serious shortfalls rather than allow the fund to collapse. In the public sector, a combination of strong, aggressive unions and a decentralized system that promotes growing entitlements is particularly problematic for the government. The central budget feels the pinch of pension plans for public sector firms that are both the nation's most generous, yet largely negotiated independently of government control.

Both socialist and conservative governments aimed to reduce the overall pension benefit by altering the entitlement formula downward across the board and by collecting more premiums. Socialist prime minister Michel Rocard made the first attempt to make changes in 1991, with the support of opposition conservatives. He intended to calculate income-related pensions on the best 20 years of a recipient's working life, rather than the best 10. It also intended to calculate cost of living increases using the consumer price index, rather than the relatively more generous wage index.[234]

The Rocard government's white paper cited the aging population, the shrinking base of ratepayers under long-term unemployment, and the trend toward early retirement as compelling reasons to alter the entitlement formula. The white paper's admission that structural unemployment lay at the root of both flagging premiums and early retirement is reinforced by common rejection of the proposal to extend the ratepayer base by raising the official retirement age.[235]

No conclusive action was taken in the wake of Rocard's replacement as Prime Minister by Edith Cresson in 1992. While the finance minister, Pierre Bérévogoy, pushed to implement the white paper,[236] the social policy minister, Réné Teulade, fought to eliminate pension credits for citizens who had not paid corresponding premiums. He wanted these

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[234] See "Ein teurer Generationsvertrag," *Handelsblatt*, April 24, 1991.

[235] Normand, Jean-Michel, "Le débat sur la retraite à l'heure du livre blanc," *Le Monde*, April 17, 1991.

[236] "Retraites: le come-back de la CSG," *Nouvelle Economiste*, June 12, 1992.

"non-insurance" provisions to be provided by the general budget,[237] where they would be more vulnerable to budget cutting. Cresson, however, remained preoccupied with the upcoming election. In particular, she was aware that cutbacks were the only more unpopular measure than higher premiums.[238] Nevertheless, the government began reducing subsidies to some public sector pension plans in January 1993, forcing premiums for local public servants and hospital workers to rise, as well as local taxes and hospital fees.[239]

In the 1993 election that brought the Balladur government to power, both parties elected to protect the 1982 policy of retirement at 60, but implement reductions in the entitlement formula.[240] Balladur exploited the widespread acceptance that the pension system required change to extend the reference period for calculating pension benefits to 25 years. He also imposed a 1% hike of the CSG to spread the burden of paying for "non-insurance" pension credits. In addition, premiums rose.[241] The number of full trimesters required to receive a full pension increased from 150 to 160. Together with the extension of the reference period to 25 years, this amounted to a significant reduction of pension entitlements to persons with irregular work histories or long university stays.[242] All of this was still inadequate to balance the fund. Both employers and unions called on the government to top

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[237] Piot, Olivier, "Le gouvernement veut clarifier le financement de l'assurance-veillesse." *Le Monde*, July 30, 1992.

[238] See "Le gouvernement modère ses ambitions sur le dossier des retraites." *Le Monde*, April 25, 1992 and "Defizit in Frankreichs Rentenversicherung." *Frankfurter Allgemeine Zeitung*, August 7, 1992.

[239] Normand, Jean-Michel, "L'état réduit ses subventions aux régimes de retraite des collectivités locales." *Le Monde*, November 3, 1992.

[240] For the socialists, see "Franzosen bangen um ihre Renten." *Süddeutsche Zeitung*, February 8, 1993. For the conservative coalition, see "Les mécomptes de la retraite à 60 ans." *Le Monde*, April 5, 1993.

[241] "La durée de cotisation des retraites serait progressivement allongée." *Le Monde*, May 8, 1993. The CSG refers to a extra premium imposed by the Rocard government to boost funding for social insurance programs. Its full name is the cotisation sociale générale.

[242] Normand, Jean-Michel, "la réforme des retraites entrera en vigueur le 1er janvier 1994." *Le Monde*, August 29, 1993.

up funds by one to one and a half billion francs per year. The government met this demand. In return, the social partners agreed to raise premiums to cover future shortfalls.[243]

In 1994, the pension plan was already feeling the increased burden from early retirement that followed restrictions to UNEDIC, the nation's unemployment insurance plan. By raising the age at which workers could rely on unemployment insurance until retirement from 57.5 to 58 years of age, and by increasing the number of fully contributed trimesters to 59 to qualify, UNEDIC simply unloaded its own liability onto the National Employment Funds (*Fonds Nationales d'Emplois*, or FNE). This program, funded by pension premiums and government top ups, was formally designed to put workers over the age of 55 back to work, but in practice provided them with income between the exhaustion of unemployment insurance benefits and full pension.[244]

In 1995, the Balladur government reformed the basic old age security pension by capping the entitlement at 50% of the average salary. Social credits paid for by ratepayers were kept intact, but premium payers who had not made full contributions were required to wait until the age of 65 before receiving a full pension.

By the end of Balladur's government, reforms to the pension system in France had given it a two-tier nature. While the extension of contribution periods meant that private sector employees no longer had an unequivocal right to retirement at 60, many public sector workers could retire as early as 50. Their pension rates were also higher on average, at 75 percent of salary, compared with 70 percent elsewhere. This result reflected the strong organization of public sector unions, and the unwillingness of either Balladur or Chirac, for that matter, to touch the issue of public pensions leading up to the 1995 presidential campaign.[245] Consequently, they left an important public spending commitment untouched.

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[243] On the government's position, see "L'état augmenterait sa contribution aux retraites complémentaires," *Le Monde*, December 21, 1993. For employer and union representatives, Jean-Michel Normand, "Le financement des retraites complémentaires sera assuré," *Le Monde*, December 31, 1993.

[244] Devaud, Antoine, "Coup de vieux pour les préretraites," *Le Monde*, February 1, 1994.

[245] Boissard, Denis, "Qui osera toucher à la retraite des cheminots?" *Nouvel Economiste*, May 12, 1995. Boissard's reference to retirement at 50 applies to national and Parisian rail service workers

Balladur's government had also been quietly grappling with an approach to reforming the pension plan for functionaries (civil servants in ministries and administrative bodies). This was of particular concern, since up to five million functionaries were due for retirement toward the end of the decade. Their pension entitlements, up to 96.4 percent of wages, threatened to undermine other efforts to reduce the budget deficit. The Balladur administration was reported to be considering dusting off plans drawn up by the Rocard government in 1991 to reduce these benefits to levels closer to those of pensions for the general public. However, he did not move to implement changes in the run-up to the 1995 presidential election,[246] during which Jacques Chirac replaced him as the favored RPR candidate.

The Juppé government, which assumed office in 1995 with Chirac's presidency, failed to undertake two key reforms of the public service pension system. Juppé attempted to consolidate 20 independent public pension plans covering both functionaries and workers in public enterprises.[247] He expected that restraining the entitlement formula for public sector pensions would be easier to implement once rather than repeatedly. The government would also gain greater influence in pension plans for public enterprises such as rail and postal service, in which public enterprises and unions had negotiated pension and retirement rules more generous than the government required if it were to control its overall spending. In order to fulfil this mission, Juppé appealed for public support for the 'justice' of equal pension benefits for public service workers and ordinary citizens by establishing a pension

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(SNCF and RATP), who can retire after 25 years of service. The largest public corporation pension funds for the previous year were in mining, rail, tobacco manufacturing, and at the Banque de France.

[246] Public recognition of the Balladur government's interest in the plan was announced by the Commisariat Générale du Plan in autumn of 1995, using a study by the national old age insurance fund, the CNAV - Caisse Nationale d'Assurance-Veillesse, that the government had commissioned. See Jean-Michel Bezat, "Un rapport du Plan note l'inégalité entre retraités selon leur âge et leur ancien métier," *Le Monde*, September 25, 1995.

[247] Hagen Bermer, Hans, "Angst um die Pensionskassen," *Frankfurter Rundschau*, December 4, 1995.

commission designed to wrest control over benefits from the social partners.[248] In response, rail, postal and Paris transport workers formed the core of a massive strike at the end of November through late December of 1995. The strike did not win any changes for itself, but forced the government to end its plan.

In 1996, the Juppé government turned away from attempting to consolidate pension plans and instead passed legislation that replaced the absolute majority of unions on pension management boards, in place since 1982, with equal representation for management and unions. This was designed to weaken the Force Ouvrière by removing its control over the social insurance funds. In addition, Juppé reserved the right to appoint the director of the National Fund *(Caisse Nationale)*, to wield more political influence over the fund's administration.[249]

Despite this change, Juppé was still unable to stop public firms and unions from approving generous early retirement plans. Retirement at 55 with full pension was protected at major public enterprises, and even earlier retirement was made available based on the number of years of service. Meanwhile, functionaries gained the right to leave at the age of 58, if 37.5 years of service had been rendered.[250] In the private sector, large firms vigorously pursued early retirement vigorously as a means of reducing the number of redundant workers. Unions took a complementary position supporting retirement as early as 50 to reduce unemployement. Together, unions and employers agreed in 1996 to extend the entitlement to retirement with a full pension to unemployed workers aged 57 years and nine months, rather than reverting back to 60.[251] However, Juppé resisted calls from the public, following

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[248] Rivais, Rafaël, "Le gouvernement met une sourdine à son projet d'allongement de la cotisation-vieillesse," *Le Monde*, December 6, 1995.

[249] Boissard, Denis, "Sécurité sociale: Force ouvrière pourrait perdre son fromage," *Nouvel Economiste*, April 5, 1996.

[250] Full details of the pension agreements for France Télécom, SNCF, the electricity and gas utility EDF-GDF and functionaries are given in Frederic Lamaitre, "Les contradictions de l'Etat face aux préretraites," *Le Monde*, October 12, 1996.

[251] Beuve-Méry, Alain, "Les chômeurs de plus de 58 ans réclament la retraite anticipée," *Le Monde*, November 20, 1996.

both these results and the right to retire at 55 that truckers had won in a strike in December 1996, to reduce the general retirement age to 55.[252]

From 1993 through 1996, French politicians also dealt with the highly controversial prospect of legalizing private pension funds as a means of taking the sting out of cuts to public plans. In 1994, Balladur's finance minister, Alain Madelin, passed tax credits for private pension contributions by the self-employed.[253] Though this allowed capital based pensions for only a very small percentage of the population, but opened up a debate on allowing such pensions for the rest of the population. During the 1995 presidential election, Jacques Chirac raised the stakes by promising the right to a capital pension if he were elected. Meanwhile, members of the Balladur government were torn between support for change (from the finance ministry) and for the status quo.[254] The RPR eventually legalized private pensions in November of 1996. In agreement with the CGT and FO unions, the Socialist Party objected strongly and promised to re-impose the national prohibition on private pension plans if elected.[255]

The key source of the pension system's insolvency proved to be early retirement, which pressed the pension funds during the 1990s. As older unemployed began to exhaust their unemployment benefits, they began to relieve pressure on the unemployment fund and shift to a special early retirement funded by general revenues. In 1992, 60 percent of unemployed workers 55 years of age and older were supported by UNEDIC, while 40 percent were supported by the national employment fund, or FNE. With the impact of the recession, the situation had reversed in 1993.[256] Under the FNE plan, workers between the ages of 55 and 65 would receive a partial pension while working part-time, and receive a full pension

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[252] "Juppé gegen Rente mit 55," *Handelsblatt*, January 15, 1997.

[253] Ridding, John, "Grey on top, thinning below," *Financial Times*, July 27, 1994.

[254] "Le gouvernement relance prudemment le projet de fonds de pension," *Le Monde*, July 2, 1995.

[255] Roland-Lévy, Fabien, "Le PS annonce sa volonté de «défaire» le système de fonds de pension voté par la droite," *Le Monde*, January 17, 1997.

[256] Devaud, Antoine, "Coup de vieux pour les préretraites," *Le Monde*, February 1, 1994.

upon retirement.[257] Alain Juppé's government failed both in 1995 and 1996 to cap early retirement and pension increases.

Health Insurance

Health insurance in France generates the highest spending on health as a percentage of GDP in Europe, and spending has frequently grown at four times the rate at which the economy grows. While the system is partially funded by premiums, the government infuses the system with significant transfers from the central budget.

Governments was able to effectively restrain part of the health care spending where it had the appropriate influence. Government controls hospitals and stationary care directly through the ministry of health. Between 1983 and 1992, it ratcheted down spending in hospitals and stationary care from 51.% to 46.% of total costs.[258]

The key entitlement that drove exploding health care spending remained untouched until 1996. French residents are entitled to unrestricted reimbursement covering medication, hospital stays and direct treatment by both general practitioners and specialists. Doctors are paid on a fee-for-service basis without a cap on doctor income.[259]

In 1991 government focused principally on raising more revenue to pay for the bills of the National Medical Insurance Fund, (*Caisse Nationale d'Assurance Médicale*, or CNAM). A disagreement in 1991 between finance minister Bérévogoy on the one hand and Mitterand and Rocard on the other simply revolved around whether the money should come from payroll taxes, as Bérévogoy preferred, or from a tax on insurance policies, as the latter preferred and eventually won.

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[257] "Un seul régime pour la préretraite progressive," *Nouvel Economiste*, May 14, 1993.

[258] Wilsfor, David, "Reforming French health care policy,' in John Keeler and Martin Schain, eds., *Chirac's Challenge: Liberalization, Europeanization, and Malaise in France*. London: MacMillan, 1995, p. 234.

[259] For a recent review of the French health care system, see David Wilsford, "Reforming French Health Care Policy," in John Keeler and Martin Schain, eds., *Chirac's Challenge: Liberalization, Europeanization and Malaise in France*. London: Macmillan, 1995, pp 231-256.

In 1992, a government project to cap doctor incomes dampened health expenditures temporarily, but collapsed in June under pressure from the the Confederation of French Doctor Unions (*Confédération des Syndicats Médicaux Français*, or CSMF) on social minister Réné Teulade.[260] In doing so, they broke an alliance within the government between Bérévogoy and Teulade,[261] designed to demonstrate the capacity to manage finances, with an eye on elections in 1993. In an attempt to find another solution, the government later reached an agreement that did not limit spending, but that established a link between income and expenditures for health for the first time. The government also took measures where it could to institute new anti-fraud programs as a means of saving money.[262]

In 1993, the new Balladur government reacted to falling premium revenues by raising the CSG[263] from 1.1 percent to 2.4 percent, and cutting funding for administration and hospital operations, where the Ministry of Social Affairs has direct control. The government placed limits on reimbursements for prescription drugs, and increased user fees for prescriptions and hospital stays. While passing the measures, Social Affairs Minister Simone Veil emphasized that voters should consider themselves to have a much better deal than either doctors or producers.[264]

In 1994, the government launched a new three-pronged attack on health spending that ended in failure. First, it aimed to cut the number of hospital beds by 22,000. In the face of opposition, it settled for reclassifying the beds for long-term care. Second, it sought to cap doctor billing. Finally, the government tried to facilitate cuts to the health budget by

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[260] Normand, Jean-Michel, "Les médecins et la méthode coué," *Le Monde*, October 6, 1992.

[261] Boissard, Denis, "Sécu: la dissimulation," *Nouvel Economiste*, July 10, 1992.

[262] Normand, Jean-Michel, "Les concessions du gouvernment atténuent la portée de l'accord sur la maîtrise des dépenses de santé," *Le Monde*, October 16, 1992.

[263] Cotisation Sociale Générale, a surtax on most types of income, designed to move the tax burden away from payroll taxes to pay for social spending commitments. See section 2.4.

[264] Chimelli, Rudolf, "Paris kürzt Gesundheitswesen," *Süddeutsche Zeitung*, July 1, 1993. The restrictions on prescription drug cost replacement applied to new drugs designed to perform the same function as older, less expensive medications. See Jean-Michel Normand, "Les dépenses de santé devront être réduites," *Le Monde*, January 22, 1994.

separating it from the general social security budget.[265]

In 1995, a second effort to cap health spending also failed to produce results. Health Minister Elisabeth Hubert introduced a general revenue fund to relieve pressure on premiums. The fund would cover some of the premiums and costs of insuring the inactive population: a category encompassing students, the disabled and the unemployed. However, spending was merely shifted.[266]

Chirac sided with doctors in the 1995 election campaign by opposing measures that would cap doctors' income, which constituted 70 percent of the health budget. He claimed that spiraling costs could be contained through efficiency measures and explicitly attacked caps and plans to close hospitals as "rationing" health care. In the wake of his election, health expenditure growth rose back to a level of six percent per year. Directly after the election, the designated health minister followed Chirac's line, announcing that there would be no "unjustified cuts."[267]

In contrast, Juppé's finance minister Jean Arthuis advocated spending cuts that would bring French health spending in line with other OECD countries, in addition to higher taxes through the CSG.[268] The CSG was the most important measure, since it is levied on a much wider variety of incomes than the payroll taxes which pay for social security premiums.

In 1996, the Juppé government introduced health system reforms in 1996 that were to be phased in through 1998. For the first time, sanctions were established to punish doctors for spending in excess of fixed limits. The social partners, through the health insurance funds, would be responsible for setting and monitoring compliance with the limits. Government would be involved in reaching agreements with the funds in order to impose

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[265] Normand, Jean-Michel, "Assurance-maladie: beaucoup d'intentions, peu de décisions," *Le Monde*, February 1, 1994.

[266] Bezat, Jean-Michel, "Le ministre de la santé envisage une réforme du financement de l'assurance-maladie en 1996," *Le Monde*, July 13, 1995.

[267] Ridding, John, "France tries to staunch health service wounds," *Financial Times*, August 17, 1995.

[268] Ibid.

some state direction on spending limits. Medical databases were planned in order to facilitate the detection of abuse. Under the insistence of Finance Minister Alain Madelin, coupon books for health services were to be phased in through 1998, beginning with residents 70 years of age and over.[269] Premiums and the CSG were also raised to close the funding gap in the health system.

The most striking and new aspect to the Juppé reforms was the explicit connection of health reforms to attaining the membership criteria for EMU under the Maastricht Treaty. This was not the only reason offered. Juppé's social Affairs Minister, Jacques Barrot, announced that liberal medicine, in which doctors enjoyed independence, was experiencing its "last chance"[270] to demonstrate its economic sustainability.

Juppé continued the policy of extending the CSG-from late 1996 onward. It applied to virtually all income except interest from a variety of savings plans-and allowed lower payroll taxes in compensation, which in turn relieved pressure on employment. In sum, the CSG rose from 2.4 to 3.4 percent, while health care premiums dropped from 6.8 to 5.5 percent.[271]

Meanwhile, Juppé helped to engineer Force Ouvrière's removal from its controlling position of CNAM, which it had controlled for the previous 30 years. Juppé moved up elections to manage the fund when the FO was unprepared, allowing the more moderate, but internally less stable CFDT to be elected as the union head of the fund. Though the FO, which had engaged in a policy of total opposition to the government's plans to use CNAM as a cost control mechanism and could have blocked it effectively, was publicly outraged and demanded control of the nation's unemployment insurance fund as minimal compensation,

[269] Bezat, Jean-Michel, "Le gouvernement engage une profonde réforme de la médecine libérale," *Le Monde*, April 6, 1996.

[270] Ridding, John, "France tries to staunch health service wounds," *Financial Times*, August 17, 1995. Additional positions from Barrot appear in an interview conducted by Thierry Bréhier and Michel Noblecourt. See "M. Barrot veut reformer la Sécurité sociale sur la base du «contrat»," *Le Monde*, April 25, 1996.

[271] Bezat, Jean-Michel, "La reforme du financement de l'assurance-maladie est engagé," *Le Monde*, September 7, 1996.

it was unable to change matters. During 1996, this provided Juppé both with the means to implement his policy, and revenge for the FO-CGT led strikes of October 1995.[272] Madelin made it clear from the finance ministry that this move was designed to endow CNAM with effective control powers found in the German health care system, while leaving government out of the dirty work. This method, he suggested would allow reforms to take place under the maximum social cohesion possible.[273] This plan gathered strength as the CFTDcontinued to outpace the FO in elections to the management boards of the nation's regional health fund boards.[274]

The changes provided the government with some momentum in pressing doctors for concessions, but not nearly what Juppé wanted. After a doctor strike in October, CNAM was able to come to an agreement with health providers that would save 30 billion FF from the budget.[275]

Overall, health reform demonstrated sensitivity to voter concerns about the quality of health care and the sanctity of the entitlement to paid doctor visits and prescription drugs. The opposition of doctor unions has played much less of a role in rising costs than in protecting broad public demand for the service. The adoption of modest restraits in the run-up to the deadline for EMU membership, and then in connection with the broader savings program for EMU demonstrate a clear desire to avoid the wrath of voters in the reform process.

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[272] "La CFTD s'installe en partenaire privilégé du l'"Etat et du patronat." *Le Monde*, June 14, 1996.

[273] "Alain Juppé réaffirme sa détermination de mener à bien la reforme de la «Sécu»." *Le Monde*, October 25, 1996.

[274] "FO subit un net recul aux éléctions dans les caisses primaires d'assurance-maladie." *Le Monde*, November 4, 1996.

[275] Bezat, Jean-Michel. "Les négotiations caisses-médecins s'engagent dans un climat tendu." *Le Monde*, November 10, 1996.

Unemployment Insurance

Like the pension and health insurance funds, unemployment insurance is managed by employer groups and unions, and funded by premiums from employees and employers. Government is responsible for setting the eligibility requirements. From 1991 onward, new, more generous eligibility rules and rising unemployment pushed the fund into deficit. Marginal cuts were implemented in 1992, then negated by a major program of benefit extensions in 1993. The deficit persisted until August 1994, when subsidies from the government's general budget began to top up the fund, meaning a worse position for the deficit.

Overall, both socialist and conservative governments were more likely to increase the number of workers with entitlements to benefits than reduce its spending commitments. The Rocard government expanded access to benefits in 1990 when it reduced the qualifying period for contract workers from two years to six months, and provided for an extension of benefits through further short-term employment.[276] This measure ensured, in contrast to Germany, that residents on the periphery of the labor market had access to benefits.

However, the Rocard government responded to imbalances in the fund in 1991 by demanding that employer and union representatives adjust premiums to relieve pressure on the general budget.[277] In 1992, spending reforms were rendered significantly easier when the FO lost control over union representation on the managing board to the CFDT. (In 1996, the shift was confirmed when the FO unsuccessfully threatened to make life difficult for the board if it were not handed back control over the fund).[278] The government accepted new managing board suggestions to trim benefits. This involved a new waiting period of three

[276] Boissard, Denis, "UNEDIC: L'épreuve de vérité,' *Nouvel Economiste*, September 13, 1991.

[277] Lebaube, Alain, "Les négotiations sur la régime d'assurance-chômage s'annonce très difficiles," *Le Monde*, September 24, 1991.

[278] On the battle between the government and the FO, see, Alain Faujas, "Le gouvernement ne souhaite pas que Marc Blondel préside l'Unedic," *Le Monde*, August 14, 1996. On the election of Nicole Notat of the CFDT, see David Buchan, "New head for French unemployment fund," *Financial Times*, October 1, 1996.

days before collecting benefits, and a declining entitlement over time to encourage job seeking. In addition, it introduced harder qualifying criteria for benefits. Instead of qualifying for benefits after paying premiums for three months within the previous year, workers under the age of 50 would qualify after six months, while workers 50 and over would qualify with four months of contributions.[279] For residents with more stable work histories, benefits remained generous. Those with a year of contributions into the fund were entitled to 14 months of benefits, and those with two years of contributions remained entitled up to five full years.[280]

Until their electoral defeat in 1993, the socialists limited changes to the unemployment insurance fund to these measures, while attempting to stimulate job growth out of general revenues. Only when the fund threatened to go bankrupt did the government consider larger subsidies from general revenues. The fund's managers requested new money in early December, while banks that had already lent UNEDIC more than three billion francs refused to lend more. They demanded that government promote early retirement and advances from the central treasury.[281] In early 1993, labor and employment minister Michel Giraud reiterated the government's determination to place pressure on entitlements by promising only to advance payments to the fund.[282] Two weeks later, the government committed more central budget money into the UNEDIC fund.[283]

After winning an election in 1993 that revolved around high unemployment, the Balladur government extended benefits for unemployment insurance recipients whose core benefits had expired. It also created new benefits lasting up to a year for first time job

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[279] Dawkins, William, "Accord heads off crisis in pay for French jobs," *Financial Times*, July 20, 1992. Alain Lebaube, "L'assurance-chômage provisoirement sauvée," *Le Monde*, July 20, 1992.

[280] "Rise in French jobless strains benefit system," *Financial Times*, June 24, 1992.

[281] Lebaube, Alain, "Les dangereuses solutions de l'assurance-chômage," *Le Monde*, December 7, 1992.

[282] Boissard, Denis, "Les negociations sur l'Unedic se durcissent," *Nouvel Economiste*, May 7, 1993.

[283] Boissard, Denis, "Létat donne un coup de pouce à Unedic," *Nouvel Economiste*, May 21, 1993.

seekers. The FNE program was also extended to promote partial retirement by topping up salaried for workers over 55. A new retraining program was also instituted that provided benefits up to six months for workers in shrinking industries.[284]

The Balladur government's most important innovation was to relieve some pressure on insurance premiums through direct transfers from general revenues into the funds. In July 1993, the labor minister pushed the social partners to raise premiums to cover some of the shortfall by offering to pay one third of the cost out of the general budget,[285] although it took until 1994 before Balladur approved the plan over the objections of the budget minister, Nicolas Salkozy.[286] Revenues recovered modestly with employment in 1994,[287] but the subsidy continued to be the reason why the fund showed a technical surplus.[288]

In addition, many recipients had simply exhausted their benefits, despite the extensions of 1993, and been pushed on to other programs funded by general revenues, including social assistance.[289] In 1994, 29 percent of those who went off unemployment insurance transferred to the social assistance program. UNEDIC, in contrast, provided for only 45.6 percent of the unemployed in 1994, compared to 62.4 percent in 1993.[290] A continued anti-fraud campaign continued to bring modest reductions in liabilities.

In 1995, the Juppé government broadened the measures to detect and punish unemployment insurance recipients and various program participants who did not meet

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284 Lebaube, Alain, "L'assurance-chômage," *Le Monde*, July 13, 1993. The salary top-up guaranteed 80% of the working wage.

285 "Sanierung von Frankreichs Arbeitslosenversicherung," *Neue Zürcher Zeitung*, July 26, 1993.

286 Devillechabrolle, Valérie, "L'Etat maintient son engagement de verser 10 mrd de francs en 1995 à l'UNEDIC," *Le Monde*, August 3, 1994.

287 "L'Unedic dégage un excédent," *Nouvel Economiste*, April 28, 1994.

288 Devillechabrolle, Valérie, "82% des chômeurs indemnisés touchent moins de 5000 francs par mois," *Le Monde*, January 12, 1995.

289 Ibid.

290 Devillechabrolle, Valérie, "De plus en plus de chambers beneficent de l'allocation de solidarité," *Le Monde*, May 18, 1995.

eligibility requirements. These measures were the most important and sweeping measure on reforming unemployment insurance that the Juppé government introduced. While checks in 1993 and 1994 under the Balladur government produced only very small numbers of benefit reductions.[291] Juppé hoped that benefits would drop once recipients were required to report regularly to a government office. They would also face a "triple sanction" of benefits forfeited during and after the investigation as well as a demand to repay benefits received.[292]

Another important development in the balance of the unemployment insurance fund was the establishment and extension of supplementary and active labor market programs that fulfilled the function of unemployment insurance without being paid for through the premium fund. In most cases, subsidies to employers were available in return for hiring particularly hard-to-place individuals in the labor market. The RMI (*Relève Minimum d'Insertion*, or RMI), established in 1988, took care of first-time job seekers, the Training and Reclassification Allowance (*Allocation Formation-Reclassement*, or AFR) for those considered good candidates for retraining. Solidarity Employment Contracts (*Contrats Emploi-Solidarité*, or CES) the second most extensive program, provided subsidies for employers hiring the long-term unemployed. 700.000 individuals benefited from this program in 1993.[293]

However, both unions and employers demonstrated unwillingness to give up subsidies from general revenues. In 1995, both expressed outrage at Juppé's attempt to cut the national deficit by delaying a subsidy of 12.5 billion FF for the current fiscal year.[294]

What do these observations tell us collectively about the impact of unemployment

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[291] "M. Juppé relance le débat sur les «faux chambers» et nomme une mission d'enquête." *Le Monde*, September 29, 1995.

[292] Devillechabrolle, Valérie, "L'indemnisation des chambers ayant une activité ne cesse de baisser." *Le Monde*, June 29, 1995.

[293] "Le traitement social du chômage se développe." *Nouvel Economiste*, March 3, 1995. In 1993, about 900.000 recipients benefited from the RMI.

[294] Beuve-Méry, Alain, "L'Etat décide de reporter le versement de ses subventions au régime d'assurance-chômage." *Le Monde*, September 6, 1995.

insurance on the national budget, and on the wider implications of unemployment itself on government finances? The unemployment insurance program, looked at narrowly, is in much better shape than its counterparts in other European countries, despite unemployment that is higher and more persistent than in most neighboring countries. The fund's deficit of about 12 billion FF (before subsidies implemented from 1994 onward) pales in comparison even to Germany's. There are several reasons for this result, and those reasons illustrate why unemployment has structural impacts on the spending commitments of the national government in other ways. The differences in contrast to the German case are instructive, and illustrate the relationship between political demands and the stability of overall entitlement levels.

Each government was reluctant to restrict the entitlement to unemployment insurance, but also looked for ways to balance the fund without government subsidies. Each governments was more likely to widen the entitlement to unemployment insurance for selected groups to cover more individuals. Older workers in particular benefited both from measures designed to bridge the gap between layoff and qualifying for early retirement, and heavy fines levied against employers who lay off workers 50 years of age and older, as an attempt to contain unemployment among older workers.

In practice, the Balladur and Juppé governments struck a compromise between the premium-based system of funding, designed to maintain pressure on expenditures, and an increasing tendency to contribute funds from the central budget. Unlike Germany, France made a fairly friction-free transition to accepting the need to pay for non-insurance labor market programs (like retraining and early retirement) out of tax revenues rather than premiums. Nevertheless, French premium payers to foot a significantly larger portion of the bill than they did in the mid-1980s. Participation of employer and union representatives did a great deal to create political support for spending reforms, especially after the CFDT replaced the FO, and further, when the government established parity on fund management boards rather than union superiority.

Both employers and unions involved in administering the unemployment insurance fund argued for a combination of strong benefits and low premiums. Employers see the fund as a means of making layoffs as friction-free as possible, while unions see the benefits for jobless residents as an economic right.

Many of the costly programs related to unemployment were not entitlements, but special programs designed to meet the strong political demand that governments promote job creation. In one way or another, all of these programs created a new category of low-wage jobs free of social security premium obligations. As a result, the modest employment growth that France experienced in 1994 did not contribute significantly to tax and premium income.

Sadly, the most important factor contributing to the small impact of unemployment insurance on the national budget was the fact that many more individuals began to exhaust their benefits between 1993 and 1995. These individuals increasingly shifted to the pension system or the welfare system rather than returning to work. While UNEDIC still covered 62.4 percent of job seekers in 1993, it covered only 45.6 percent in 1994.[295]

One last observation about development of the fund and Maastricht is notable in comparison with the pension and health care systems. While governments, and the Juppé government in particular, used the entrance requirements of Maastricht to justify changes to the core of the pension and health insurance programs, they did not do so with the unemployment insurance program. Only savings from anti-fraud measures were brought into connection with the governments' EMU-related savings programs.

Spending reforms in France illustrate the benefit that corporatist negotiating arrangements had, both for implementing changes and controlling backlash against cuts. The main obstacle to reforming spending commitments was their fragmented nature, which rendered spending in some sectors more immune to reform, where employers and unions were not receptive.

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[295] "De plus en plus de chambers bénéficient de l'allocation de solidarité," *Le Monde*, May 18, 1995.

Banque de France

Central bank independence contributes to price stability in two important ways. First, it carries out monetary policy to prevent or fight inflation, forcing government, employers and unions to consider the consequences of their economic behavior. To the extent that these actors are receptive to advice, the central bank can recommend appropriate behavior. Second, the central bank can actively promote political support for price stability, both among government officials and voters, by emphasizing the rewards that follow discipline in economic behavior. Often, the rewards stressed are lower interest rates, which raises prospects of growth and employment, and secure savings.

Structural Reform

Structural reform for the Banque de France first became a public issue in the parliamentary elections of 1993. The currency crisis of 1992 had forced the *de facto* suspension of the European Exchange Rate Mechanism and raised concerns about the future value of the franc. To mitigate uncertainty, Banque de France President Jacques Larosière publicly urged politicians to grant independence as quickly as possible. As an incentive, he predicted that independence would protect the franc's exchange rate by stabilizing the expectations of international currency market on its future value. He also stressed that French voters expected the measure as an demonstration of competence from any party hopeful of leading the country.[296] Though bipartisan agreement reigned in principle, there were serious doubts that Edith Cresson, the socialist caretaker prime minister, could deliver a central bank with the independence required to ensure price stability. Central bank independence consequently became an election issue. Edouard Balladur, the RPR (Rally for the Republic, or *Rassemblement pour la République*) candidate for the post of prime minister, presented his proposals for granting the bank its independence as early as January. The liberal Union for

[296] Gumbel, Peter. "Banque de France may get its independence," *Wall Street Journal*, January 20, 1993.

French Democracy (*Union pour la démocratie française*, or UDF), with the blessing of the EMS's co-creator, Valéry Giscard d'Estaing, laid out a similar manifesto.[297]

The Balladur government made central bank independence one of its first priorities after its election in spring of 1993. The first proposals for reforming the bank focused on its mission to ensure price stability. Before a bill was laid before the National Assembly, however, concerns about constitutional challenges to the legislation had already placed its capacity to pursue price stability in question. Economics minister Edmond Alphandéry expressed dissatisfaction with a clause protecting the government's control over general economic policy and expressed his hope that the clause could be removed once France had entered the third stage of monetary union. Alphandéry later confirmed that the pertinent clause was designed to pre-empt constitutional challenges against the legislation rather than challenge independence. Under Article 20 of the French constitution, the government was responsible for conducting economic policy, and could not delegate that authority.[298]

The balance of measures ensure that the bank's independence in monetary policy has a firm legal grounding. Furthermore, National Assembly members in favor of independence for the Banque de France strengthened this bias by inserting a clause ensuring that the Treaty on European Union would form a key component of that legal basis.

The competing principles were found in two sections. First, the provision that "the Banque de France carries out its mission within the framework of the government's general policy," could have been interpreted to allow government to virtually dictate exchange rate or interest rate policy, thereby allowing government theoretically to control monetary policy. Second, the bank was otherwise given the responsibility to "define and implement monetary policy with the goal of price stability." Moreover, the bill provided the legal framework for protecting the bank's president, vice-president, and monetary policy members from government interference. The bill explicitly prohibited these individuals from either

[297] Robin, Jean-Pierre, "Vers l'indépendence de la Banque de France," *Le Figaro*, January 22, 1993.

[298] Buchan, David, "France gets its Bundesbank, but a Gallic one," *Financial Times*, May 12, 1993.

soliciting or accepting instructions from the government.[299]

The provisions of the bill required further assurances of the Banque de France's independence before economic conservatives in the National Assembly and in the Senate would vote for the legislation. In order to ensure that future governments could not use the "framework of government policy" clause to undermine the bank's commitment to stability, the National Assembly inserted an indirect reference to the Treaty on European Union designed to strengthen the bank's position against future legislation.[300] The Senate enhanced the Bank's explicit responsibility for controlling the supply of money and credit. It also insisted on fewer persons involved in the nomination process for monetary policy board members (specifically, the vice president of the State Council, or *Conseil d'Etat* was to be removed) as a means of excluding political influence over the monetary council. Finally, they opposed the right of the economics minister to make presentations to the monetary policy council, to avoid an informally institutionalized government presence on the board.[301]

The key feature of the Banque de France which distinguishes it from both the Bundesbank and from the European Central Bank is the composition of the Monetary Policy Council (MPC). Both government and the National Assembly agreed that the bank should be directed by a board representing various sectors of society, while attempting to retain expertise in monetary policy issues.[302] In addition to the president and two vice-presidents of the central bank, the first monetary policy council consisted of the CEO of a leading insurance company, the former socialist finance minister, Michel Sapin, an economics professor, an engineer serving as the head of France's national standards testing laboratories,

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[299] Bobin, Frédéric, "Cinquante députés de la majorité refusent d'avaliser la réforme de la Banque de France," *Le Monde*, June 14, 1993. This article also contains an account of which deputies voted for and against the bill, which was passed by 433 votes to 90.

[300] Bobin, Frédéric, "La commission des finances simplifie le mode de désignation du conseil de la politique monétaire de la future Banque de France," *Le Monde*, June 5, 1993.

[301] Blandin, Claire, "Le Sénat en désaccord avec M. Alphandéry sur la réforme de la Banque de France," *Le Monde*, July 3, 1993.

[302] "Neither a fed nor a bundesbank," *Financial Times*, January 6, 1994.

an economic journalist, and the head of the country's stock market oversight body.[303] A key feature of the MPC that is significant in light of its more societally-based membership is the principle of collegiality, in which the President of the Banque de France can be outvoted by the council.[304] In sum, the Banque de France's executive board acquired a lower dependence on bankers than in Germany, and reflected a wider set of societal interests.

Before the bank could achieve independence, it had to survive the constitutional challenge that Mitterand called for indirectly, and which the socialist and communist parties followed through with. In May of 1993, Mitterrand warned that the central bank's independence was incompatible with Article 20 of the constitution, which required that government assume responsibility for economic matters.[305] The constitutional court consequently ruled that the Banque de France could only become independent in conjunction with the coming into force of the Treaty on European Union, but not before. It explicitly ruled that the provisions preventing the government from giving orders to the Banque de France were illegal until the Treaty took effect.[306]

Since the reforms of 1993, no meaningful effort to reverse the structural changes has been undertaken. Criticism of the Banque de France's monetary policy has led to public calls from President Chirac and other politicians to make more room for economic growth, but the MPC has retained its independence in monetary policy. It has also gained the confidence to take clear stands on a broad range of economic policy issues for the first time.

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[303] Ridding, John and Alice Rawsthorn, "Defenders of the franc," *Financial Times*, January 6, 1994.

[304] Interview with Finance Minister Edmond Alphandéry published as "Der Weg ist frei," *Wirtschaftswoche*, May 7, 1993.

[305] Buchan, David, "France gets its Bundesbank, but a Gallic one," *Financial Times*, May 12, 1993.

[306] See "Banque de France doch noch nicht autonom," *Frankfurter Allgemeine Zeitung*," August 5, 1993; "Verfassungsrat moniert Gesetz über Notenbank," *Handelsblatt*, August 5, 1993; and "Saisi par des sénateurs socialistes et par les députés socialistes, communistes et radicaux de gauche," *Le Monde*, August 5, 1993.

Under Jacques Larosière, who headed the Banque de France from 1987 to 1994, the central bank focused most of its attention on restricting inflation and defending the franc's exchange rate within the European Monetary System. The absence of commentary on either specific government economic policies or specific strategies to promote growth or employment is striking when compared to both the record of the Bundesbank and the Banque de France under Trichet.[307] It also distinguished itself from these two models by promoting the prospect of an early monetary union with Germany and the Benelux countries before internal reforms had been accomplished.[308] Though the bank under Larosière was unquestionably committed to a strong currency and low inflation, it did not demonstrate the same concern for sweeping reform of social entitlements and labor market legislation.[309] On the other hand, the Banque of France was often too busy trying to defend the franc against speculative attacks, particularly in 1992[310] The linkage between getting residents back to work and the long-term stability of both the franc and EMU appeared to be less important to the bank.

In contrast, Jean-Claude Trichet, who headed the newly independent Banque de France from 1994 onward, made periodic evaluations of the government's economic policy in addition to defending the franc fort policy. Trichet focused particular attention on the need to reform spending programs and institutions. In April 1994, Trichet used the forecast of a record government deficit to urge spending cuts, particularly in social insurance programs. If the government failed to do so, he warned that interest rates and debt could develop an

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[307] "De Larosière: Erfolge der französischen Wirtschaftspolitik," *Frankfurter Allgemeine Zeitung*, April 12, 1993.

[308] "Bundesbanque de France," *Die Zeit*, February 19, 1993.

[309] For a more detailed account of Larosière's views on the benefits of the French government's policy, see his interview in "Le franc, bouclier de la construction europééne," *Le Figaro*, February 11, 1993.

[310] For an overview of how the Banque de France and the Bundesbank collaborated to fight the currency crisis of 1992, see William Dawkins, "French weaponry secured win in battle for franc," *Financial Times*, November 3, 1992.

uncontrollable and devastating life of their own.[311]

Trichet, like Larosière, was frequently criticized by a political minority seeking lower interest rates and economic growth for following German interest rates and protecting the exchange rate to the mark rather than considering the requirements of the French economy. After German rates had come down beginning in late 1994, Trichet repeated that France's monetary and interest rate policies were geared to allow room in the economy for non-inflationary growth that critics were seeking, and that the country's short term interest rates were among the lowest in the advanced industrialized economies. He also pointed out that firms were paying money back to creditors rather than re-investing in new equipment, and that the central bank could hardly be blamed for this damper on growth and employment. In addition, he stressed that both society and government would have to do their parts to ensure training, education, and labor market flexibility were sufficient to create jobs in the low inflation environment the bank had created.[312]

The most remarkable attempt to influence economic policy came in the end of 1994, when the Banque de France's Monetary Policy Council attempted to deter criticism of the *franc fort* policy from potential presidential candidates. The MPC, backed by Trichet, sprang into action after Jacques Chirac published a pamphlet entitled "A New France," which called for job creation to be placed on "at least" the same footing as low inflation and low deficits. The Socialist Party, meanwhile, had taken such a turn to the left that no stability-minded candidate was prepared to run for office. The MPC warned that "those who don't support the franc will only devalue themselves." When asked to comment further, Trichet added that attempts to exploit the public concern over unemployment that advocated an abandonment of the *franc fort* policy and stimulating the economy would backfire. A fear of higher inflation and a loose exchange rate would draw fire on the French economy from international investors and destroy even more jobs. He underlined as well the opportunities that he saw at stake: "We have the lowest inflation rate in the European Union and a good

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[311] "Bank von Frankreich kritisiert öffentliche Schuldenmache," *Frankfurter Allgemeine Zeitung*, April 23, 1994.

[312] Ibid.

trade surplus. Only political uncertainty could provoke a crisis for the franc."[313]

Trichet's first end-of-the-year statement after independence placed comprehensive demands on the government's economic policy and on labor market practices in the private sector. The Banque de France would continue a strategy based on the three principles of stability, credibility and continuity. Within this framework, the bank would keep interest rates as low as possible to allow room for growth, without hurting the economy. Government, however, would have to do its part by reducing the debt and deficit, and by focusing its cuts on "non-productive" expenditures. This meant that it would have to reform social welfare spending and aid restructuring of the labor market with education and training measures to allow investment in infrastructure. The private sector, on the other hand, had the responsibility of wage restraint if the bank's anti-inflation policy were to be compatible with the lowest possible interest rates and job creation.[314]

Trichet continued to link success in budgetary, social insurance and labor market reform to job creation and economic growth afterward. In July 1995, the Banque de France lowered interest rates somewhat, as many growth proponents had been advocating. Trichet made it clear that the Juppé government's austerity plan, and in particular its plan to reduce the deficit to three percent of GDP in pursuit of EMU membership, had given confidence to the franc, and allowed the bank to reduce interest rates for the benefit of the economy. To underline this point and to rebuff calls for even lower interest rates, he compared the current spread between French and German rates at 0.7 percent to the spread in rates while Mitterand's expansionist policy was under way. In 1982 and 1983, the penalty that the French paid had been ten times higher at 7 percent.[315] This meant that its policy of ensuring a strong currency and low inflation wasn't costing France any more growth than it was

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[313] "'Wer den Franc nicht ehrt, wertet sich selber ab.'" *Frankfurter Allgemeine Zeitung*, November 19, 1994.

[314] *Monetary Policy Results in 1994 and Outlook for 1995*. Press Release of the Banque de France, December, 1994.

[315] See interview conducted by Pierre-Antoine Delhommais, Eric le Boucher and Eric Leser, "«Les conditions d'une baisse ordonnée des taux, avec un franc solide, sont réunies»," *Le Monde*, July 4, 1995.

costing its most important economic partner.

A crack in the unity of the Banque de France's support of the *franc fort* policy first appeared in December of 1996. At that time, two members of the Monetary Policy Council, Paul Marchelli and Jean-Pierre Gérard called for a looser monetary policy, and were only brought into line after censure by the Juppé government, which wanted to maintain EMU discipline. In an extraordinary breach of the rules prohibiting the government from giving political orders to the central bank, Economics Minister Jean Arthuis demanded that the two public dissenters remain silent. Trichet's activities focused on damage control, to prevent renewed attacks on the franc.[316]

A notable difference from the government's position, especially in 1995 and 1996, was the Banque de France's tendency to avoid justifying internal reforms with the membership criteria for EMU.

EMU

Although the Banque de France was involved in the negotiations which set many of the plans for EMU's rules, Jacques Larosière let government take the lead on policy statements. After Bérévogoy announced at the Maastricht summit that the bank would gain its independence, Larosière assured the curious that the technical requirements could be met easily, and that there would be few outward changes for people doing business with the bank.[317]

Under Trichet, the Banque de France continued to place most of its emphasis on EMU-related matters in terms of national challenges required for their own sake. The challenge of maintaining the *franc fort* policy was the most important and central of these issues. The bank viewed the convergence criteria as reasonable goals that the country could meet, with the bank, the government, and with society working together. EMU membership would constitute the crowning, institutionalizing solidification of the policy. For this reason,

[316] "Trichet plädiert gegen Abwertung des Franc," *Frankfurter Allgemeine Zeitung*, December 2, 1996.

[317] "Alte Dame, Neuer Glanz," *Wirtschaftswoche*, February 12, 1993.

and because the *franc fort* policy tended to be far more popular than EMU itself, the Banque de France under Trichet emphasized the specific anti-inflation and budgetary measures needed to sustain it. Discussion of EMU itself, however, was peripheral to the *franc fort* issue.

In sum, political divisions within the main political parties made it more difficult for the Balladur government than it expected to establish central bank independence. In addition, the French constitution and courts made it clear that independence was only legal within the context of the country's international commitment to EMU. Therefore, the EMU commitment achieved more for France's stability camp than simply aid the reform of budget policy.

Under the leadership of Jean-Claude Trichet, the Banque de France maintained an independent monetary policy geared toward maintaining stable prices, and exercising independent criticism of the government's spending and broader economic policies. This is a notable development in the context of continuing political ambivalence to the central bank's newfound independence from political control. Neither François Mitterrand nor Jacques Chirac were comfortable with the central bank's independence, but neither seriously challenged it once the central bank insisted on its independent line.

Central bank independence institutionalized the newest component of the political compromise between the *franc fort* and the fight against unemployment that had dominated national economic policy since 1984. Furthermore, it effectively introduced a new political actor in national budgetary policy, capable of reinforcing budget discipline with an aggressive public relations strategy.

3.4 Parties

Parties link society and the state in more than one way. They set policies with electoral consequences in mind or suffer the consequences of political competition by failing to attain office. If this holds true, we should expect government policies and platforms to reflect the basic economic interests of voters. If they do not, we should expect to witness a competitive attempt to capture the political center from another party.

Both major political groupings, the Socialist Party and the RPR-UDF alliance remained committed to the *franc fort* policy, though tenuously. At all times, however, the commitment to the *franc fort* was presented as half of a compromise, in which voters expected governments to combat unemployment as well. Both camps had to contend with critics within their own ranks who argued that governments were neglecting employment, and who called for exchange rate devaluations in order to stimulate exports. As unemployment continued to grow after 1990, the savings measures that the *franc fort* policy required became more and more unpopular, and more and more critics began to articulate the demand for "the other policy," a reference to devaluation and government spending in the pursuit of growth and employment.

The political center in France meant a balance of stability and measures to promote employment and support social welfare that reflected the difficult state of the economy, particularly with respect to unemployment. The tension between these priorities increased during the National Assembly elections for 1993, 1995 and 1997, and in the presidential elections of 1995. The period of 1995-1997 witnessed both the biggest push for economic reforms, and the greatest resistance.

The Socialist Party

The Socialist Party controlled the Presidency until François Mitterrand's death at the beginning of 1995, and the government until the spring of 1993. It remained firmly committed to the *franc fort* policy of stable exchange rates and low inflation that had pervaded French economic policy since 1984. The party, and even Mitterrand himself were less than enthusiastic about this policy commitment, but accepted it after 1983 as the price of economic responsibility, and as an indispensable component of a successful electoral platform. Mitterrand sought to promote the fortunes of party members who were at ease with a program of economic and political modernization. Michel Rocard was one such member, and he governed for the party as prime minister from 1988 until May of 1991, during negotiations for EMU. He challenged his party to commit to low inflation, restrained public spending and a strong currency, and argued that France could achieve these goals in a socially responsible way, i.e. without abandoning the commitment to social fairness and solidarity and employment that French economic policy had traditionally pursued. This strategy formed the basis of the socialist compromise between the commitment to the slate of economic reforms that came with the *franc fort*, and a determination to combat unemployment and promote social welfare.[318]

While unemployment became an increasingly salient concern for voters after 1990, the government's job creation efforts remained modest, and passive measures dominated. It left unemployment insurance benefits intact and made no attempt to force reductions when the fund went into deficit. On the other hand, there were no new direct incentives for employers to create jobs.

The successor socialist governments also introduced targeted tax relief to promote job creation. In a late effort to incite employers to hire people with particular problems finding work, the Cresson (May 1991 - April 1992) and Bérévogoy (April 1992 - March 1993) governments announced social security premium reductions for part-time workers and youth as pressure for action against unemployment increased in the runup to the 1993 elections.[319]

Two developments explain the absence of reforms to labor markets. The first is that unemployment had only begun increasing rapidly in France after 1990, as the government attempted to maintain the exchange rate with the German mark in the wake of reunification. The government believed that it could alleviate pressure on the economy and contain unemployment if it could convince Germany to keep its interest rates and exchange rate down. Bilateral negotiations with Germany, multilateral negotiations with the members of

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[318] Teyssier, Arnaud, *La Ve République*. Paris, Editions Pygmalion, 1995, pp. 432-435, 470.

[319] Holcblat, Norbert, "Les politiques de l'emploi en France depuis 1974," *Problèmes Economiques* No. 2509, February 26, 1997.

the European Monetary System and additional lobbying through the G7 were aimed at removing the need for domestic reforms.[320] As a consequence, it took time to convince the government that external relief was not coming and that a domestic adjustment strategy was unavoidable, and more time to translate this demand into action. Second, Rocard planned to contain and reduce unemployment by limiting the impact of social insurance programs on labor costs.[321] Social security premiums levied on wages would be reduced by shifting the tax base to cover non-wage income as well, through the Cotisation Social Général, or CSG. Benefits were to be trimmed, particularly to control premium levels, and pension commitments in public sector enterprises. The focus on pension reform reflects the government's focus on tackling deep-seated problems that would reduce unemployment over the long term rather than tackling problems superficially or in the short term only.

Third, with its long-term focus on cutting internal and external burdens on employment, the Socialist Party could refuse to combat unemployment by introducing flexibility into French labor markets as the OECD traditionally recommends. In fact, the Rocard government re-imposed some restrictions on the ability of employers and workers to agree to temporary work contracts in 1989.[322] In the public sector, the government stopped the process of privatization and liberalization begun by the conservative government between 1986 and 1988. During Rocard's tenure, the policy of "*ni, ni*," moving neither toward privatization and liberalization or re-nationalization attracted attention for the contrast it posed against governments both before and after.[323]

At the Maastricht summit in December 1991, finance minister Bérégovoy announced that the government intended to grant independence to the Banque de France. At that time,

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[320] "L'appréciation du franc est un préalable à la baisse des taux," *Le Monde*, May 4, 1992.

[321] Holcblat, Norbert, 1997.

[322] Saint-Paul, Gilles, "Exploring the Political Economy of Labour Market Institutions," *Economic Policy* 23, October, 1996, p.286.

[323] Schmidt, Vivien, "Business, the State, and the End of Dirigisme," in John Keeler and Martin Schain, eds., *Chirac's Challenge: Liberalization, Europeanization, and Malaise in France*. London: MacMillan, 1995, p. 117.

the government indicated that the bank would be responsible for monetary policy and credit, and that it would have similar interest rate tools at its disposal to control inflation.[324]

Voter discontent over the economy in 1992 forced the Cresson and Bérévogoy governments to retreat from Rocard's firm commitment to the exchange rate and promise instead more efforts to stimulate growth and employment. In November of 1991, Bérévogoy had dismissed calls from Socialist backbenchers to lower interest rates as a means of promoting growth. He responded that previous interest rate drops had brought the French economy no advantages, and that a drop at the time would hurt the franc without helping the jobless.[325] Instead, he suggested that an even higher exchange rate would provide the necessary room for a drop in interest rates.[326] Since neither voters nor the party itself were enthused by this option, discussion of it was quickly closed.[327]

Two electoral rebukes in 1992 underlined the erosion of support for the *franc fort* policy and incited the government to pay more attention to fighting unemployment. In March, voters punished the socialists decisively in local elections, defecting to both the Greens and the nationalist-protectionist-growth-oriented National Front (Front Nationale).[328] France's razor-thin majority in favor of Maastricht in September 1992 dealt another blow to the government's economic program. When it responded by planning to loosen its hold on the economy by dropping interest rates and expanding the money supply, it spurred capital flight into the German mark and ignited a Europe-wide currency crisis.

In response to the 1992 currency crisis, finance minister Michel Sapin sought and obtained support from both the German finance minister Theo Waigel and the president of the Bundesbank, Helmut Schlesinger. The Bundesbank helped out by intervening in currency markets, but more importantly by insisting that there was no rational reason to

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[324] "Banque de France wird unabhängig," *Nachrichten für Außenhandel*, December 12, 1991.

[325] "Pariser Zuwende," *Börsen-Zeitung*, November 21,1991.

[326] "«L'appréciation du franc est un préalable à la baisse des taux.»" *Le Monde*, May 4, 1992.

[327] "Et si le franc était réévalué?" *Le Monde*, May 5, 1992.

[328] Teyssier, Arnaud, *La Ve République*. Paris: Editions Pygmalions, 1995, p. 482.

dump the franc.[329] While international currency markets continued to hammer the franc over the next several months, the government, backed by the Banque de France, continued to insist that the country's economic fundamentals were good enough to keep the franc at its rate in the EMS. While Spain, Italy, and the UK left the mechanism, the French government insisted on staying within the system and protecting the currency.[330] The government went so far as to float the idea of an early monetary union in order to fend off pressure for devaluation and push back against the market demand for higher interest rates.[331]

The real end to the crisis for the franc ended only with lower German interest rates, which began coming down in October 1993. Investors did not have confidence in the Balladur government's commitment to the *franc fort*, despite support from both the RPR and the UDF to continue the policy,[332] and their large majority in the National Assembly. Support from these parties was less than unanimous, and uncertainty about any government's ability to resist growing pressure to take tangible measures to promote job creation sustained pressure on the franc while the socialists continued to govern at the end of 1992.[333]

Between 1993 and 1995, the socialist party in opposition remained tremendously unpopular as a result of poor economic and job performance during its tenure. It also became internally divided between the centrists who had dominated since 1984 and 'old labor' arguing for a return to reflation. The massive defeat in the parliamentary elections of 1993 were followed by another poor showing in the 1994 elections for the European Parliament. After the 1994 failure to rebound, the party ejected Rocard as leader and opened up the field

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[329] "France and Germany insist the franc is healthy," *Financial Times*, September 22, 1992. Sapin reduced minimum reserve requirements from 4.1 percent to 1.0 percent. See "Beharren Frankreichs auf einem «franc fort»" *Neue Zürcher Zeitung*, May 9, 1992.

[330] Sapin's statement is recorded in "La bataille du franc," *Le Monde*, December 30, 1992. Support for his claim from Jacques Larosière, president of the Banque de France is found in "Atempause für den Franc," *Börsen-Zeitung*, January 7, 1993.

[331] "Historischer Irrtum," *Wirtschaftswoche*, January 1, 1993.

[332] "Rückenstärkung für den Franc," *Börsen-Zeitung*, January 9, 1993.

[333] "Historischer Irrtum," *Wirtschaftswoche*, January 1, 1993.

for a new party economic policy.[334] Supporters of his economic policies hoped that Jacques Delors would assume leadership of the party, since he was due to step down as EU Commission president. They hoped that he would give voters confidence that the party stood for a continued commitment to socially-responsible economic reforms and a strong currency.[335] Delors had launched the party's economic program of fiscal restraint and the *franc fort* as finance minister in 1984. He had also presided over an extensive program at the European level of economic liberalization and championed measures to make the future European currency a strong and stable one. Of course, he had also been responsible for guiding the Maastricht Treaty through the planning and negotiation processes.

Meanwhile, Mitterrand continued to give the Balladur government leeway to undertake budget-balancing reforms as it privatized state businesses and attempted major structural reforms to social entitlements. As former Socialist MNAs Francois Holland and Jean-Paul Planchou noted, the party's economic policy in 1994, to the extent that there was one, consisted of reducing public debt, keeping interest rates low, conducting privatizations and any remaining industrial policy with the special social needs of regions in mind, and reshaping taxes and social policies to reduce economic inequalities within the country. The impact of taxes on consumption was considered important, but in contrast to 1997, the party did not bless strong wage growth in the economy as a desirable element of growth.[336]

February 1995 was significant in the sense that party proposals for a new economic policy dropped all reference to the *franc fort* and to the policy of competitive disinflation that had dominated both socialist and conservative economic policy since 1984. The linkage between growth and reducing the deficit remained clear. At this time, the party discussed the proposal of a 35 hour work week to combat unemployment, though it was silent about

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[334] Machin, Howard, "The 1995 Presidential Election Campaigns," in Robert Elgie, ed., *Electing the French President*. London: MacMillan, 1996, pp 33-35.

[335] Hanley, David, "Change and Continuity in the Mitterand Years," in Robert Elgie, ed., *Electing the French President*. London: MacMillan, 1996, p. 15.

[336] Hollande, François, and Jean-Paul Planchou, "Existe-t-il une politique économique de gauche?" *Le Monde*, May 11, 1994.

the question of whether the same pay could be expected. Redistribution would also be given more emphasis in economic policy. Finally, the platform endorsed EMU, even on an accelerated timetable. Due to internal divisions within the party, however, there were no proposals on whether the membership criteria for EMU should be re-negotiated.[337]

The Socialist Party supported EMU in its agreed terms up through the end of 1996, and lost voter support. After the 1995 presidential elections, the socialists gradually lost support among leftist voters as well. The party lost a socialist stronghold to the Communist Party in a December 1996 by-election. The National Front took second place. The Socialist Party gained only 13% of the vote. Meanwhile, the national party, led by Lionel Jospin, had 28% of the vote in December 1996 and was leaning further to left in order to regain votes from that camp.[338]

The first initiative to drop the Socialist Party's commitment to EMU's convergence criteria came in February 1996. A working group of the party released a discussion paper that would distance the party from its previous support for economic austerity. It advocated that the party treat the Maastricht criteria for EMU membership flexibly, and called on a future socialist government to promote this approach to other EU governments, stressing the political nature of the decision. However, the most innovative proposal was for a "European economic government subject to democratic control alongside the European Central Bank and a precise definition of its degree of competence for directing economic policy."[339]

Finally, the paper proposed a four point strategy for the party in the next legislative elections that would provide an alternative to existing economic and EMU policy. First, a socialist government would promote job creation by reducing work hours without pay reduction, by creating public service jobs and implementing public works projects, and be stimulating the economy until the unemployment rate dropped to seven percent. Second,

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[337] Mauduit, Laurent, "Le PS propose «un nouveau contrat pour la République sociale»," *Le Monde*, February 2, 1995.

[338] "A plague on them both," *The Economist*, October 26, 1996.

[339] Excerpts are reprinted in, "«La monnaie unique, un projet politique»," *Le Monde*, February 29, 1996.

monetary policy would be conducted in a countercyclical fashion, by creating liquidity and keeping interest rates low in comparison to German rates. Third, concern for the deficit would take a back seat to investment in research, housing, and technology. Fourth, promotion of strong wage growth would revive demand, growth, and employment.[340]

In December of 1996, the Socialist Party followed this line of logic by demanding that the Juppé government push for a "Growth and Solidarity Pact" to counter the German proposals for a "Stability Pact" at the Dublin Intergovernmental Conference. Party chief Henri Emmanuelli challenged the government to resist German calls for the pact without some significant concessions in favor of growth and jobs. The party also supported guaranteed membership for Italy and Spain with the explicit purpose of balancing the influence of Germany and other conservative countries over monetary policy in the euro zone.[341]

Pressure to abandon the commitment to EMU came from defections from the party and outside pressure as well. Three days before this announcement, Jean-Pierre Chévènement of the Socialists had formed a new party, the *Mouvement des Citoyens*, designed to appeal to Socialist voters who wanted a non-communist leftist option.[342] The PCF, of course, had long opposed privatization and European integration, and promoted a full range of work guarantees, subsidies and social programs.[343] The timing of the announcement of the new party thus served to use the government's EMU policy against it, and served indirectly to prompt the Socialist Party to take the public move to the left, away from its previous policy of restraint, and toward a growth policy that promoted employment even at the cost of inflation, debt and devaluation.

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[340] Ibid.

[341] "Sozialisten fordern für die EWWU Solidaritäts- und Wachstumspakt," *Handelsblatt*, December 17, 1996.

[342] "Paris soll nicht Bonn werden," *Frankfurter Rundschau*, December 14, 1996.

[343] "Die Politik des harten Franc steht im Mittelpunkt der Diskussion vor der Wahl," *Handelsblatt*, February 17, 1993.

The RPR - UDF Coalition

The conservative coalition was internally divided over the benefits of the franc fort and economic policy reforms required to commit to EMU, but more committed than PSF members.

Lower German interest rates and the wider margins of the EMS Exchange Rate Mechanism, implemented in late 1993 helped the Balladur government to maintain the franc's parity by reducing the impact of interest rates on the currency's value and enhancing the importance of the underlying economy.[344] This measure carried the political symbolism of retaining the commitment to a strong currency while loosening the need to bind the franc closely to the mark. This solution eased pressure on interest rates, which could more easily reflect the performance of the French economy more than the German.

The Union for France (Union pour la France, or UPF), a coalition of the RPR and the UDF from 1990 onward, governed with two remarkably different economic policies. The Balladur government, which held office from 1993 to 1995, won on a platform that emphasized measures to reduce unemployment and boost economic growth without damaging the stability of the franc. His economic policy consisted of two main elements. First, he sought to contain social insurance premiums through marginal spending cuts in order to stabilize payroll costs and prevent increases in unemployment. He also introduced a series of targeted tax expenditures that subsidized the cost of labor from specific segments of the labor market (see section 2.3).

Second, he planned to continue the commitment to the *franc fort* policy of his predecessors. The intense effort to generate growth in the French economy meant, however, that this policy focused primarily on granting independence to the Banque de France, and on re-negotiating the rules of the European Monetary System to loosen the impact of German interest rates on the franc.

The Juppé government left targeted social insurance premium subsides intact, but

[344] Ridding, John, "French franc makes a comeback." *Financial Times*, December 11, 1993.

focused much more heavily on cutting spending than stimulating growth. After Balladur's government had managed to generate an astronomical deficit, a reversal was impossible to avoid. Nevertheless, voters had not responded as much to a need for cost-cutting reform, but rather Jacques Chirac's insistence that government could both do more to help the unemployed without damaging the franc.

The policy tension reflected a split that cut across party lines and which had caused the coalition problems during the Maastricht referendum in 1992. Although the RPR party leadership was generally in favor of Maastricht, it was also the most concerned about soothing anti-Maastricht voters, since many of them were defecting to the Front Nationale and its clear policy of economic and cultural nationalism. It was also the party of Philippe Séguin and Charles Pasqua, who commanded the allegiance of nationalist voters who might otherwise defect to the FN camp, in particular, the unemployed and those in endangered sectors. In late 1991 and in 1992, Jacques Chirac tried to broker a deal between this group and reformists in the RPR by appealing to the two nationalist RPR members to make no public stands on EMU and Maastricht before full negotiations on a common position with the more pro-Maastricht UDF could be undertaken and concluded. When this effort failed, Chirac was left with the option of announcing his support for the treaty and appealing to members to support him without attempting to impose party discipline.[345] The inability of the party to take a stronger stand on Maastricht reflected the constant and growing fear of voter defections to the FN that narrowed the conservatives' overall chances of instituting a comprehensive institutional reform program between 1993 and 1996.

In the election campaign of 1992, the UPF complained that the socialists had driven the economy into its worst shape since WWII, and developed an economic platform with three main points. First, they promised to continue the *franc fort* policy that the PSF had conducted for the previous 5 years. The parties were not uniformly behind this commitment, but the nationalist camp led by Pasqua and Séguin of the RPR and Madelin of the UDF were

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[345] For a review of these events, see Andrew Appleton, "The Maastricht Referendum and the Party System," in John Keeler and Martin Schain, eds., *Chirac's Challenge: Liberalization, Europeanization, and Malaise in France*. London: MacMillan, 1995, pp. 304 - 308.

too small a minority to get their devaluation and reflation policy considered seriously. Second, they committed themselves to a massive privatization program designed to revitalize the economy and bring income to government coffers with which borrowing requirements could be balanced. While specific firms were not mentioned, the state banks BNP and Crédit Lyonnais were confirmed as likely targets, as were the insurance giants UAP and AGF.[346] These privatizations followed a strategy to develop 'popular capitalism' in France by making shareholding more common among average voters.

Most of all, voters happily received proposals to lower taxes and social security contributions designed to boost consumer spending. In the 1993 election campaign, Balladur promised to waive employers' social security contributions for new employees for three years, to collapse income taxes into five progressive rates beginning in 1994, and to make the CSG tax deductible.[347] Balladur committed the government to finding spending cuts to balance the tax cuts, promised not to cut the government's total spending, and pledged to spend more on investment and job creation, while increasing payouts no more than the rate of inflation.[348]

The unemployed who had suffered under the socialists were looking to the conservatives for relief from the deflation that had accompanied the *franc fort* policy. Instead, Balladur offered them a tough attitude toward the Uruguay Round of GATT, in which fair trade and the prospect of export sector jobs, and not free trade would be emphasized.[349] In this area, Balladur allowed the nationalist components of his party some consolation.

Once in office, Balladur committed his government to focusing on employment, economic growth and investment. Deficits were depicted as the "the only real menace

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[346] "Die Politik des harten Franc steht im Mittelpunkt der Diskussion vor der Wahl." *Handelsblatt*, February 17, 1993.

[347] Seux, Dominique. "Le programme de l'opposition." *Nouvel Economiste*, January 29, 1993.

[348] "Die Konservativen sind vorsichtig." *Börsen-Zeitung*, February 24, 1993.

[349] "Frankreichs Wirtschaftspolitik auf neuen Wegen." *Nachrichten für Außenhandel*, March 30, 1993.

weighing against social protection," and served as the justification for cost-cutting plans in health, pensions, and public service. Payroll taxes for social insurance programs were singled out as a negative influence on employment, and used to justify both more social spending in the general budget, more premium subsidies, and a higher tax on non-wage income. Finally, the government planned to spend money to create jobs in housing, public works and the environment, and award subsidies to move individuals out of minimum wage jobs into better paying ones. Along with these measures, he emphasized that central bank independence and "the European policy," meaning EMU, was a crucial component of the entire reform package.[350]

Balladur held steady to membership in both the EMS and EMU despite loud criticism from within the coalition and from business. Alain Madelin of the UDF blamed high German interest rates for "strangling the French economy." Seventy percent of businesses now supported withdrawal from the EMS as a means of lowering interest rates. In contrast, only 20 percent wanted the government to continue following the franc fort policy. The critics included Claude Bebear, chief of the country's second biggest insurer, Axa. Where the party was split, pressures on MNAs from the unemployed and businesses suffering from the recession were reported to be a crucial factor encouraging the nationalists.[351] Meanwhile, Philippe Séguin, also of the RPR, not only rejected the Balladur platform from within the RPR, but continued to propagate a much more nationalist platform from his position as the president of the National Assembly.[352]

Balladur's chose his cabinet to demonstrate a pro-European stance, but more importantly a commitment to taking savings seriously. (His cabinet was smaller at 29 members than the old 40-member cabinet.) The savings-minded UDF and CDS were overproportionally represented. Pasqua was given charge of internal affairs and

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[350] The text of Balladur's press conference regarding the government's comprehensive strategy is published in, "«L'effort de tous doit être concentré sur l'objectif de redressement», déclare le premier ministre." *Le Monde*, May 12, 1993.

[351] "Brutaler Schock." *Wirtschaftswoche*, March 19, 1993.

[352] Cotta, Michelle, "Séguin, est-il sérieux?" *Nouvel Economiste*, June 25, 1993.

unemployment insurance,[353] while Alphandéry as economics minister was acceptable enough to nationalist sympathizers to win praise from *Le Figaro*.[354] Balladur received support from Mitterand for his policy stance in favor of EMU as a key component of building the European Union.

Beyond the savings programs discussed in section 3.3, the most pervasive aspect of Balladur's domestic economic policy was an attempt to stimulate economic growth through consumer spending. Plans to raise taxes on gasoline, alcohol and middle and higher incomes in May 1993[355] turned into broader tax cuts for the middle classes and promises of cheaper credit in late summer in a effort to revive spending. Consumers, however, were already heavily indebted, and paid down debts rather than invigorating economic growth. Similarly, businesses were not making capital investments with their new tax breaks.[356] When the economy still failed to grow, tax cuts and subsidies expanded to 100 million francs in VAT breaks for businesses hiring youth, and rebates of 5000 francs to new car buyers.[357]

The timing of these increasingly aggressive stimulus policies was closely linked to speculative attacks of the French currency in 1993. At that time, reports on France's increasing unemployment problem, and the hard blow dealt to manufacturing less than a year after the 1992 currency crisis drove speculation that the government would be forced to devalue the franc.[358] The government renewed its commitment to a strong franc, meaning a monetary policy tight enough to support the franc's external value while the government

[353] "Balladur zeigt Schnelligkeit und Effizienz," *Nachrichten für Außenhandel*, April 1, 1993.

[354] "Auf die Finger," *Wirtschaftswoche*, April 9, 1993.

[355] "Premier Balladur kündigt höhere Steuern und Konjunkturhilfen an," *Handelsblatt*, May 11, 1993.

[356] "Balladur zündet erneut eine Konjunkturrakete," *Süddeutsche Zeitung*, August 25, 1993. On consumers paying down debt and credit proposals, see "A little more joie de vivre, please," *International Herald Tribune*, September 11, 1993.

[357] "Franzosen sollen ihre Spardosen plündern," *Die Welt*, February 2, 1994; "Paris will Neuwagenkäufern Prämie zahlen," *Frankfurter Rundschau*, February 1, 1994.

[358] The key report came from the OECD. See "Monetary tests apres le deluge," *Financial Times*, December 23, 1993.

attempted to stimulate consumption. To ensure that the public registered the linkage. Balladur emphasized that France's economic strength was fully capable of supporting a strong franc, that international speculators were responsible for wanting to destroy the EMS through the French currency, and that the country could fight back by stimulating growth.[359]

Overall, the Balladur economic policy reflected a mix of priorities that differed from the German situation. Commitment to a strong currency was consistently strong because voters expected the commitment, despite equally loud calls to promote economic growth. As a result, the way to a strong currency was through economic growth, employment and consumption-promoting tax expenditures rather than capital investment and inflation-dampening tax increases as in Germany. The French way also reflects that the political commitment to price stability could only share center stage with the need for growth.[360]

Balladur proved incapable of imposing the bitter aspects of his growth strategy on significant areas of the economy. A significant part of his program to get people working again was to allow employers to take on trainees at rates even lower than the minimum wage. In 1994, parents, teachers, unions, and the socialist and communist parties protested against the training promotion program until Balladur withdrew it. Another key policy, the ban on firing older workers, actually hurt business and drew fire without creating any jobs: computer manufacturer Bull, Air France, steel manufacturer Usinor Sacilor and Crédit Lyonnais attributed large losses attributed to the program. Meanwhile, the deficit had doubled during his first year in office, even after privatization funds had brought the figure down.[361] Balladur also backed down from an attempt to lay off 4,000 workers at Air France in 1993.

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[359] "Frankreich nach dem Währungssturm," *Neue Zürcher Zeitung*, August 7, 1993; "Balladur: Mit mir keine Politik des billigen Geldes," *Frankfurter Allgemeine Zeitung*, August 14, 1993.

[360] Balladur not only gained significantly from bashing speculators for the summer crisis, he also benefited by making a show of hard bargaining in the Uruguay Round of GATT negotiations to protect French jobs and industries. See "Monetary tests apres le deluge," *Financial Times*, December 23, 1993.

[361] "Balladurs Reformen Scheitern am Druck der Interessenverbände," *Frankfurter Allgemeine Zeitung*, March 30, 1994.

After Air France workers went on strike, he agreed to simply not replace retiring workers.[362] On balance, Balladur was able to achieve changes to programs that had the least direct impact on the budget, such as independence for the Banque de France, while others, mainly private sector pensions and unemployment, spiraled out of control.

Any doubt of the voting public's support for the uneasy compromise was demonstrated over the course of 1994 when Jacques Chirac was forced to withdraw his suggestion of abandoning the franc fort policy in favor of whatever was required to boost growth and employment. Between May and November, he had returned to advocating a stable exchange rate, lower debt and deficits. The main incentive for Chirac was the combination of an exploding government deficit that Balladur's subsidies and failed savings measures had generated, and voter concern over the impact this would have on the value of the franc. However, he tried to create some room for himself to lengthen the time plan by advocating a referendum before France proceeded to the third and final stage of EMU.[363]

Chirac's reversal set the tone for the rest of his presidency during the study period. The contradictory positions reflected the divided economic interests that were supporting the conservative coalition. The rising fortunes of the right-wing Front Nationale on a tide of economically disaffected voters put pressure on Chirac to make two incompatible camps somehow compatible.

The Juppé government demonstrated an exceptionally strong determination to reform national economic institutions compared to previous governments in the 1990s, but also sensitivity to the concerns of economic nationalists. Juppé began his tenure by appointing Alain Madelin as finance minister. In Madelin, Juppé had a minister committed to stringent control of government spending commitments, but who also had a reputation as a strong defender of France's national interest, and who could frame budget reforms as necessary sacrifices for France, rather than for Europe and EMU. However, Juppé's early financial

[362] "Blaue Flecken bei der Notlandung," *Süddeutsche Zeitung*, October 28, 1993.

[363] "In Frankreich ein Kurswechsel der Wirtschaftspolitik verlangt," *Frankfurter Allgemeine Zeitung*, May 5, 1994; "Chirac revidiert seine Wirtschaftspolitik," *Frankfurter Allgemeine Zeitung*, November 18, 1994.

reform proposals froze selected spending commitments instead of instituting cuts. In contrast, he extended incentive programs inherited from the Balladur administration to hire the unemployed and train youth, mainly by lowering the cost of social insurance premiums for employers. Contracts for Employment Initiatives (CIE) were to promote hiring of long-term unemployed by paying one third of the minimum wage for two years, and freeing employers from social security contributions. Tax cuts were also promised as an incentive to growth, the minimum wage increased, and pension payments raised ahead of schedule.[364]

Madelin's savings plans emphasized cuts that Juppé had not approved, and mounting opposition led Juppé to fire him after only three months. Rather than adopting a policy of spending freezes, Madelin had proposed spending cuts to agriculture, defense and the public service. He advocated the privatization of France Télécom, the reduction of France's top income tax rate from 56.8 to 50 percent to generate economic activity, and the legalization of private, capital-based pension funds. Madelin's departure led reformers in the UDF to accuse Juppé of giving into the left and right nationalist wings of the RPR and undermining the prospects for meaningful reform of France's spending institutions. In contrast, both the CGT and the CFDT expressed their satisfaction at Madelin's removal.[365]

It is interesting to note that Madelin's sacking as finance minister took place shortly before Juppé abandoned the combination of a soft policy toward balancing the books and putting EMU in the background, and began the controversial work of linking EMU membership to implementing cutbacks. Madelin himself had criticized EMU more often than not in the past, and had accepted EMU principally as a means of helping through national reforms.[366] The fact that Juppé adopted Madelin's approach after his departure (below) underlines, however, that Madelin was used as a scapegoat for early resentment over reforms.

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[364] At a cost of 14 billion francs. See "Die großzügigen finanziellen Versprechen der Regierung Juppé," *Frankfurter Allgemeine Zeitung*, May 26, 1995.

[365] "Allen Wohl," *Wirtschaftswoche*, August 31, 1995.

[366] "Kaputter Aufzug," *Wirtschaftswoche*, May 25, 1995.

One month after replacing Madelin with Jean Arthuis, Juppé's emphasis on reducing the deficit took the leading role in the government's economic plan. Furthermore, the previous combination of tax cuts and spending restraints gave way to spending cuts in the short term and tax relief in the medium term. In the budget law for 1996, Arthuis imposed a new anti-deficit surtax on incomes of 0.5 percent, froze health spending, family support and civil servant salaries. Civil servants were also subjected to new rules requiring 40 years of service before retirement.[367] He cut subsidies to UNEDIC and raised transport taxes to cover declining subsidies for rail and Paris transit operation. Significant cuts hit industrial credit programs, foreign affairs, agriculture, defense payrolls and direct aid for small and medium sized businesses. As partial compensation, increases were provided in labor market and education spending and a small net number of public service positions. Defense equipment spending was also allowed up to the amount saved from personnel costs. In addition, tobacco taxes, the VAT, surtaxes on corporations and wealth, and the CSG were raised significantly. The notable characteristic of this strategy is that it did not reflect the demands of most businesses at the time-that taxes come down as soon as possible. Instead, the broader desire to reduce the deficit took priority. The new taxes raised non-insurance business taxes as a percentage of GDP to their highest historical point.[368]

Shortly after the budget was tabled, Juppé assured the public that there would be benefits in return for the pain. Not only would the tax increases be temporary, but the government would also look for ways to reduce both payroll and income taxes as a means of preserving jobs and promoting consumption. This consisted of the old policy of replacing more payroll taxes with CSG and VAT income, and a new policy of reducing the top tax rate to 40 percent within an overall simplification of the tax system.[369] Despite a one-day warning strike by the public service, transportation and post offices in October 1995, the government

[367] "Frankreich soll den Gürtel enger schnallen." *Tageszeitung*, November 17, 1995.

[368] Mauduit, Laurent, "Les prélèvements obligatoires vont atteindre un niveau sans précédent." *Le Monde*, September 22, 1995.

[369] "Juppé strebt Steuer und Sozialreform an." *Frankfurter Allgemeine Zeitung*, September 28, 1995.

remained firm.[370]

The strikes that followed in November and December brought over a million public service workers and students into the streets, and transportation strikes largely shut down the country. While they forced a retreat on the governments plans to reform pensions, the strikers did not succeed in convincing Chirac to dismiss the prime minister or change the overall commitment to spending reforms. In contrast, Chirac emphasized that "there is no alternative to this policy," if France were to remain "master of her destiny," referring to the impact of international currency markets on France's interest and exchange rates. Significant, however, was Chirac's and the government's tendency by the end of the strike to avoid a direct linkage with EMU membership.[371] Renewed discussion came only later in 1996, after the government had time to recover public support.

In the meantime, the strike not only forced Juppé to back down on reforming public pensions, it prompted Chirac to swing his support in favor of more economic stimulus to fight unemployment. Chirac began proposing in vain that Germany and France negotiate a common, lower interest rate,[372] and put pressure on the Banque de France to reduce interest rates to allow room for economic growth. Since interest rates had risen over the previous six months because of uncertainty over Chirac's commitment to the Maastricht Treaty and to independence for the Banque de France, this renewed, if weak attempt to set the bank's independence aside simply emphasized the instability and desperation of national economic priorities. Chirac's wobble gave additional courage to the nationalists of the RPR and the UDF, who began calling for a policy of devaluation and reflation from the National Assembly.[373]

The Banque de France was able to accommodate the government's call for moderated

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[370] "Aus fünf mach drei," *Die Zeit*, October 20, 1995.

[371] "Frankreich's dilemma," *Börsen-Zeitung*, December 21, 1995; "Frankreich: Austerity-Politik im Crashtest," *Börsen-Zeitung*," December 30, 1995..

[372] "Rätselraten in Bonn und Paris," *Handelsblatt*, January 8, 1996.

[373] "La stratégie économique d'Alain Juppé est contestée à droite," *Le Monde*, January 9, 1996.

interest rates, but demanded compensation from the government in the form of lower interest payments on savings deposits with the Banque de France, to constrain the growth of the money supply.[374] The government agreed to the terms, but won a concession of even higher rates for the poor and the unemployed.[375]

The confusion over the government's economic priorities was strong enough to split the cabinet and attract the intervention of the European Commission in favor of Juppé and his savings program. By late January of 1996, Juppé had censured foreign minister Hervé de Charette for publicly endorsing a renegotiation of the entrance criteria for membership in the European Central Bank, and redoubled his commitment to the full criteria for EMU. Industry minister Frank Borotra went on record as saying that the government should create jobs first and worry about the entrance criteria later.[376] Giscard d'Estaing, leader of the UDF in the National Assembly, also called for the entrance criteria to be modified to whatever levels France managed to achieve. The EU Commission felt compelled to respond to the European press that the criteria were not up for discussion.[377]

The 1997 elections, as conservatives expected them, played a significant role in the break from the government line. After the strike of 1995, many feared for their seats, having won by very thin margins in 1993, and feeling voter anger at the poor state of the economy, and the government's role in worsening their own prospects.[378]

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[374] The accounts in question are Livret A accounts, which paid interest more than commercial savings accounts and were therefore very popular. See Jack Andrew, "French plan to relaunch economic growth," *Financial Times*, January 10, 1996.

[375] Livret A savings accounts had paid 4.5 percent interest since 1986, regardless of the market. The new regular rate dropped to 3.5 percent, while the poor and unemployed received 4.75 percent with the agreement. See "Auch Paris legt ein Konjunkturprogramm vor," *Frankfurter Allgemeine Zeitung*, January 31, 1996.

[376] "Streit in der französischen Regierung über die Währungsunion," *Frankfurter Allgemeine Zeitung*, January 27, 1996.

[377] "Brüssel warnt vor Konfusion," *Handelsblatt*, January 26, 1996.

[378] "Streit in der französischen Regierung über die Währungsunion," *Frankfurter Allgemeine Zeitung*, January 27, 1996.

A month later, and two months after the strikes, the government recommitted itself to budget reform and to EMU membership under the hard criteria. Defense and civil servant wage freezes would be complemented by a renewed program of reforming social security.[379]

While Juppé focused on restraint, Chirac attempted to make EMU more politically feasible by promoting a European social and employment policy that would stand beside the independent central bank and the hard criteria for entry. While arguing for the re-introduction of narrow bands in the EMS as a confidence-building measure and insisting that France would make the Maastricht criteria, he also made a point of endorsing the EMS II institution as a means of providing continuing stability for those countries not able to make the criteria on time.[380]

Forced to cut spending further in late 1996, Arthuis took a different approach than his predecessors by introducing across-the-board cuts in government departments, and planning to reduce the number of functionaries by replacing few of those going into retirement. In this way, opposition could not be concentrated on a single spending commitment. In addition, the savings were explicitly linked to the need to qualify for ECB membership. Arthuis decided not to risk a repeat of the 1995 strike by not freezing public servants' salaries. The largest lump of savings, 37.5 billion francs, was the most controversial, the most dubious over the long term, and would not have taken place without the deadline for EMU membership. Arthuis arranged for France Télécom to give the government the money in exchange for the government assuming FT's future pension liabilities.[381]

Economic growth continued to form a large concern for the government's economic plan, however. Poor consumption was singled out as a specific problem, as were high interest rates and a correspondingly low level of business investment. Arthuis still held out

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[379] Buchan, David, "EMU back on French lips," *Financial Times*, February 20, 1996.

[380] "Vor Turin fordert Präsident Chirac ein 'europäisches soziales Modell'," *Handelsblatt*, March 26, 1996.

[381] "Easing the road to Maastricht," *Financial Times*, September 27, 1996.

the hope of stronger economic growth as a help for the government's balance, but did not stimulate as the Balladur government had done.[382]

Meanwhile, conservative calls for some type of alternative policy grew over the course of 1996, particularly in competition with more advanced developments in the Socialist Party. One of the earliest, and EMU-friendly policies came from Edouard Balladur, who echoed the socialists in calling on the European Union to make the development of an employment strategy a priority.[383]

By December 1996, Conservatives in the National Assembly were increasingly ready to abandon support for the government's EMU and economic strategy. While Juppé was present in the National Assembly to defend his policies, Giscard d'Estaing accused him of neglecting France's economic interests, drawing cheers from both the RPR and the Socialists. For the first time since the franc fort policy was introduced, Gaullist MNAs were defying the EMU policy of a Gaullist President and a Gaullist Prime Minister. The French, according to Ian Davidson, wanted a European institution that promoted "stability *and growth*," (as the socialists had proposed) and the MNAs were afraid for their seats. They were also eager to pursue an exchange rate policy against the dollar (i.e. devalue the euro against the dollar) without regard to internal stability.[384]

Giscard d'Estaing won particular points by accusing Juppé of forgetting how the euro affects the little man, and ridiculed the notion that policy should be made in the "wood-paneled chambers of the central banks."[385]

Chirac supported Juppé and dual policies of internal reforms and membership in a hard currency monetary union right up until the latter's defeat in early elections in 1997. Chirac made it explicit to the public that only a renewed majority could give the prime minister the political capital he required to consolidate the state's finances and assure the

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[382] Ibid.

[383] "Edouard Balladur veut faire de l'emploi une priorité europćene," *Le Monde*, March 8, 1996.

[384] "Nerve fails in Paris," *Financial Times*, December 4, 1996.

[385] "Zerbrochenes Vertrauen," *Der Spiegel*, December 2, 1996, pp. 155-157.

country of a place in the European Central Bank with a permanently solid currency. Juppé was expected to win on the basis of the strong currency alone, if by a slim margin. The fact that he lost to a socialist candidate who rejected most internal reforms underlined the end of the conservative attempt to impose an institutional revolution in France.

3.5 Conclusions

Voters had a tremendous impact on the basic priorities of economic policy for all of the governments between 1991 and 1996. The population was divided between ushering in a new era of strength for the franc on the one hand, and relaxing the central bank's grip on the economy to create jobs on the other. Though this forced compromise between stability and growth is more equivocal than the German pursuit of stability first and growth second, the fact that voters made stability an indispensable component of every government's economic policy underlines the country's stability orientation.

While stability was a commitment made in the 1980s, spending commitments and the budget deficit first became an issue in the 1990s when the fight against inflation generated increasingly high levels of unemployment and deficits. This development points to the expectation that a shift from an electorate that does not demand currency stability to one that does will likely generate the type of conflict between governments and spending institutions that provide social benefits, particularly those that alleviate unemployment directly (unemployment insurance) or indirectly (e.g. pensions).

The study also shows that not all institutional-governmental conflicts are created equal. Successive governments had a relatively easy time restricting benefits for the general population and keeping pressure on the deficit under control. Where the government was an employer, as it was in France to an unusually strong degree, spending commitments were adjusted less easily. Current pay and future pension benefits placed a large, direct and unavoidable claim on the national budget. This made it more difficult for French governments to reach their deficit goals than would have otherwise been the case.

Furthermore, the tenacity of the conflict with unions from 1995 onward manipulated the political majority's preference for stability by increasing the number of unemployed and keeping them out of work for longer periods of time. The spread and duration of unemployment worked against the stability coalition by robbing the government of employed supporters and by raising taxes and premiums on the supporters that remain. Some of those, in turn, lost their jobs as employers shed labor.

The French case also demonstrated that promoting the creation of the European Central Bank and holding out the prospect of guaranteed stability in exchange for spending and monetary policy reform was fairly effective for introducing spending cuts that applied to the general population. In addition, granting independence to the Banque de France was accomplished only with the help of the Maastricht Treaty.

In contrast, the ECB strategy was ineffective at pushing through reforms of institutions that were strongly defended by public sector unions. Given their unwillingness to compromise, the strategy that worked with the rest of the population failed. The contrast demonstrates that a program of reform at the national level in exchange for beneficial institutional reform at the European level is only as effective as the support that a political party can marshall. At the end of 1996, the institutional deadlock had generated enough unemployment to endanger the electorate's commitment to stability. While it had been eroding already, its continued presence was confirmed in Chirac's personified, if uncomfortable, compromise of stability and welfare in the 1995 presidential elections. This weakened commitment explains why the government failed to prevail over the unions by attempting to use the power of public opinion against them. Juppé stood firm against the unions in 1995 and 1996, but persistent rumors of his replacement showed that the public was not willing to support stronger state measures to put a decisive end to the showdown in either 1995 or 1996. By then, the justification of EMU membership to cut public sector jobs and pension entitlements failed to help the government achieve its goals.

The failing reforms also explain the attractiveness of a launch for EMU in advance of fulfilling the membership criteria. These suggestions came when the government was having difficulty defending the exchange rate, which was also when doubts about the government's public support for reforms were highest. Early ECB membership proposals floated in 1992, 1993, and 1995, when the Maastricht referendum, protests against Balladur's reforms and uncertainty about the economic priorities of Chirac and Juppé sent the franc on bumpy and (for the Banque de France) expensive rides. Talk about a growth and stability council to stand alongside the ECB followed a similar pattern.

The collapse of the conservative coalition in 1997 emphasized by the fact that EMU was the Chirac's stated reason for calling an early election, raises some important points for future study. In particular, we need to consider that it is possible for a new coalition to crumble in the effort to change national institutions.

4 Spain

Franco-German plans for EMU were unattractive for Spain during the 1990s. The timetable was considered too short a time within which to reduce the country's inflation rate and budget deficit. Nevertheless, government and opposition parties recognized the potential costs of not participating. Both the Gonzales (socialist, until 1996) and Aznar (conservative, 1996 and onward) governments feared that European investors would shun the country if it failed the confidence test of making the grade for EMU membership. Lower foreign investment, in turn, would undermine the country's capacity for economic development, job creation, and convergence with the standard of living elsewhere in the EU. These goals were the acid test of electoral success in Spain throughout the 1990s.

A collection of societal interests made it difficult to converge with EMU's inflation and deficit criteria. Until 1995, neither employers nor unions were interested in restraining wage increases, ensuring that inflation remained strong. With few exceptions, the political popularity of inflation-indexed social spending commitments made it impossible to control government spending while inflation persisted. Even during the strongest periods of government borrowing, both parties declared these programs to be untouchable. Finally, strong unemployment and uneven economic growth limited the government's capacity to restrain inflation with monetary policy until wage agreements were controlled. Only a persistent campaign to link wage and productivity increases during an extraordinarily deep recession, followed by strong economic growth, allowed the government to converge toward the EMU criteria in 1997.

Institutions influenced Spain's inflation and deficit characteristics in interaction with political interests and the state of the economy. Although Spain's spending commitments, particularly its social entitlements, were not particularly generous by European standards, the country's high unemployment rate and weak economy ensured that they had a larger impact on the Spanish budget than would have been the case with more robust economic activity. At the same time, their importance to the electorate made them politically untouchable, even during the strongest periods of government borrowing.

Given these domestic challenges, Spain led the drive to vastly expand the European Union's Structural Funds program as compensation for the hardship that ECB membership would impose on the EU's poorer, less competitive member states. The Gonzales government also attempted to shape EMU's timetable and entrance requirements to better suit the country's inflation rate and budget deficit, both of which were much higher than the EU average. This meant lobbying to delay the launch of monetary union as far as possible into the future, and periodically suggesting that the membership criteria be interpreted liberally to allow Spain to enter with higher inflation rates and budget deficits. Finally, the Aznar government offered brief and unsuccessful resistance against German plans to permanently commit all EMU members to the convergence criteria for inflation and deficits.

4.1 Economy: Performance and Characteristics

Between 1990 and 1996, the Spanish economy and the Spanish government's budget deficit did not significantly approach the convergence criteria for EMU membership, despite the Gonzales government's efforts to control inflation and spending. A breakthrough in controlling price levels toward the end of the PSOE administration aided the Aznar government in converging inflation rates and the budget deficit in time to secure EMU membership at the end of 1997.

Table 4.1 Spanish Convergence with EMU Entrance Criteria

	1991	1992	1993	1994	1995	1996	1997
Inflation Rate°	5.9	5.9	4.6	4.7	4.7	3.6	2.0
Budget Deficit*	-4.2	-3.8	-6.9	-6.3	-7.3	-4.6	-2.6
Public Debt*	45.5	48.0	60.0	62.6	65.5	70.1	68.8

Source: EMI, *Convergence Report*. Frankfurt, 1998.
° Consumer Price Index * Percent of GDP

By 1997, Spain had reduced its overall *inflation rate* from one of Europe's highest to the EU average. Before then, Spain's high inflation rate reflected four characteristics of its economy, which are discussed further over the course of this chapter.[386] First, wage agreements in many sectors, but in manufacturing in particular, exceeded both productivity increases and the inflation rate, pushing prices higher each year. This effect ebbed after 1994, when a strong increase in unemployment moderated wage demands.

Second, rising wages and inflation-indexed social transfers led to strong increases in private consumption, particularly for relatively expensive goods from other EU countries. Within this context, higher unemployment after 1991 helped to constrain consumer-induced price increases.

Third, the Gonzales and Aznar governments invested heavily in economic infrastructure to facilitate integration with the European market. Large sums of public and private money (much of it foreign) came into circulation, increasing demand and raising prices.

Finally, the Bank of Spain became independent in late 1994, and was able to manage monetary policy independently from the government's growth targets for the first time.

Spain's public sector borrowing requirements were modest in 1990, but then grew out of control. The *budget deficit* reflected the interaction of two significant spending commitments and a weakened economy that could not raise the revenue to pay for them. The first commitment was to social spending, which increased significantly in 1990 as expanded entitlements to social transfers took effect, and which were funded principally by payroll taxes. The deficit also expanded as rising unemployment increased the number of claimants and reduced the number of taxpayers. Persistent inflation increased the commitment to pay indexed benefits. By 1997, improved economic and job growth, combined with lower inflation rates and interest payments contributed to a smaller budget deficit.

Second, considerable government borrowing helped to fund an extensive program of public infrastructure investment, designed to attract foreign investment and generate

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[386] A discussion of Spain's performance on EMU entrance criteria is available in the European Monetary Institute's *Convergence Report*, pp. 114-119. Frankfurt, 1998.

economic growth. The doubling of regional development payments from the EU in 1994 relieved some pressure on this side of the budget.

At the beginning of the 1990s, Spain's *national debt* was far below the ceiling set out in the Maastricht Treaty, but jumped above it in 1993 as a result of uncontrolled borrowing and continued growing at a slower rate through 1996.

Structure

Spain's economic structure was more conducive to a growth-oriented monetary policy and a flexible exchange rate than to a stability-oriented monetary policy and a fixed exchange rate. The country proceeded with economic reconversion through the late 1990s, suffering high unemployment as a result. It relied partially on export earnings to pay for capital imports, as well as on public sector deficits.

Spain's economy is one of the EU's poorest. Many of the country's regions have a per capita income of less than 80 per cent of the EU average, making them first priority development aid recipients from the EU's structural and social funds. Economic activity in the 1990s favored a relatively loose monetary policy and a flexible exchange rate, according to the propositions made in chapter one. The economy was characterized by a dominant, domestic-oriented service industry, a manufacturing sector that was slowly reorienting itself away from captive Spanish customers and exporting more to the EU market, and an agricultural sector that was relatively large by EU standards. Consequently, economic growth depended heavily on domestic consumption and, given national inflation rates, periodic devaluations of the peseta in order to sustain manufacturing an agricultural exports.[387]

Table 4.2 demonstrates the contributions of primary (agricultural and raw materials), secondary (manufacturing and construction), and tertiary (service) industries to the national

[387] By 1992, only 15 of 40 economic sectors were in a position to take advantage of export opportunities to the single European market. See "Um für die Herausforderung des Binnenmarktes gerüstet zu sein, sind noch stärkere Anstrengungen nötig," *Handelsblatt*, March 25, 1992.

economy, compared with employment in these sectors. Raw figures, as well as productivity figures by kind of activity are listed in the appendix.

Table 4.2 Spanish Share of GDP (& Employment) by Kind of Activity°

	1991	1992	1993	1994	1995	1996
P*	4.1 (10.7)	3.5 (10.1)	3.6 (10.1)	3.5 (9.4)	3.1 (8.2)	(8.4)
S	34.5 (33.0)	32.7 (32.4)	31.4 (30.7)	31.3	32.3	
T	55.2 (56.3)	57.3 (57.5)	59.3 (59.2)	59.3	58.8	

* P=Primary (agricultural and resources), S=Secondary (including construction), T=Tertiary activities
Source: OECD, *National Accounts*, Paris, 1996; ILO, *Yearbook of Labour Statistics*, 1995. °Older, but more accurate data than in appendix.

Industry's contribution to national income was slightly weaker than elsewhere in Europe, despite a growing export sector.[388] Spain underwent a substantial restructuring of industrial production in the 1990s characterized by large imports of capital goods (for producing manufactured goods) and high value-added components for manufactured goods (such as engines for the automobile industry), and a diminished reliance on manufacturing for the domestic market, compensated for partially by increased manufacturing and assembly of goods for export to the EU. This change took place through the closure of businesses that had relied on protection during the Franco era and into the first years of membership in the EU[389], and the establishment of branch plants by EU firms seeking to lower production costs by shifting some of their operations to Spain. The speed of the transition was slowed,

[388] Detailed figures of industrial production by sector through 1994, and by broad economic sector until 1996, are available in OECD *National Accounts*, Volume II, 1998, Table 12, p. 554.

[389] The protection ran out in 1992, and extended to state monopolies such as oil and tobacco producers. See *España en la Union Europea: Diez Años desde la firma del Tratado de Adhesión*, Madrid: Ministerio de la Presidencia, 1995, p. 11.

however, by the slump in European markets after 1990 that inhibited exports.[390] Nevertheless, the automobile industry's rise and the shipbuilding industry's decline are two prominent examples of this industrial shift. Industrial employment, however, continued to decline, showing that the more competitive industries do not require the same workforce that the outgoing industries do.

The service sector was strongest, both in production and employment. Services productivity remained less impressive than in manufacturing, but witnessed the strongest growth of the three broad sectors. This points to a Spanish service sector that is not yet generating the lion's share of its income from high value-added services, but which is also developing rapidly. The key remaining problem in the service sector is that it contributes more to inflation than the other two sectors, despite its strong productivity growth.

One service sector strength is the banking industry. Here, the Spanish government approved of mergers in the late 1980s designed to prepare them for competition with their European counterparts in 1991.[391] The mergers created three large, profitable banks with international investments and a bias toward industrial restructuring, low inflation, and government budgetary restraint. Two reform-minded Basque banks, Banco de Bilbao and Banco de Vizcaya, merged in 1988. Six public banks, including the newly organized Catalan savings banks, were merged in 1991 to form the Corporacion Bancaria de España. The direction of the new bank was indicated by the election of a former official of the Banco de Vizcaya as president. Finally, the modern leadership of the Banco Hispano Americano was able to orchestrate a takeover of the conservative Banco Central in 1991. Just as important, the mergers absorbed large banks which were tied to the nation's older, outdated and least profitable industries. By 1991, only Banesto remained opposed to the restructuring of

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[390] "Um für die Herausforderung des Binnenmarktes gerüstet zu sein, sind noch stärkere Anstrengungen nötig." *Handelsblatt*, March 25, 1992.

[391] *España en la Union Europea: Diez Años desde la firma del Tratado de Adhesión*. Madrid: Ministerio de la Presidencia, 1995, p. 11.

Spanish industry as a major player in the banking industry.[392]

Elsewhere in services, a strong influx of new investment was working to build up the country's palette of telecommunications, transportation, financial and business services in the 1990s.

Employment demonstrated a strong secular decline in agriculture and fishing, and significant declines in manufacturing and construction.[393] Tourism, restaurant, transportation and communication industries experienced small declines but remained stable in the service sector. The significant shift here was a break from the pattern of increasing employment in community, social and personal services in 1993, and significant new levels of employment in financial, insurance, real estate and business services.

The Spanish economy had difficulty improving on its competitiveness in the European market without devaluations before 1994, mostly because of wage increases that outstripped productivity. The table below shows productivity gains in percent over the previous year, and below it, unit labour cost growth, which shows the impact that wages have on productivity and competitiveness. If it outstrips productivity growth, as it did until 1994, wages have an inflationary impact on prices. The figures show that Spain brought wage increases closer in line with productivity growth after 1993.

Table 4.3 Annual Productivity and Unit Labour Cost Growth, Spain

	1991	1992	1993	1994	1995	1996
Productivity	1.3	2.3	1.8	2.7	1.1	0.8
ULCs	8.1	8.0	4.9	0.0	1.9	2.9

Source: EMI, *Convergence Report*, Table 2. Frankfurt, 1998.

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[392] For a more detailed account, see Otto Holman, *Integrating Southern Europe: EC Expansion and the Transnationalization of Spain*. London: Routledge, 1996, pp. 192-196.

[393] Sectoral employment information is based on figures from the International Labour Office's *Yearbook of Labour Statistics*. Geneva, 1998.

Spain has by far the EU's highest unemployment rate, and this made it difficult for the Gonzales and Aznar governments to exercise budgetary restraint. Even more problematic, however, was that economic recessions in Spain destroyed a larger percentage of the country's jobs than elsewhere.[394] Not only did downturns hit the country harder, businesses that survived and restructured kept fewer of their employees.

The unemployment rate had two implications for Spain's medium and long term ability to sustain low budget deficits and low inflation. First, the large number of unemployed meant a smaller core of taxpayers and a larger group of social welfare recipients than in many countries. Therefore, job creation is a particularly important requirement for improving public finances.

Table 4.4 Unemployment Rate, Spain

1991	1992	1993	1994	1995	1996
16.3	18.4	22.7	24.2	22.9	22.2

Source: EMI, *Convergence Report*, Table 2. Frankfurt, 1998.

Another aspect of the labor market that hurt government finances was the country's low participation rate. In 1997, only 41.3 percent of Spaniards were either working or looking for employment, significantly lower than in either France or Germany.[395]

Spain's current account (table 4.5) in its balance of payments showed a fluctuating deficit in the 1990s. This means that Spain made less from investments and the sale of goods

[394] Fuentes Quintan, Enrique, *El Modelo de Economía Abierta y el Modelo Castizo en el Desarollo Económico de la España de los Años 90*. Zaragoza: Prensas Universitarias de Zaragoza, 1995, pp. 161-3.

[395] See ILO, *Yearbook of Labour Statistics*, Table 1A. Geneva, 1998.

and services to the outside world than it consumed. The most important factor was Spain's considerable trade deficit in goods after 1989. This was due to a strong inflow of machinery used to manufacture future exports. Spain's rapidly growing export receipts paid for a significantly larger share of the country's imports after 1992.[396] Services such as tourism, on the other hand, generated a more stable source of income, though not enough to fully compensate for the country's trade deficit. High demand for foreign business services, financial and insurance services, freight (trade related) transportation and telecommunications services added to this imbalance.

Spain's financial account (table 4.6) shows that it was a net recipient of foreign investment, with exceptionally high inflows between 1989 and 1992. Direct investment correlates positively to Spain's entry into the common market, with additional volume during the period of Spain's participation in EMS, with a dramatic reduction once the peseta was devalued. As section 4.4 notes, the Spanish government recognized and valued the link between committing to stability through the EMS and the capacity to attract investment capital.

Table 4.5 Current Account, Spain, Million US Dollars

	1991	1992	1993	1994	1995	1996
G°	-30,335	-30,420	-14,946	-14,833	-18,244	-16,027
S	11,908	12,608	11,108	14,712	17,899	19,789
I	-4,269	-5,791	-3,573	-8,194	-3,878	-5,799
Total*	-19,798	-21,537	-6,017	-6,927	513	503

Source: IMF, Balance of Payments Statistics Yearbook, Table 1. Washington, 1998.
°G=goods; S=services; I=investment income. * Includes an adjustment for current transfers.

[396] For a detailed sectoral account of trade and investment relations, see International Monetary Fund, *Balance of Payments Statistics Yearbook*. Washington, D.C. 1998.

Exchange rate volatility and government deficits combined to draw in huge sums of foreign capital into government bonds, particularly in 1991 and 1993. In both of these cases, the demand for bonds to support the currency and the deficit correspond to drops in direct investment of foreign capital in the country. In addition, interest payments abroad to finance the debt more than tripled between 1989 and 1992, and remained high thereafter, despite a decline.[397]

Table 4.6 Financial Account, Spain, Million US Dollars

	1991	1992	1993	1994	1995	1996
DI°	8.051	11.084	5.492	5.528	2.551	1.246
(Out)	-4.442	-2.192	-2.652	-3.831	-3.650	-5.208
(In)	12.493	13.276	8.144	9.359	6.201	6.454
Port~	20.080	9.358	49.213	-22.314	20.879	-1.306
Assets	-2.410	-2.811	-6.771	-1.837	-624	-3.813
Liab.	22.489	12.169	55.984	-20.476	21.502	2.507
Total*	17.707	23.768	4.530	5.418	-1.200	-4.159

Source: IMF, Balance of Payments Statistics Yearbook, Table 1 Washington, 1998.
°Direct investment, outward and into Spain. ~Portfolio assets abroad and liabilities to foreigners. *Includes an adjustment for other investment assets.

Finally, a breakdown of GDP by type of expenditure[398] shows the impact of the budget on the economy, and priorities for growth and stability. During the recession between 1991 and 1994, GDP remained the same, but government spending on consumption (i.e. income support) took up a larger portion of the economy. This was partly at the cost of private consumption (taxes cut into private spending), but even more so at the cost of

[397] See EMI, *Convergence Report*, Table 8. Frankfurt, 1998.

[398] See appendix, Table 4.13.

investment (measured below as gross fixed capital formation). The strong dip in 1993 and 1994 reflects government cutbacks in investment in the national budget. In 1995, with the economic recovery beginning, all of these values increased. Increased investment reflects the flow of EU structural funds. Overall, consumption remained more important in 1995 than it had been in 1991.

Overall, performance and characteristics show that Spain had a hard fight to achieve the criteria for monetary union. Lower productivity and high unemployment, coupled with an economic structure vulnerable to economic downturns, particularly in the EU, worked against consolidating prices and public finances along the lines set down in the Maastricht Treaty. As a result, government was only able to meet the criteria after inflicting serious hardship on the labor force,[399] and even then, only with the good fortune of an economic recovery both at home, and in its new export markets in the EU.

4.2 Society: Economic Policy Preferences and EMU

Business Interests

Spanish employers did not demonstrate any significant preference for a strong currency that one finds in Germany or in certain sectors of the French economy. Even the business community's public commitment to low inflation did not begin crossing the barrier from simple rhetoric to a tangible business goal until about 1994. Employers then began taking advantage of the shock of massive layoffs to negotiate lower wage increases and profit-related wage packets in substantial numbers, a significant shift from the past. At the national level, the business community was represented primarily by a single organization, the Confederation of Spanish Business Associations (Confederación Española de Organizaciones Empresariales, or CEOE).

[399] Larre and Torres, pp. 184-189.

Most employers were preoccupied with the cost of doing business, particularly exporters and tourist industry providers. As a result, they focused on five related economic issues. First, employers lobbied the government to reduce its debt and tax burden by cutting social entitlements and restraining taxes. Because employers pay about 80 percent of social security premiums, they felt these costs strongly and directly. In 1992, the CEOE fought government plans to reduce the budget deficit by increasing income taxes retroactively, and offloading the cost of sick pay from the social security budget directly onto firms. The protests were unsuccessful.[400] Afterward, the CEOE demanded a long-term budget plan that kept the growth of government spending below the growth rate of the overall economy.[401]

Second, the CEOE placed great public emphasis on winning wage restraint from unions. While the Socialist Party (Partido Socialista Obrero Español, or PSOE) and People's Party (Partido Popular, or PP) governments were both committed to this goal within the tripartite negotiation process, unions were not, and employers generally were less committed during wage negotiations at the firm level than their national representatives insisted they were to the public and in social talks. Even the public sector did not attempt to introduce wage agreements below the rate of inflation in 1991.

For the first time in 1992, employers began offering unions the prospect of enhanced job protection in exchange for wage restraint.[402] The CEOE underlined that modest wage agreements would bring employers lower interest rates and preserve jobs for the Spanish workforce. The banking sector also underlined the importance of wage restraint after a devaluation to secure export gains. However, Spanish employers only first began striking wage agreements with modest increases in 1994, as the recession hit hard. In 1995, the government-proposed concept of linking wages to productivity levels found widespread application in the business community. More than a quarter of negotiated wage agreements

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[400] Vieweger, Hans-Joachim, "Spanien will das Haushaltsdefizit drastisch begrenzen," *Blick durch die Wirtschaft*, August 4, 1992.

[401] "Finanzplanung Solchagas löst Hagel der Kritik aus," *Handelsblatt*, October 9, 1992.

[402] "Malas pagas," *Negocios*, September 20, 1992.

were based on this formula in early 1995, demonstrating a quick willingness among employers to commit to this model.[403] This method was never discussed seriously in the public sector, however.

Third, employers pushed the government vigorously to reduce the cost of laying off workers. In practice, this meant overhauling the worker-friendly appeal procedure which determined whether layoffs were justified or not. While Spanish labor law levies only modest penalties against employers for laying off workers when this is "justified," it levies very large penalties in all other cases, and labor courts are pre-disposed toward finding in favor of the complaining employee. This was a sore point among employers throughout the 1990s. No government attacked it directly, despite persistent lobbying.[404]

The main benefit that employers enjoyed was the lack of penalties imposed for not renewing temporary work contracts. As temporary contracts made up about a third of the workforce during the 1990s, employers could adjust their labor costs downward during the recession more cheaply than would have otherwise been possible, by not requiring government permission before letting employees go.[405] Layoffs began to increase toward the end of 1991, as the Spanish economy suffered under high interest rates in the EMS Exchange Rate Mechanism. Layoffs reached their peak in 1993, and were concentrated principally among Spaniards working under temporary contracts.

Layoff rules moved marginally toward employer proposals for the first time in 1994. In that year, the Gonzales government passed legislation allowing small and medium sized enterprises (those with less than 500 employees) to lay off workers without prior permission from the labor department. This did less to reduce the tendency of layoffs than to reduce the cost (since it enhanced the legitimacy of layoffs induced by restructuring and reduced the likelihood of an employer having to pay penalties for 'unfair firing.') and to increase the

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[403] Ruiz, José, "Uno de cada cuatros pactos liga el salario a la productividad," *Negocios*, September 24, 1995.

[404] See, for example, Belén Cebrián, "La lenta agonía del empleo fijo," *El País*, February 26, 1995.

[405] Potthoff, Christian, "Harmlose Volksfest," *Wirtschaftswoche*, January 21, 1994.

efficiency of the process (by reducing the paperwork and waiting time). It also applied to about 98 percent of Spanish businesses in the private sector, since large enterprises are rare. Incidentally, this change reduced the government's regulatory workload at a time when the demand to reduce payrolls created a great deal of work, and cost for the government.

The absence of continual controls did not mean an end to the penalties on employers, and in particular, did not mean an end to the uncertainty of penalties that labor courts would levy on employers for layoffs. As a result, the CEOE continued to complain loudly throughout 1996 that the PSOE government was failing to introduce labor market reforms in an election year when they were desperately needed.[406] During negotiations with the successor PP government, the CEOE pushed hard for the government to support its calls for dropping layoff costs to meet the EU average. This demand was not met, and the government pushed the CEOE to focus on wage agreements instead.[407]

Fourth, employers pressed the government consistently to introduce lower interest rates, particularly up through 1993, when the Gonzales administration kept them high to control inflation and protect the exchange rate. They were willing to accept a drop in the value of the Spanish currency in exchange for cheaper lending, and in exchange for the increase in domestic demand that the interest rate drop would introduce.[408]

Finally, the appeal for a lower exchange rate to promote export-oriented growth was a fairly common call from the Spanish business community. In 1993, the CEOE expressed dissatisfaction with the three devaluations of the peseta within the EMS that had taken place since the currency crisis of 1992. Instead, they demanded full withdrawal from the exchange rate mechanism to allow a further devaluation and a significant drop in interest rates.[409] In addition, they challenged the mandate of PSOE minority government to change the country's

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[406] "Solbes asegura que el PSOE no hará una nueva reforma laboral." *El País*, February 11, 1996.

[407] "Arenas dice a CiU que hay un pacto para no plantear medidas laborales." *El País*, July 7, 1996; "Spanischer Beschäftigungspakt rückt in Griffnähe." *Neue Zürcher Zeitung*, March 6, 1997.

[408] Jurado, Enrique, "Buenas compañías." *Negocios*, June 13, 1993.

[409] "Madrid legt ein Programm gegen die Arbeitslosigkeit auf." *Handelsblatt*, February 26, 1993.

economic structure through EMS membership. Together with the business community's hostility to high interest rates as a means of controlling inflation, this meant that Spanish business neither supported nor contributed to the work necessary for Spain to enter EMU. Even as Spanish business began paying more attention to inflation after 1994, it remained conspicuously reluctant to support EMU membership as a positive goal.

Overall, the Spanish business community followed the government's lead on economic policy much more frequently than government has taken directions from the business community. Monetary policy, exchange rate policy and interest rate policy were all designed to force business to pay more attention to productivity and price inflation, not to neglect them. In fact, the Gonzales government had already followed this strategy in entering the EMS in 1989, to the disappointment of exporters. They and unions had favored a currency devaluation to compensate for the higher costs of increases to the nation's unemployment insurance and pension programs, while the government enjoyed public support for their program.

The PSOE government not only led the Spanish business community during the study period, it actively pursued 'industrial reconversion' to alter the structural makeup of the Spanish economy. In effect, the government's openness to trade and investment with the EU, combined with its determination to use monetary policy to make life difficult for firms that could not or would not improve their competitiveness, created an environment in which only companies able to operate in a low-inflation environment could thrive. In this sense, the PSOE made progress in ensuring that a greater proportion of the Spanish business community was able to live with the consequences of membership in monetary union after 1994.

The peseta's difficulties in 1995 partly reflect lingering doubts among investors about the Spanish business community's long-term commitment to improving their competitiveness, and being able to live with EMU membership, given ongoing inflation. More important, while the Spanish economy is moving toward a more developed and competitive structure, it remains far behind the European average in terms of investment in high value-added products.[410]

Overall, the business community favored measures to promote economic growth above price stability until late 1994. This undermined investor confidence in the government's ability to bring inflation under control, and led to the exchange rate crises of 1992, 1993 and 1995.

Labor Interests

Labor is represented by two main union confederations, the General Workers' Union (Unión General de Trabajadores, or UGT) and the Workers' Commission (Comisiones Obreras, or CCOO). The UGT stood closest to the PSOE, while the CCOO stood closest to the Communist Party and the larger left political coalition, the United Left (Izquierda Unida, or IU). While the UGT has shown marginally more willingness to discuss the terms of reforming some labor market practices, both unions offered systematic resistance to the government's program of introducing flexibility into the labor market, reducing inflation and restricting social spending measures in preparation for membership in the European Central Bank. As with the business community, unions had a much stronger impact on monetary policy through their behavior in setting wage agreements, rather than through lobbying the government on economic policy. As with the business community, there was a discrepancy between the preferences of voters and government on the one hand, and union interests on the other.

Both of the unions demonstrated four main priorities in economic policy. The unions worked most intensively at stabilizing and increasing real wages for their members. Wage demands showed an overwhelming concern with gains or losses relative to the national inflation rate. In the private sector, this position produced strong wage growth that only began moderating after a severe deterioration in the labor market in 1993, when businesses

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[410] Fuentes Quintana, Enrique. *El Modelo de Economía Abierta y el Modelo Castizo en el Desarollo Económico de la España de los Años 90.* Zaragoza: Prensas Universitarias de Zaragoza, 1995, pp. 156-174.

became less willing to accommodate higher wages. Both the UGT and the CCOO extended their demand for real wage increases into broader expectations for a consumption-led economic recovery, higher employment levels and an accommodating, i.e. less restrictive monetary policy and a flexible exchange rate.[411] In the public sector, the government's attempts to impose wage freezes year after year[412] led the unions to articulate the real wage agenda strongly and publicly.

The importance to unions of securing real wage increases was important enough to undermine support for government efforts to reduce youth unemployment as a measure that could undermine wage demands or even lead to lower wages in the workplace. In particular, they opposed government policies which subsidized or otherwise reduced the cost of labor and social security premiums for employers training and hiring Spanish youth and first time job seekers, and in January of 1994, carried out general strikes in protest. They also opposed new measures to lower the cost of laying off employees with fixed contracts and the normalization of part time work as an attack on their capacity to force a liberal monetary policy. The changes allowed firms to layoff workers without explicit government permission, and without negotiating with unions and the governments for up to two months in advance.[413] In the course of the next year, over a million Spaniards signed apprenticeship and trainee contracts, or gained part time work under the new rules, demonstrating the public's preference for the government's approach.[414]

Massive increases in unemployment led the UGT to abandon its wage and monetary policy tentatively in 1993 to save jobs. More contracts provided for lower wage rates, though with re-insurance clauses that nullified the wage agreement if inflation were to exceed

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[411] "Haushaltsplan 1993" *España 92*. October, 1992.

[412] For example, Peter Bruce, "Gonzales attempts to force the pace on pay policy," *Financial Times*, September 2, 1993, and David White, "Spain slashes spending by $6 bn," *Financial Times*, September 28, 1996.

[413] Poffhoff, Christian, "Harmlose Volksfest," *Wirtschaftswoche*, January 21, 1994.

[414] "Arbeitsmarktreform in Spanien senkt die Erwerbslosigkeit," *Blick durch die Wirtschaft*, January 24, 1995.

government predictions. By 1995, the union adopted a productivity-related model of wage increases in line with government economic reform policies, provided that businesses would invest the money to ensure that productivity had a real chance of increasing.[415] Here, the government won a significant victory, giving its restrictive monetary policy a prospect of success.

The CCOO, on the other hand, emphasized that restraint was temporary, not conditional, after the massive layoffs of 1993.[416] This position extended to an attack on profit-sharing wage agreements, which became more popular during the recession. The CCOO also opposed wage increases related to productivity and profit-sharing wage structures, in which workers could not receive guaranteed wage hikes, as an assault on wages (even the nominal rate could drop) and on the buying power of salaries (raises below the rate of inflation).[417] Both unions remained united on real increases for the minimum wage, citing the need to securely protect these workers against inflation.[418]

A series of public sector wage freezes guaranteed union discontent throughout the early and mid-1990s, culminating in the third one-day general strike in December 1996. In each case, turnout was high (up to two million in 1992), but peaceful and designed first and foremost as a show of political support for their demands. The events were organized with enough warning and media attention to act as a gauge of support that could be subsequently reflected in both legislation and in tripartite talks on wage agreements. There was never any intention to extend the strikes beyond a single day, and unlike France, transportation workers chose to strike on separate days each time, rather than shutting the country down entirely.

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[415] Ruiz, José, "Uno de cada cuatro pactos liga el salario a la productividad," *Negocios*, September 24, 1995.

[416] Parra, Carmen, "La subida salarial media es inferior a la inflación prevista, por primera vez desde 1979," *El País*, July 3, 1994.

[417] "CCOO rechaza la propuesta de CiU para que un 30% de los salarios se vincule a los beneficios de las empresas," *El País*, August 18, 1996; "CCOO pedirá en los convenios una subida salarial 'mínima' del 3.6%," *El País*, February 25, 1996.

[418] Parra, Carmen, "Los syndicatos piden una subida del salario mínimo del 7.1% y el Gobierno sugiere el 2.6%," *El País*, December 22, 1996.

Second, the unions fundamentally opposed the government's attempts to reduce the importance of lifetime work contracts in the Spanish labor market. For union members, they constitute an important protection against unemployment in a country with an extremely high unemployment rate. For the unemployed, they can be an obstacle to restructuring leading to new jobs. For the government, they can be a source of inflationary wage demands, since unions tend not to fear unemployment when demanding wage increases. The unions lobbied the government heavily to keep the cost of terminating a lifetime contract as high as possible. They also approved of measures to lower the cost to employers of signing new workers on to lifetime contracts.[419] The unions declared government intentions in 1992 to reduce the penalties for laying off workers to be a 'casus belli' and were a principal reason, in conjunction with the cuts to unemployment insurance, for carrying out the one day general strike in November of that year.[420] In January 1994, the newly relaxed layoff rules constituted one of the major reasons for a one day general strike. Meanwhile, the UGT and the CCOO announced later the same year that they would boycott tripartite talks whenever labor market deregulation came on to the agenda.[421] The unions were partially successful in keeping layoff protection intact.

Third, the unions lobbied vigorously for increased spending on social programs, particularly for those who had not benefited directly from the economic boom that followed entry into the European Community. In 1989, the unions won increases in pensions and unemployment insurance that significantly expanded budget layouts during the 1990s. Afterward, they worked hard to preserve benefits in the face of government austerity measures, and to expand entitlement to unemployment insurance where possible. In 1992, the unions carried out a one day general strike to protest the Gonzales government's decision to cut unemployment insurance benefits, just as unemployment was beginning to rise

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[419] "Spaniens Probleme mit der Beschäftigung," *Neue Zürcher Zeitung*, February 16, 1994.

[420] "Fuertas críticas sindicales a Gonzales por respaidar a Economía en agilizar despidos," *El País*, November 8, 1992.

[421] "Candido Méndez advierte al Govierno que no habrá diálogo social si desregula más el mercado laboral," *El País*, September 4, 1994.

strongly.[422] They also struck to protest cuts to health care set out in the budget.[423]

Finally, the unions both urged the government to take more direct action to create and protect jobs, particularly as the economy began slowing in 1991. The CCOO argued that employers were laying off far more workers in response to fears of a recession than was necessary. In conjunction with the UGT, the CCOO criticized the government's lack of a national industrial policy to promote growth and employment, particularly in industrial manufacturing. While industrial manufacturing was hit hard during the recession, it was not hit as hard as agriculture in 1991, but neither union was prepared to take up the cause.[424] In 1993, demands for a looser, growth-oriented macroeconomic policy were also raised to the forefront. This call for lower interest rates, more public spending and a looser money supply demonstrated a growth-oriented philosophy with which employers agreed.[425] They wanted a currency devaluation that would aid exports, and union proposals for demand stimulus would have proven compatible.

In the campaign to push the government to create good-paying jobs in growth industries, unions turned frequently to the argument that the government's lack of action was allowing Spain to slip farther and farther away from its aspiration to be one of Europe's most developed and prosperous countries. As the recession after 1991 took an increasingly high toll in unemployment, the UGT appealed to young Spaniards looking to enter the labor market for the first time by arguing that the government was needlessly creating a labor market with poor prospects.[426]

Both the UGT and the CCOO saw Spain's EMU policy as a secondary consideration in light of the direct challenges to labor market policy, wage policy, and the general

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[422] "Madrid plant ergeiziges Konvergenzprogramm," *Handelsblatt*, April 2, 1992; "Der Generalstreik soll Gonzales auf den sozialistischen Pfad zurückführen," *Handelsblatt*, May 27, 1992.

[423] "Sparkurs beendet spanische Fiesta," *Tageszeitung*, May 6, 1992.

[424] Jurado, Enrique. "Como el congrejo," *Negocios*, March 8, 1992.

[425] Jurado, Enrique. "El paro que aprieta," *Negocios*, February 21, 1993.

[426] "UGT detecta un fuerte aumento de la precariedad en el mercado de trabajo," *El País*, August 16, 1992.

orientation of macroeconomic policy. On the other hand, they had a tremendous impact on the viability of the government's ability to commit to a stability-oriented EMU, through inflation, budget performance, and consequently exchange rate performance leading up to EMU. Direct grappling with EMU came only in 1996, when the Aznar government's savings plans, turned out to be more serious than the socialist government's had been. Therefore, it took concerted and more aggressive government pressure on the basic interests of unions, and the government's insistence that there was a linkage between EMU and the new aggressiveness, for unions to deal directly with the requirements of EMU membership.

Overall, the impact of unions on government policy was indirect and less impressive than their impact on Spain's economic performance. Unions had as little an impact on the government's preferences in budgetary, monetary, or exchange rate policy. They were able to slow the pace of restructuring the economy by refusing to accept rules that weakened the importance of permanent employment contracts.

The Spanish case underlines the finding that organized opposition makes it difficult for governments to reduce the inflation rate (by creating portions of the economy who successfully defend their insensitivity to contracting or slowing economy) or budget deficits (when spending cuts are opposed or when countervailing economic contraction to lower the inflation rate generates unemployment and revenue shortfalls for the state).

Unions would have been unable to achieve inflationary wage agreements without the complicity of business. This is confirmed by the fact that wage restraint first came about when businesses committed themselves as well in 1994. As inflation came down, so did the problems that the government experienced with the budget deficit. Therefore, the structure of the Spanish business sector played an equally important role in shaping the impact of unions on Spain's ability to meet the membership criteria for EMU.

Voters

Voter pressure on political parties with respect to EMU remained indirect during both the Gonzales and Aznar administrations. They strongly supported the central bank and the single currency, and agreed with the Gonzales and Aznar governments in opposing a two-speed monetary union that would leave Spain outside the euro zone,[427] but were relatively uninformed about the costs of membership, which made budget retrenchment difficult in preparation for the launch of EMU[428] (see sections 4.3 and 4.4).

Table 4.7 European Central Bank: Support / Opposition, Spain

1991	1992	1993
56 / 16	62 / 17	66 / 13

Source: Eurostat. *Eurobarometer*. Surveys 36, 38, 40.

Table 4.8 Single European Currency: Support / Opposition, Spain

1991	1992	1993	1994	1995	1996
58 / 18	60 / 21	60 / 20		59 / 18	63 / 21

Source: Eurostat. *Eurobarometer*. Surveys 36, 38, 40, 42, 44, 46.

In spring 1998, 72 percent of Spaniards surveyed by Eurostat expressed support for the currency, an 11 percent increase in support from 1997.[429]

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[427] 54 percent of a representative survey preferred a single-speed Europe that would include Spain, as opposed to 22 percent who supported a multi-speed model. See *Eurobarometer*. European Commission, Brussels, Survey 44, 1995.

[428] Survey 44 of the *Eurobarometer* reports that 85 percent of Spaniards considered themselves poorly informed about EMU in 1995. European Commission, Brussels.

[429] Eurostat, *Eurobarometer* Survey 49, questions 44-60. Brussels, 1998.

4.3 Institutions, Inflation Rates and Budget Positions

Spending Commitments and Budget Adjustment

Spanish social entitlements provide less generous benefits than similar provisions elsewhere in Europe. Public pressure for greater access ensured that coverage approached EU norms, however. In the general strike of 1989, unions successfully pressured the Gonzales government to enrich pension and unemployment insurance programs, both of which had provided poorly for those on the periphery of the labor market, i.e. those without stable, lasting employment. In the election campaign that followed, voters supported the PSOE's plan to extend access to unemployment insurance and pension coverage along union demands, and to reject the opposition's plan to cut spending in order to lower taxes. The PSOE won a solid majority, and as it broadened access to social insurance, it broke with the tradition of granting pensions to premium payers only, by introducing general old age security pensions for the first time.

Health, pension and unemployment insurance decisions are met by government after discussion with both business and union representatives.[430] This form of consultation is considered a centerpiece of Spanish social policy making. It was developed to preserve social peace in the transition to democracy and has become a useful tool for governments as they continue to liberalize the Spanish economy, and seek a new balance for social entitlements. During the 1990s, however, tense relations between government, unions and employers left the government to make decisions alone.

As the table below illustrates, social security transfers from general government revenues were considerable and growing strongly up to 1994.

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[430] Lessenich, Stefan, *Wohlfahrtsstaat, Arbeitsmarkt und Sozialpolitik in Spanien*. Opladen: Leske & Budrich, 1995, p.147.

Table 4.9 Social Security Receipts from General Government Transfers, Spain*

1991	1992	1993	1994	1995
2.633.1	3.009.5	3.677.7	3.893.4	4.070

Source. OECD *National Accounts*. Vol. II. Table 6.4. Paris. 1998.
* Billion Pesetas

Pension Insurance

The Spanish public pension system was significantly overhauled in 1990 to extend the entitlement to retirement benefits and increase their value. Consequently. spending on pension entitlements constituted the single largest social expenditure of the national government.

As in France and Germany. the core of the pension system is a retirement benefit paid for in large part by premiums. The general budget covers just over 25 percent of the contributions. to which employees pay 20 percent and employers about 55 percent. Until 1990. it also resembled the French and German systems by allowing employees with stable work histories to accumulate much better benefits than the large percentage of the population with erratic employment.[431] For the former. benefits represent a relatively high percentage of income by European standards. However. the portion of the population with access to these benefits was lower. due to high unemployment.

In 1995. the Gonzales government made a symbolic effort to discipline spending by changing the reference period over which pension benefits would be calculated. Instead of basing benefits on a percentage of a person's income in the 10 years preceding retirement. the law began calculating benefits based on the previous 15. This held the prospect of

[431] Stapf. Heinz. *Alterssicherung in Spanien.* Berlin: Duncker & Humboldt. 1996. pp. 54.

capturing periods of lower pay in the benefit calculation.[432] The restrictions made possible through the 15 year rule were more than compensated by the creation of pension credits in 1990 for Spaniards receiving unemployment insurance benefits, and mothers staying at home for up to one year per child.[433]

Early and partial retirement benefits were also made possible, but provisions remained less generous than in France or Germany. Partial retirement is possible at the age of 62 provided the employee has met the non-age requirements. While the employee works half time, employers are required to replace the partially retired worker with an unemployed youth (up to age 24). Early retirees gain an entitlement to fully subsidized prescription medication, which would normally be available only at 65. Employers must wait longer to see benefits. If they sign the replacement worker onto a new work contract, they are awarded a 50 percent subsidy on that employee's social insurance contributions, from 24 percent to 12 percent. Another plan allows early retirement as soon as 52, but only with full completion of non-age requirements, and only with three quarters of the usual pension.[434]

The pension system's second tier is a general old age security pension, adjusted by income, introduced in 1991. It provides benefits to residents who have made no contributions to a pension plan. This spending commitment has a significant impact on the budget, since the entitlement is paid from general revenues. Recipients must be 65, and have lived in Spain for the preceding two years, and a total of 10 years since the age of 18. The amount of the entitlement is highest when living alone, and is reduced according to income (up to 25 percent of the pension can be forfeit), or non-family members with incomes exceeding 170 percent of the basic pension entitlement. When living with children, this reduction of pension benefits fades into the background: family incomes must exceed 425 percent of the basic pension entitlement before reductions are calculated.[435] Overall, the

[432] Stapf, Heinz, *Altersicherung in Spanien*. Berlin: Duncker & Humboldt, 1996, pp 90-92.

[433] Ibid.

[434] Ibid., pp.88-89.

[435] Ibid., pp. 79-80.

OAS strikes a balance between reducing poverty and promoting the continued reliance on family on which Spaniards without pensions have traditionally depended in old age. This has a mixed effect for the level of retirement-related social spending in Spain. On the one hand, the new OAS significantly expands entitlement to pension benefits. On the other, the strong economic incentives for OAS recipients to live with relatives can serve to contain care-related costs for the elderly that many other European states need to pay for.

Overall, pension provisions are similar to those available in other EU countries since OAS pensions were introduced. The contribution-based pensions start paying benefits later than elsewhere (at age 65), but begin with a generous base entitlement (based on 10-15 years of earnings), and enjoy protection from inflation through annual benefit adjustments. The OAS pensions have an impact that comes more from the sheer numbers of entitled rather than the amount of the payment.

Three factors led to difficulties controlling payments. First, inflation kept payouts rising strongly each year. Second, the continuing low participation rate meant a larger than average demand for OAS pensions. Third, underemployment and unemployment kept premiums for contribution-related pension modest.

Unemployment Insurance

Unemployment insurance provides benefits similar to those in other EU countries. It is funded by premiums from employers and employees and general revenues, in the same proportions that apply to pension insurance contributions. Nevertheless, it is somewhat more difficult to qualify for unemployment insurance and for those who just qualify, benefits do not last as long as those in France or Germany. Those with stable employment histories enjoy benefits that compare well with those available to employees elsewhere in the EU, with a relatively high wage replacement rate. Benefits are available to those with fixed or temporary work contracts, beginning with one year of contributions (up from 6 months in 1992) and four months of benefits, ranging up to two years.

Unemployment insurance in Spain provides benefits to laid off workers who have contributed premiums for a full year or longer. Benefits for periods up to two years are available both to workers on indefinite work contracts and on limited contracts. The increasing incidence of temporary work contracts in the Spanish labor market as a percentage of total population resulted in a far larger portion of the workforce (about a third) qualifying for and using unemployment insurance in the 1990s. Unlike workers with indefinite contracts, employment can be terminated at the end of a contract without large financial penalties. By late 1991, the end of a three-year economic boom led to an increase in the number of freshly unemployed, and to a larger burden for the nation's unemployment insurance fund.[436]

One change was made to the qualification criteria for unemployment insurance during the study period. In May of 1992, the government attempted to restrict access to unemployment insurance by raising the qualification period for benefits. Instead of qualifying after six months of contributions, employees would first qualify for benefits after a full year. This measure excluded much of the labor force in seasonal industries, such as tourism and construction.[437] In this measure, the government not only worked against a portion of the unemployed, but also against the country's main unions, which called a half-day general strike later that month to protest the more restrictive rules.[438]

However, the core of the labor force and a good portion of the periphery remained protected from the new rules. About two-thirds of those laid off from temporary contracts qualified for unemployment insurance under the new rules, up from only 40 percent in the late 1980s.[439] This was made possible by the government's decision a year beforehand to increase the minimum period of a work contract in the past from six months to a full year.[440]

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[436] Jurado, Enrique, "Cuestion de tiempo," *Negocios*, January 26, 1992.

[437] Mauersberger, Volker, "Der rücksichtslose Streber," *Die Zeit*, May 22, 1992.

[438] Bruce, Peter, "Gonzales steps into strike row," *Financial Times*, May 13, 1992.

[439] "Die Arbeitslosenzahlen steigen in Madrid stark," *Frankfurter Allgemeine Zeitung*, February 18, 1993.

[440] "UGT detecta un fuerte aumento de la precariedad en el mercado de trabajo," *El País*, August 16, 1992.

One year later, those who were working on temporary contracts either had work or qualified for unemployment insurance once the contract was over. As a result, the total number of eligible and the payouts rose during the following economic recession.[441] Protection also appears to be the result of pressure from within the party caucus, which refused to accept real cuts to the unemployment insurance program.[442] This amounted to a rejection of Solchaga's attempt to package cuts as a convergence program for meeting the criteria for EMU membership.[443]

By late 1993, the PSOE government responded to the increased payouts with a combination of benefit cuts and an anti-fraud program. The maximum UI benefit rate was reduced from 80 percent of wages to 70 percent. The minimum benefit was reduced from 100 percent of the minimum wage to 75 percent.[444]

Until the launch of EMU, savings measures in the unemployment insurance fund were limited to anti-fraud measures. These responded to the increasing tendency from 1993 onward for employers to lay off salaried workers officially, but keep them employed on the black market.[445] Otherwise, the commitment to no further cuts in unemployment insurance benefits held firm as the private sector began shedding a large percentage of its workforce in 1993, and as the government loosened layoff regulations even further in 1994.

It may seem odd for the government to have facilitated the accelerating pace of layoffs in 1994, but the new ruling effectively redistributed the recession's negative impact so that not only employees with temporary contracts in growing economic sectors lost their jobs. Employees with indefinite contracts in uncompetitive industries would be phased out as well. This move not only promoted the economic restructuring that the PSOE desired: it also helped to put pressure on wage demands from employees with indefinite contracts and

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[441] Jurado, Enrique, "Más difícil todavía," *Negocios*, September 12, 1993.

[442] Bruce, Peter, " Gonzales gives ground under party fire," *Financial Times*, April 24, 1992.

[443] "Reform des Arbeitmarktes in Spanien," *Neue Zürcher Zeitung*, March 31, 1992.

[444] Herzog, Werner, "Mit Familie und List überleben," *Frankfurter Rundschau*, October 29, 1993.

[445] Ibid.

contribute to the government's anti-inflation campaign (see section 4.4). By the time the economy began to recover in 1995, temporary contracts had claimed an even larger share of the Spanish labor market.[446]

From late 1993 onward, the principle means of reducing the impact of unemployment insurance benefits on the budget was to get the unemployed into apprenticeships and similar training contracts. These arrangements lasted from six months to three years. As an incentive, the government granted relief from social security contributions. It also offered one time cash payments to employers that took trainees on as permanent employees. The problem for the government and the UI fund, however, was that hiring did not become apparent until the end of 1994. When it did, however, new industries in commercial, financial and communication services were picking up where industry had left off in 1993.[447] By 1996, much of the recession's damage had been undone. Unemployment remained high by European standards, however.

In sum, the unemployment insurance fund emphasizes social welfare and access to benefits more than it stresses restraint. As payouts increased and premiums dropped during the mid-1990s, state contributions grew more strongly.

Health Insurance

Health insurance is provided by a state agency known as INSALUD, and health services managed by the National Health Service (*Servicio Nacional de Salud*, or SNS) in conjunction with autonomous regional governments. It provides both stationary and out-patient care to Spanish residents and pays 60 percent of prescription drug costs for almost the entire population. Retirees are entitled to 100 percent of the cost for medicine. It is financed

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[446] By May 1995, temporary contracts accounted for 34.7 percent of total jobs, up from about 32 percent before the recession. See Carmen Alcaide, "Dualidad del mercado laboral," *Negocios*, May 21, 1995.

[447] Jurado, Enrique, "Remedio a cuentagotas," *Negocios*, November 27, 1994; for an overview of the methods implemented through 1994, see "El nuevo mercado laboral," *El País*, February 26, 1995.

primarily through the national government's general revenues, and constitutes its second largest social spending commitment.[448] Additional revenues are brought in by a payroll tax which covers the cost of health care for work-related injuries and illness.

Near-universal health care has proven such a popular public policy that cutbacks to the public health sector in the run-up to EMU's launch focused on streamlining administration rather than restricting treatment or capacity. This made sense, given that the socialist government had only achieved universal coverage by the end of the 1980s. Within the context of the government's overall savings policies, efficiency and bureaucracy costs were about all the Gonzales government and opposition could criticize. In 1992, the government underlined its resistance to restricting health spending when it canceled half of INSALUD's accumulated debt, rather than demand that the fund overhaul its priorities.[449]

When the time came to trim health spending in 1993, the government focused on streamlining the SNS, giving it less money, and giving more responsibilities to the regional governments for administering health budgets. By 1994, the SNS was operating more and more as a coordinator for the various regions, and helping them cope with the system's new emphasis on reforming care for the elderly and chronic patients.[450]

In the same year, the health system won a case brought before the constitutional court by employers seeking to stop paying premiums for work related industries.[451] This helped to reassure the financial stability of health spending for the government.

In another court case, however, INSALUD was given a clear message that it would cause itself more grief than relief if it streamlined services so markedly that they became

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[448] For an overview, see Jesus Maria de Miguel, "Estructura del Sector Sanitario," in Miguel Juárez, ed., *Informe Sociologico Sobre la Situacion Social en España*. Madrid: Fundación Foessa, 1994, pp. 837-860.

[449] Rodríguez Cabrero, Gregorio, "La Politica Social en España: 1980-92," in Miguel Juárez, ed., *Informe Sociologico sobre la Situacion Social en España*. Madrid: Fundación Foessa, 1994, pp. 1455, 1476-1477.

[450] De Miguel, Jesus Maria, "Estructura del Sector Sanitario," in Miguel Juárez, 1994, pp. 837-60.

[451] *El País*, May 15, 1994.

inadequate. In a 1995 case, the courts forced the health insurance board to pay for the hospital costs of an emergency victim who was treated at a private facility after being refused treatment at two public hospitals.[452]

Overall, health insurance provided firm entitlements, with little emphasis on cutbacks. Spending overhauls that touched health spending took place as a result of across-the-board cuts rather than targeted program reforms (see section 4.4).

Banco de España

The PSOE government passed legislation granting independence to the Banco de España in June, 1994. Full independence took force on January 1, 1995, supported by both the government, the main opposition party, and both the Basque and Catalan parties. Unlike in France, the motive to establish independence was rooted entirely in meeting the commitment laid out in the Maastricht Treaty, and in keeping the Spanish candidacy alive for membership in the ECB. The Gonzales government referred consistently to the legislation as the European Bank of Spain law, as a means of linking support for independence to support for the benefits of European integration as a whole.

Despite broad support among the political parties for introducing central bank independence within the wider context of integration, two factors delayed independence for the Banco de España. First, a series of political scandals undermined confidence in the central bank's leadership and in the economics minister. Second, the economic and social price of battling inflation had eroded the PSOE's electoral position to such an extent by 1993 that it dared not promote a discussion on independence until after the upcoming election. The PP's campaign accused the Gonzales government of trying to fight inflation too quickly and without consideration for the economic and social consequences for ordinary people. Indeed, it questioned the government's strategy of enacting domestic reforms and securing EMU membership in the first wave. The bank's independence was part of this restructuring

[452] De la Cuadra, Bonifacio, "El Insalud deberá pagar medio millón por una operación hecha por la privado," *Domingo*, February 26, 1995.

process, and delaying its introduction could prevent undecided voters from switching to the opposition. Independence legislation was possible in 1994 only in the context of an economic upswing, and the fact that it was a mandatory requirement for EMU membership. The Gonzales government justified independence almost solely on this reason, tapping the popular connection between EMU membership and economic development.

Structural Reform

Until independence, the law of June 21, 1980 set out the Bank of Spain's responsibilities regarding monetary and exchange rate policy. The bank executed monetary policy and exchange rate policy, while the Spanish government retained the authority to set the objectives.[453] Until 1993, the country's high rate of inflation corresponded to the government's tolerant attitude toward price increases, particularly before the Maastricht Treaty made monetary union a certainty, and in spite of the central bank's suggestions that inflation should be fought more seriously.

In addition to its legal responsibility to set monetary policy goals, the government dominated the bank's key decision making organs. It effectively appointed the Governor, the Vice Governor, and six additional members of the 15-member General Council, to ensure a majority influence over the bank's key policy decisions. The Governor was entitled in turn to choose four council members, and the bank's staff had one representative on the council. In addition, two ministerial representatives - the Directors General of the Finance and Treasury Ministries, represented government interests directly. The Executive Council, which made more detailed decisions on executing monetary and currency policy on instructions from the General Council, consisted of the Governor and Vice Governor, and three members voted from the General Council.[454]

Government ensured its control over the bank's staff through a short term of office

[453] For a review of the relationship between government and the central bank, see Marietta Kurt, "Freiheit besteht nur bei der Wahl der Geldpolitischen Instrumente," *Handelsblatt*, February 6, 1990.

[454] Ibid.

(four years for governors and three for council members). and the a right to recall appointees. Effective control over much of the bank's leading personnel ensured that the choice of monetary policy instruments reflected political goals.[455]

The law also required the Banco de España to finance government debts with interest free credits. without any hard limit. The government could demand and receive credits corresponding to 12 percent of its expenditures on administration and public enterprises before seeking permission from parliament (in which it is represented) for additional credits. At this stage. the government could request additional funds to pay for short-term job creation in public enterprises. In addition to providing these credits. the Bank. not the government. held responsibility no limit was placed on the bank's responsibility for Treasury bonds. meaning that the Bank could not.[456] The government made use of this through 1994. despite the bank's opposition. hurting it's ability to control inflation through the money supply.

Plans for central bank independence reflected the government's desire to instill confidence and credibility in its commitment to economic reforms and price stability as early as possible. In practice. the timetable for reforms reflected the political explosiveness of central bank independence and a commitment to price stability in Spain. The government announced plans to grant independence to the Banco de España shortly after the Maastricht Treaty had been negotiated in 1992. The fact that the legislation had already been drafted and approved by cabinet before the end of the year. and before the Maastricht Treaty was signed in March 1993.[457] underlines the importance of the project to the government. It also underlines the government's intention to try to sell the project to Spaniards as part and parcel of the larger Maastricht agreement. The government intended to pass the legislation in conjunction with legislation to ratify the Maastricht Treaty. shortly before national elections

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[455] Ibid.

[456] Ibid.

[457] Burns. Tom. "Spain to establish central bank autonomy." *Financial Times*. December 30. 1992.

in 1993.[458] This plan would have allowed the government to bundle central bank independence, which was not popular, with a series of new financial transfers from the European Union embedded in the Maastricht Treaty.

By the end of 1992, the Gonzales government announced that the Banco de España would be modeled on the Bundesbank.[459] It would have the authority to define monetary policy within the framework of the government's economic policy, and have an explicit mission to ensure price stability. The reforms would also underpin the commitment to stable prices by forbidding the bank for the first time from subsidizing the government's deficits in the future.

A series of corruption scandals delayed passage of the legislation to reform the Banco de España. They raised the question of who would retain their positions in the new bank, and by the worsening economic situation over the course of 1993. Independence itself proved to be uncontroversial among the major parties through the spring of 1993. During preliminary readings, both the PP and the PSOE supported the bill establishing independence. The regional parties, the Basque Nationalist Party (Partido Nacionalista Vasco, or PNV) and the Catalan nationalist party (Convergencia i Union, or CiU), supported greater independence and the mission of price stability for the Banco de España, but were fighting for more parliamentary accountability for the bank. Only the IU and the soon-to-be-extinct CDS opposed independence for the central bank. Not only was there no need to tie the government's hands, both maintained that it was particularly heartless of the government to introduce such a measure during such a severe recession.[460]

The credibility of the government's economic strategy and its commitment to central bank independence was shown to be weak during the 1993 election, however. As the economic situation worsened over the first half of the year, Gonzales withdrew the law on

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[458] "Die spanische Zentralbank ist ab 1994 so unabhängig wie die Bundesbank," *Handelsblatt*, March 31, 1993.

[459] Burns, Tom, "Spain to establish central bank autonomy," *Financial Times*, December 30, 1992.

[460] "Die spanische Zentralbank ist ab 1994 so unabhängig wie die Bundesbank," *Handelsblatt*, March 31, 1993.

independence for the Banco de España from parliament and called an early election. The political uncertainty generated by high discontent with the government's policy of economic restructuring, combined with the increasing success of the PP's calls for a more humane alternative, and the subsequent withdrawal of the central bank reform bill, contributed to increased pressure on the peseta, forcing a third devaluation three weeks before the election.[461] The beating that the PSOE had taken in the election at the hands of the PP, and the strategic position of the regional parties across from the PSOE's minority government, raised doubts that true independence could be agreed to.

Several key persons who were expected to lead the new central bank, or who were responsible for navigating the enabling legislation through parliament, were tainted by a series of insider trading scandals that stretched from 1992 through 1994. This problem diminished the credibility and political capital of those involved, and made it difficult for the government to rally support for changes to the bank. In 1992, Mariano Rubio, the Governor of the Banco de España, was implicated along with several other bank employees in an investigation over the sale of shares in a company called Iberocorp, shortly before their value plummeted.[462] The government replaced Rubio with Luis Angel Rojo in July of that year. Rojo was a long-time insider at the Banco de España, a respected economist, and a believer in the both the bank's independence and the government's goal of economic reform.[463] Policy continuity was thereby assured, despite a widening of the scandal through 1996 that implicated Rojo and forced the economics minister, Solchaga, to resign.[464] Rojo, however, was not only able to retain his position, he served as the first President of the newly independent Banco de España in 1995, with a term of office extending to the year 2000.[465]

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461 Bruce, Peter, "A double-edged sword," *Financial Times*, June 23, 1993.

462 See *The Economist*, March 29, 1992.

463 See "Luis Angel Rojo," *Domingo*, July 5, 1992, "Regierung nominiert Rojo als neuen Notenbankchef," *Handelsblatt*, July 2, 1992, and "Luis Angel Rojo," *Domingo*, July 17, 1994.

464 Bruce, Peter, "A double-edged sword," *Financial Times*, June 23, 1993.

465 See also "Las Tribulaciones de Rojo," *El Economista*, January 18, 1995.

This would ensure that the country had a central bank committed to independence and price stability in the transition to membership in the ECB.

The weak commitment to central bank independence as a virtue in itself persisted even as the legislation was debated and passed in the Cortes. Alongside the government's timidity about establishing independence, and its own wavering commitment to fiscal restraint (see below), the need to rely primarily on the government's broader European strategy to legitimize independence for the Banco de España and its mission to provide price stability is a significant sign of an intrinsic interest in a policy change. It also points to a fragile commitment to compatible societal and governmental practices in wage, budgetary and fiscal policy.

Economic Policy

In the 1990s, the Banco de España's first priority was reducing the national inflation rate. While it was willing to act unilaterally to contain prices, it emphasized that it could not produce lasting stability alone, and aimed to alter the attitudes of government, employers and unions toward inflation in a lasting way.

The bank attempted to cultivate a societal commitment to price stability by emphasizing the lasting gains in economic growth and employment that would likely follow, used a carrot and stick approach against all three target groups, offering lasting jobs and growth in return for lasting low inflation. Employers and unions could lay the groundwork for economic growth and rising employment by restraining wage and salary increases. In one case, the Banco de España's Governor accused unions of deliberately contributing to higher unemployment by striking repeatedly for real wage increases that subseque :tly forced massive layoffs.

Government could contribute to stability by adjusting its spending to control its budget deficit. Here, the Banco de España singled out for criticism the government's persistent tendency to commit to large spending increases during election periods.[466] Government and could also reduce the risk to employers of hiring new staff by making layoff rules more flexible. The OECD had openly recommended such a change repeatedly since 1986, without a significant impact on labor market policy. Finally, government could put pressure on prices in the service sector by introducing greater competition from abroad ahead of schedule.

The Banco de España emphasized that if private and public actors adopted these practices, Spaniards could conquer and hold on to a larger share of the European export market. If they did not adopt those practices, however, inflation would repeatedly rob the country of the markets it had entered, and scare away investors who were the key to Spain's economic development and employment future. If national actors refused to change their behavior voluntarily, the bank would only be able to impose low inflation by keeping interest rates artificially high. Though the bank never explicitly said so, it was clear that in practice, this meant destroying economic growth and jobs until employers, unions and government conformed with the bank's wishes. The Banco de España's commitment to reducing inflation is further emphasized by repeated demonstrations that controlling inflation was more important than the currency's exchange rate.

The Banco de España's capacity to put downward pressure on the country's high inflation rate became particularly difficult from 1990 onward, eroding societal confidence in the need to contribute to stable prices. Three reasons stand out. First, Iraq's invasion of Kuwait in 1990 and the subsequent Gulf War raised oil prices, putting severe pressure on the entire economy. Spain's dependence on imported oil meant that the spike in oil prices hurt demand and increased prices in most sectors.[467] This not only meant a necessary increase in domestic prices, but a strong deterioration of its export prices as well.

Second, high interest rates within the European Monetary System following German

[466] One example of spending increases was a government promise to subsidize the construction of 460,000 apartments in 1991 at a cost of 300 billion pesetas. See Rubio's speech in "Deutliche Mahnungen der spanischen Zentralbank," *Neue Zürcher Zeitung*, May 24, 1991.

[467] "Spaniens Notenbank bleibt auf Stabilitätskurs," *Börsen-Zeitung*, October 9, 1990.

reunification and high oil prices began to choke off economic activity in late 1990. Further restraint on the economy to control inflation had an even more devastating effect on national unemployment levels. This mattered less to the central bank leadership than it did to the government, and this constituted the crux of the problem. The Spanish government demonstrated only a fairweather commitment to low inflation, budget restraint and central bank independence up until 1994 (see section IV), and was unlikely to give the central bank *carte blanche* to fight inflation first, while leaving growth and employment second.

Third, the fluctuation band for the national currency in the European Monetary System limited the interest rate that the Banco de España could impose on the national economy. The peseta traded consistently at the upper limit of its band within the EMS, following the high interest rates required to control Spanish inflation and the bank was required to periodically defend the government's commitment to the exchange rate during the periodic exchange rate crises by moderating interest rates. The Bank's domestic policies were also subordinated to supporting the peseta's exchange rate by buying up pesetas on the open market.[468]

In addition to poor technical circumstances within which it tried to manage the country's inflation rate, the Banco de España faced a government and political actors that resisted restraint in price setting, and budget management and macroeconomic policy. The bank's first defeat came about between 1990 and 1991. The Banco de España announced its commitment in October 1990 to begin restricting the growth of the money supply. It justified its action in light of increased prices and wages following the oil shock late in the year.[469] Had the Banco de España continued its fight against such resilient inflationary pressures, higher interest rates would have followed, along with an even more overvalued exchange rate (requiring a revaluation within the EMS), and even higher unemployment at the beginning of a recession. By early 1991, unions, business leaders and even government saw interest rates as the country's most immediate problem, not inflation or deficits.

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[468] Bruce, Peter, "U-turn leads to cut in Madrid interest rates," *Financial Times*, March 16, 1991.

[469] "Spaniens Notenbank bleibt auf Stabilitätskurs," *Börsen-Zeitung*, October 9, 1990.

By March 1991, the worsening economy had placed enough pressure on the government to force a retreat. Over the Banco de España's objections, the government ordered interest rates back down.[470] Unlike in France or in the UK, however, interest rates remained high enough to keep the currency at the top of the exchange rate band, forcing additional interest rate adjustments over the course of the year. Both the EMS restrictions and government pressure to loosen up on the economy prompted the Banco de España to express frustration over its ability to fight inflation. Not only were current prices high, but commercial credit continued to grow more quickly than the bank considered prudent.[471]

The Bank's relative weakness against growth-oriented government goals was demonstrated in 1993, when the Banco de España warned the government of an impending devaluation on international markets shortly before national elections. It offered and delivered a politically popular cut in interest rates in an attempt to prompt the Gonzales government to restrain its spending promises during the election. The government's unwillingness to impose restraint was weak, however--it had nearly lost the national election, stood poorly in regional races and had poor prospects in the 1994 elections to the European parliament. In light of failing government discipline, the Banco de España raised rates back up in 1993, and kept them high through 1995.[472]

Despite its use of high interest rates, the bank's willingness to accept currency devaluations demonstrates that it saw the exchange rate as a second-order priority. Two devaluations in 1992 prompted by outside pressure used up a great deal of the foreign reserves that the Banco de España had accumulated since 1989, when Spain had entered the EMS. In 1993, it presented the government with the need for another devaluation shortly before national elections, and again in 1995.

The Banco de España only began intervening and taking a more open public stand

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[470] Bruce, Peter, "U-turn leads to cut in Madrid interest rates," *Financial Times*, March 16, 1991.

[471] Maliniak, Thierry, "La Banque d'Espagne baisse d'un point ses taux d'intérêt," *Le Monde*, March 18, 1991.

[472] "Die Notenbank mahnt Sparsamkeit an," *Handelsblatt*, June 24, 1994.

on the exchange rate in 1996. This time, however, it was to prevent the peseta from rising too far to quickly. In late 1995, foreign investors began responding to more aggressive pitches from Spanish politicians and businessmen, who stressed political deals on budget reduction and inflation as a strong sign that Spain was a profitable investment again. By the end of 1996, the peseta was flying so high that the Banco de España had to sell pesetas on markets to keep it from exceeding its EMS parity. The Banco de España also presided over the world's eight largest foreign exchange reserves by this time.

In contrast to the frustrating experience of fighting government and societal actors over control of economic policy during the first half of the 1990s, the Banco de España was able to combine a high exchange rate, (ensuring discipline on economic actors) lower interest rates (at a lower cost to the economy), and large foreign exchange reserves (with which to protect the exchange rate).

Shortly after the bank achieved independence in 1995, it set out to demonstrate its authority in small ways that still attracted attention. A month before the bank was to formally assume independence, central bank president Luis Rojo announced that it would target inflation at three percent for 1995. The number in itself was unremarkable, but the fact that it challenged the government's publicly stated intent to target 3.5 percent set some distance between the bank and the government.[473] Since pension and other entitlement increases were based on projected inflation, this was a powerful political message.

In late 1996, the Banco de España greeted the new Aznar government with the message that the country still had to make sweeping changes to lay the groundwork for low-inflationary growth and job creation on a lasting basis. This was designed in part to warn the PP against lacking the nerve to undertake reforms, since it had won the 1996 elections on a criticism of the PSOE's botched reform strategy (see section 4.4).

The Banco de España used interest rates demonstratively not only to pressure the PP government to introduce budget cuts in 1996, but also to present the new government with a public reward for doing so. When the PP was elected at the beginning of March, financial

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[473] "Die Notenbank betont ihre Unabhängigkeit," *Handelsblatt*, November 23, 1994.

market uncertainty over the PP's commitment to reducing the deficit and fighting inflation led to a drop in the exchange rate, and to higher interest rates from the bank. After the PP reached an agreement with the two regional parties, the CiU and the PNV to reduce the deficit, the Banco de España demonstrated its approval by reducing interest rates. As difficulties persisted into the summer over working out the details of a reduction, the bank delayed announcing changes in its leading interest rates, which raised attention in the financial community and raised pressure on the government to make some concrete decisions. Once the deal was sealed, interest rates dropped to their lowest levels since the introduction of democracy in Spain, providing the government with a high-profile political success.[474] Interest rates had long been the target of criticism among pro-growth proponents.

A year later, in the summer of 1997, the Banco de España praised the government publicly for the savings it had accomplished, without letting them forget that it expected more changes in the future. Rojo made more frequent announcements of interest rate reductions and positive assessments of the country's progress toward meeting the entrance criteria for EMU.

EMU

The Banco de España supported rules for EMU that would maximize pressure for price and budget reform from unions, employers and government. Its EMU policy focused principally on promoting it domestic economic policy agenda, as outlined above, with the added linkage of economic reforms and European integration. During the negotiation of the Maastricht Treaty, Banco de España Governor Mariano Rubio supported the creation of an independent central bank, and stressed its use in fighting inflation.

At the same time, Rubio preferred an open timetable for monetary union that would allow as broad a membership as possible without compromising the convergence criteria.

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[474] "Leitzins in Spanien kräftig gesenkt," *Frankfurter Allgemeine Zeitung*, October 4, 1996.

This would provide the time Spain needed to adopt new habits of low inflation and budgetary discipline. Consequently, he rejected early Franco-German proposals for a two-speed monetary union. Rubio's statements at the time make it clear, however, that he believed that the Spanish government not only needed time to achieve the criteria, but to accept them as well.[475]

In addition, the Banco de España appreciated that delaying monetary union could motivate future reforms by extending the prospect of exchange range crises until inflation and budget deficits were brought under control. Unlike the French and Belgian governments, which pushed for setting up a monetary union as early as 1993, the Bank of Spain was willing to accept devaluations of the peseta within the EMS as a means of drawing attention to inflation and budget deficits, allowing government the opportunity to extend reforms in its wake. Refusing to do so would set the country before a clear alternative to effectively give up exchange rate values in pursuit of greater economic growth.

Rubio's management of the peseta in the EMS demonstrates his preoccupation with using the European monetary order as much as possible to deal with national economic reforms rather than engaging in international cooperation. The bank's commitment to fighting inflation brought it into frequent conflict with France and Britain over appropriate interest rates for countries participating in the EMS' exchange rate mechanism until the devaluations of late 1992. As the *Bundesbank* ratcheted up German interest rates in 1990 to combat inflation, the Banco de España was doing precisely the same thing. The Banco de España deflected French and British criticism of its interest rate policy by pointing out that Germany, not Spain, was leading European interest rates higher.[476]

Rubio's successor, Luis Rojo, took a softer position on entrance criteria for EMU when he first took over the Bank of Spain. In early 1993, Rojo expressed doubt that Spain could support price stability on a lasting basis, and preferred a freely floating exchange rate within the European Monetary System as a means of helping the country through economic

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[475] "Spain counts cost of joining the club," *Financial Times*, June 20, 1990.

[476] "Madrid schließt Senkung der Zinsen weiterhin aus," *Handelsblatt*, April 17, 1991.

adjustment rather than EMU membership. However, he also believed that pursuing economic convergence over a shorter time period to qualify for membership in the ECB was more likely to secure low inflation and economic growth than going it alone in a floating exchange rate system. Consequently, Rojo favored 're-interpreting' EMU's convergence criteria to allow Spain to enter.[477]

By 1995, however, Rojo began pushing the government to do more to meet the criteria. Suggestions of postponing EMU, or Spain's entry in the first wave of members, or of weakening or renegotiating the criteria were nowhere to be heard. Given the Spanish government's calls at the same time in 1993 to suspend the EMS system,[478] and the bank's continuing domination by the government, it is reasonable to attribute the bank's 1993 call for renegotiating the terms of EMU as a passing submission to political pressure.

The principal difference that came with independence was that the central bank began criticizing the government more forcefully for its slow progress toward fulfilling the Maastricht criteria. In mid-1996, the newly elected conservative government gave the Bank of Spain its first and only opportunity to take a strong public stand on the terms of EMU itself. Aznar, the new Prime Minister, had suggested shortly after taking office that the European Union should delay transition to the third and final stage of EMU. The government wanted more time to meet the requirements for membership in the European Central Bank. The Banco de España condemned the proposal,[479] apparently fearing that the new government would not enact the economic reforms that the bank had promoted during the 1990s. While an economic boom could relieve the immediate necessity to cut spending formulas and restructure the economy, it would prevent the country from meeting the membership criteria for EMU on a lasting basis. This would cause hardship under the terms of the stability pact, agreed at Dublin in September 1996.

Until 1995, the Banco de España lacked the capacity to decisively restrain spending

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[477] Görtz, Rolf. "Euro-Baisse in Spanien," *Börsen-Zeitung*, February 13, 1993.

[478] "Stalwart Spain suffers sense of 'betrayal,'" *Financial Times*, August 3, 1993.

[479] "Spaniens Notenbank hält an Euro-Zeitplan fest," *Handelsblatt*, June 18, 1996.

or inflation. Both main parties ultimately granted independence in 1995, just in time to qualify for the first wave of EMU membership. The new Bank of Spain raised pressure on the Gonzales government to proceed with reforms but without immediate results. Economic growth from 1995 onward and EU transfers contributed more to deficit reduction than spending overhauls. The bank provided the framework for low inflation, which stayed low as the country came out of recession in 1995, and engaged in a new, independent public relations campaign that emphasized the benefits of economic reforms. There is good reason to believe that central bank independence will help lock in reforms of price levels and public finances.

4.4 Parties

Two parties dominated the Spanish political landscape in the 1990s: the Socialist Party (PSOE) and the renamed and reconstituted conservative party, the People's Party (PP). The United Left (IU) represented the far left vote. Two regional parties represented the Basque (PNV) and Catalan regions (CiU) respectively. Of these smaller parties, only the center-right CiU was in a position to exercise influence, and only since 1993.

Mainstream parties developed economic policies that reflected a combination of: the historical positioning of socialists and conservatives after democracy was introduced in 1978; a growing preference in the executive branch to control inflation and debt after the turn-around of Mitterrand's economic policy in 1984; and most importantly, the political requirements of a population with a large percentage dependant on an uncompetitive, poorly performing economy. The first two factors led the PSOE's parliamentary executive to pursue a combination of economic restraint and growth promotion that emphasized restructuring the economy. The third factor, however, pressured the PSOE leadership to ease the impact of economic transition by relaxing its hold on public finances, inflation and interest rates. This pressure was transmitted both through periodic elections, and through resulting pressure in the party's parliamentary caucus and larger cabinet.

The PSOE in particular was forced into a compromise between a core of economic reformers in the executive and a large cohort of voters and representatives who prevented anything resembling shock therapy for the Spanish economy. Consequently, the party developed a strategy of gradual economic adjustment (new opportunities for work through term contracts alongside stringent layoff protection), investment, and least comfortably, a compromise of economic transfers and a monetary policy that tried to introduce price stability without choking the economy.

The PSOE won a majority government from 1989 to 1993 more on the basis of massive increases in social insurance spending and a program to boost economic development, than on the economic success of Spain's first three years as a member of the European Community. The Gonzales government's periodic attempts to restrain inflation and moderate spending during that term cost the Socialists their majority in parliament between 1993 and 1996, and finally drove them out of office in the March 1996 elections, to be replaced by the PP.

In this policy environment, low budget deficits and low inflation proved to be matters of secondary importance. Inflation reduction and job-creation measures took precedence in turn over restrictions to social transfer spending, which remained politically untouchable in budget policy. In the context of the Franco-German drive to establish a European Central Bank, concrete commitments to reducing public spending and inflation were framed as part of a larger strategy to secure Spain's place in Europe and setting aside the obstacles to future prosperity.

Consequently, both parties favored aggressively shaping the EU's structural development programs to suit the country's development strategy. Neither was ready to accept the costs of adjusting the Spanish economy to meet the entrance criteria for monetary union without significant compensation for the economic dislocation that EMU would impose on Spain.

Economic Policy

Economic liberalization gained credibility in Spanish politics after the democratic transition as an alternative to the highly regulated, state-dominated and largely autarkic economy that Franco had cultivated until 1975. During the 1980s, the PSOE's economic policy promoted economic growth, restructuring and development by introducing new export markets (through accession to the EC) and new employment opportunities (through the legalization of temporary work contracts). These measures sought to cultivate a new dominant coalition of voters who would accept competition and labor market flexibility as facts of economic life. The party's leadership also committed itself to ensuring low inflation and controlled spending after Mitterrand's decision to abandon his reflation policy in 1984.

In the years leading up to 1990, this strategy suited the Gonzales government well. Trade growth with the rest of the European Community made it possible for the PSOE to gather support for economic transformation without incurring the political losses that a campaign of economic restructuring would have imposed. A national consensus on the benefits of membership was solid enough in 1989 that it never became an election issue in itself. Until recession hit in 1991, EC membership meant export markets for those in modern, EU-oriented sectors, along with greater prosperity, less unemployment, and a boom in consumer spending.[480]

This success also made it possible for the PSOE to introduce the national currency, the peseta, into the European Monetary System, and at an exchange rate so high that skeptics doubted that the country could support the parity, though the government held the rate for three years. By the beginning of the 1990s, Spain's experience with EC membership and EMS membership had been so positive that neither government nor opposition (with the exception of the IU-the United Left) felt the need to diverge from the long-standing policy of promoting gradual economic restructuring alongside the pressures of competition from the European Community.

However, union pressure and popular support forced the government to increase its spending commitments after the 1988 general strike, largely in the form of personal income transfers (see section 4.3). These spending commitments imposed large budget deficits for

[480] Hooper, John, *The New Spaniards*. London: Penguin Books, 1995, p. 62.

the first time at the beginning of the 1990s, and introduced a policy tension between the executive and the party's larger membership base. This tension between stability and export-led growth and prosperity and consumption-led growth characterized Spanish economic policy up until 1998, when the Aznar government secured EMU membership. Up until the deadline, however, the political demands to retain personal income transfers, and the persistence of inflation, combined to make membership close to impossible.

In contrast to both France and Germany, labor market policy reform was the greatest and most relevant challenge that the Gonzales and Aznar governments faced in preparation for monetary union, since its parameters influenced wage agreements, the resulting impact on employment and tax income that would follow, and inflation-indexed spending commitments. Consequently, attempts to reduce unemployment, improve government finances and reduce the overall inflation rate began with labor market policy, and wage policy first and foremost.

Most of the Gonzales government's economic policies gave priority reducing the inflation rate as a means of attracting foreign investment, increasing economic competitiveness, and creating jobs that the public expected the government to deliver. Negotiations between government, business and unions geared toward reducing rising inflation after 1989 were unfruitful into the early 1990s.

During the recession of 1992 to 1994, reducing inflation also gained credence among employers, unions and within the broader PSOE membership as the key to economic stabilization and recovery (see section 4.2). For the government, this finally opened the possibility of spending less on inflation-indexed social entitlements, and on interest payments to cover the money borrowed to meet the spending commitments. This last measure was crucial, since the PSOE dared not cut into most of the entitlements that it established in 1989 (see section 4.3). Finally, lower inflation and higher employment levels through wage moderation made it more likely that tax revenues would improve with the economy.

Unlike France, Spain's monetary policy was not a credible alternative to controlling wage-led inflation until the Bank of Spain gained its independence, due to the resistance of employers and unions, as well as the Gonzales government's habit or relaxing exchange and interest rates during periods of stress.

The PSOE attempted to pressure reluctant employers and unions into adopting moderate wage increases by threatening countermeasures in spending. Annual wage negotiations were normally scheduled to take place shortly before debate on the national budget, which must be passed by September of each year. When negotiations failed to reduce the inflation rate, economics minister Solchaga tabled spending cuts, and emphasized that successful wage restraint would have controlled government spending and removed the need for austerity.

In 1991, Solchaga attempted to introduce a 'Competitiveness Pact' between businesses and unions that would link wage increases to business profits. Furthermore, he offered businesses tax cuts for investment, research and development, in the hope of stimulating job growth.[481] When the 1991 talks failed, Solchaga unveiled plans to cut the budget by 2.5 percent, in areas that would demonstratively hurt the country's economic development. Public works, transportation and defense procurement spending were reduced by one third. Science and education, trade and tourism, and industry budgets were cut between 7 and 11 percent.[482]

Forced devaluations of the peseta in 1992 and 1993 increased the Solchaga's determination to demand wage restraint. In 1993, he unsuccessfully urged businesses and unions to exploit the competitive benefits of the 1992 devaluations by moderating wage increases. High unemployment, a continuing recession and slumping PSOE popularity in the run-up to elections increased the prospect that the government could change, and with it, the pressure to control prices. Many wage contracts remained unrenewed until after the election, when the PSOE lost its majority. Wages then continued rising more quickly than the rate of inflation, particularly in the service sector, which was responsible for almost two thirds of

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[481] Görtz, Rolf, "Spaniens Pacto de Competitividad," *Börsen-Zeitung*, June 27, 1991; "Project eines «Sozialen Paktes» in Spanien," *Neue Zürcher Zeitung*, June 10, 1991.

[482] "Sozialpakt geplatzt-jetzt kappt Madrid sein Budget," *Die Welt*, July 25, 1991.

the country's economic activity.[483]

By the end 1993, the new, even more stability-oriented PSOE economics minister, Pedro Solbes, began threatening broad labor market reforms that could effectively reduce wages if unions and employers did not agree on more reductions for 1994.[484] While the government did not specify the changes it had in mind, speculation was that they intended to use wage subsidies and training programs to bring unemployed workers into the workplace, reducing the demand for highly-paid labor.

1994 marked a turnaround in wage trends. Solbes' determination to push wages down, combined with the effects of the 1993 job loss, had the desired effect. For the first time since 1979, wages grew less strongly than the inflation rate.[485]

Wage restraint was made possible by a shift in union policy. They offered in 1994 to restrain wage demands in return for an employer commitment to halt layoffs.[486] The trade was made possible by a wage agreement formula that included adjustments if the national inflation rate exceeded 3.5 percent.[487] With this formula, the initiative shifted back to government to ensure lower prices.

Solbes reinforced the recession's pressure on wages by introducing new hiring practices and categories that took effect in January 1994. The new rules provided subsidies for employers to sign on apprentices for up to three years, and other trainees, who were often

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[483] Alcaide, Carmen, "La inflación en España," *Negocios*, January 24, 1993.

[484] Tobarra, S., and J. M. Cortés, "Solbes pide a los empresarios que resistan las presiones salariales ante la quiebra del pacto social," *El País*, November 14, 1993.

[485] Parra, Carmen, "La subida salarial media es inferior a la inflación prevista, por la primera vez desde 1979," *El País*, July 3, 1994.

[486] Employers had laid off between 4.3 and 5 percent of the entire Spanish workforce in 1993, with average losses of 7.6 percent in industry, despite the high cost of laying off many workers. Furthermore, Spanish productivity remained behind European levels, meaning that more layoffs could follow. See Carmen Alcaide "Moderación salarial y costes laborales," *Negocios*, June 19, 1994; "Ein dramatischer Stellenabbau," *Handelsblatt*, August 26, 1994.

[487] "Gemäßigte Lohnerhöhungen in Spanien," *Blick durch die Wirtschaft*, May 25, 1994.

signed on for about six months.[488] For employers, this meant that they could more easily resist union pressure for wage increases once the economy began recovering by relying more heavily on less expensive labor. The new contracts not only put pressure on prices but significantly reduced unemployment.[489]

Although national negotiations did not produce firm agreements until 1997, an increasing proportion of unions and firms were agreeing to an alternate formula for wage restraint by late 1995. Labor and Social Security Minister Jose Antonio Griñan admitted that it would be impossible for workers to accept a permanent pattern of wage restraint behind the rate of inflation, and suggested that unions and employers aim at wage contracts for 1996 that would link wage and productivity increases.[490] Since 1994, one quarter of Spanish wage agreements had already adopted the model.[491] The approval of one of the country's two major unions, the UGT, was a significant victory for the Spanish government in its long-term battle against reforming wage patterns, considering union opposition to this formula before the 1991-1994 recession.[492]

The government had mixed success in controlling wages where it was the employer, even though public sector pay restraint constituted its main wage policy before the currency crisis of 1992. The economic chaos that swept across Europe in the wake of the French referendum on EMU membership undermined the Gonzales government's attempt to reign in overall spending (a contributing factor to inflation), to control the deficit, to protect the exchange rate and to qualify for EMU.[493] Instead of cutting back general budget spending

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[488] Potthoff, Christian, "Harmlose Volksfest," *Wirtschaftswoche*, January 21, 1994.

[489] "Arbeitsmarktreform in Spanien senkt die Erwerbslosigkeit," *Blick durch die Wirtschaft*, January 24, 1995.

[490] "Griñan, partidario de que los sueldos suban según la productividad," *El País*, August 20, 1995.

[491] Ruiz, José, "Uno de cada cuatro pactos liga el salario a la productividad," *Negocios*, September 24, 1995.

[492] "Projekt eines «Sozialen Paktes» in Spanien," *Neue Zürcher Zeitung*, June 10, 1991.

[493] Zafras, Juan Manuel, "Malas pagas," *Negocios*, September 20, 1992.

in 1992 and 1993, the government froze wages in unprofitable public firms, and capped pay packets for other public sector employees at four per cent, with a thinly veiled threat at mass firings if the unions refused.[494]

Talks with public sector unions to freeze spending again for 1994 failed. The government had been openly seeking to reduce the real value of public salaries by six percent over three years.[495] The government simply entered salary freezes, benefit cuts and a revised pension formula (based on projected inflation rather than past inflation) into the budget after having decided that talks had broken down.[496]

Overall, the attempt to force wage moderation by threatening budget cuts was not successful. A direct fear for employment seems to have generated the turn in private sector attitudes in Spain.

Labor market reform was another part of the PSOE's attempt to bring prices and unemployment levels down. In 1992, rules governing temporary work contracts, which dominate employment in growth industries, were reformed to ensure a longer minimum period of employment (up from six months to one year). In early 1993, changes were introduced to allow a longer duration for temporary contracts (from three years to four).[497] This extension was an important sign of the contract's importance to the economy, since labor market rules require employers to either hire employees indefinitely when the term contract can no longer be legally renewed, or to lay off the employee, which they do more frequently.

In the wake of the 1993 election, the centrist faction of the PSOE's parliamentary wing, centered around Gonzales and Solbes, attempted to use the country's shift to the right

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[494] Parra, Carmen, "El Gobierno crea una comisión especial para vigilar la congelación salarial en las empresas públicas," *El País*, November 29, 1992.

[495] "Vorschläge zur Einkommenspolitik in Spanien," *Neue Zürcher Zeitung*, August 5, 1993.

[496] Bruce, Peter, "Hopes fade for Madrid's wages agreement," *Financial Times*, October 5, 1993.

[497] "Madrid legt ein Programm gegen die Arbeitslosigkeit auf," *Handelsblatt*, February 26, 1993; Peter Bruce, "Spanish debate on jobless adds pressure on Gonzales," *Financial Times*, March 2, 1993.

and help from the market-oriented CiU and the PNV to push through labor market changes that would increase the share of jobs in growth industries. Renewing the argument that only a liberalization of the labor market could create jobs, Solbes tried to push through a simplification of layoff practices, in particular, reducing the cost of "unfair dismissals." The labor minister was able to block this attempt in an attempt to prevent a new wave of layoffs.[498]

Instead, the PSOE provided new incentives with the 1994 labor market reform for employers to sign trainees, apprentices and fixed term employees to permanent contracts. It kept the financial penalty for layoffs (and economic restructuring) much higher than elsewhere in the EU, despite the frequent advice of the OECD and the European Commission to loosen regulations,[499] but streamlined the process by eliminating the requirement for businesses to acquire explicit administrative approval for collective layoffs. This can be attributed to the PSOE's desire to keep the door open to social dialog with the country's unions, and also because most Spaniards still aspired to permanent contracts. Altering the layoff penalties could have placed the government's commitment to employment protection into doubt, and cost it support.

By the run-up to the 1996 elections , the PSOE was still considering how to implement major reforms in conjunction with both the other political parties (who favored changes) and unions (in the form of social talks).[500] This lack of vision proved to be a significant handicap in competition with the PP, discussed below.

Spanish budget policy stressed income distribution, economic investment and expenditure control, in that order, particularly until 1994, when budget reform gained importance. At the beginning of the 1990s, centrists conceded significant expansions of public health, unemployment and pension insurance to the party's left wing, and maintained

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[498] "El sector económico del Gobierno dará la batalla en el Parlamento para abaratar los despidos." *El País*, December 5, 1993.

[499] For a comprehensive overview, see, *Spain*. Paris: OECD Economic Surveys, 1996, pp. 54-70.

[500] Cebrián, Belén, "La lenta agonía del empleo fijo." *El País*, February 26, 1995.

the entitlements as the subsequent recession began, stressing solidarity with Spaniards on the sidelines of economic growth and prosperity. The savings required to meet the EMU budget criteria were backloaded into the last years before the deadline, relying on growth, employment and EU transfers to reduce spending and increase revenue. While these contributed to revenues, both the PSOE preferred to control expenditures through wage policy, administrative and investment cuts, and income transfer cuts, in that order to cover the balance of budget reduction measures required.

Until the PSOE brought inflation under control in 1995, it proved incapable of containing spending commitments, many of which were tied to or influenced by the inflation rate. From 1991 through 1995, Spain's budgetary situation was characterized by lower than average tax revenues (due to the recession), high and rapidly increasing social spending, and shrinking spending in other areas as the PSOE tried to compensate for its other expenditures.

The 1991 budget relied partially on tax increases to compensate for spending commitments, but even more on overly-optimistic expectations of economic growth. Just as the recession was beginning in 1991, Solchaga was working with predictions of 3.3 percent economic growth, and nearly double the existing flow of private investment into the country, from three percent to 5.2.[501]

The poor growth predictions and the lack of spending adjustment led to a budget deficit for 1992 that was 47 percent larger than predicted, exacerbated by dropping business tax revenues,[502] and higher interest rate payments as a result of the 1992 currency crisis.[503] Rather than propose adjustments to spending commitments, government made inflation responsible for overspending and increased pressure on employers and unions to control

[501] The VAT's standard rate for 1992 rose from 12 to 13 percent, and the budget levied additional excise taxes on gasoline, tobacco, and alcohol. See "Mit Steuererhöhungen sucht Madrid den Ausgleich des Staatshaushalts zu erzielen," *Handelsblatt*, October 2, 1991.

[502] Business tax revenues dropped 42 percent See "Schlechte Zwischenbilanz des spanischen Haushalts," *Neue Zürcher Zeitung*, June 27, 1992.

[503] Alcaide, Carmen, "El déficit público," *El País*, June 21, 1996.

wage agreements.[504]

While the government continued to view budget problems as a function of labor market practices, the opposition PP singled out the growing budget deficit for criticism. In 1991, the PP was already attacking the government for losing control of spending. It urged the government to alter the tax structure to increase consumption, by relying more heavily on income taxes and less on value added taxes for revenues. It also championed a program to counter the country's notoriously high tax evasion rate, as a fairer alternative to raising taxes.[505] At that point in time, however, the opposition's focus on deficit reduction did not attract majority sympathy, confirming its relative lack of popular support.

In 1992, emergency cuts hurt investment rather than politically-sensitive social spending commitments. Cuts in summer hit subsidies and federal equalization payments hardest, followed by spending on public works, defense, and other infrastructure and administration costs.[506] Only the government's high-profile Eurofighter project was saved from cutbacks.[507] By the time the budget was hammered out in October, planned spending on health, labor market programs, and regional allowances rose by more than 10 percent, while pensions and equalization payments rose between seven and eight percent.[508] The PSOE expected that these cuts, combined with a retroactive increase in income taxes, would allow the government to limit the deficit to four percent of GDP and protect the position of the peseta in the EMS.[509]

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[504] Rivera, Jorge, "Economía estima que el déficit superará el 9% en 1997 si no se corrigen los desequilibros," *El País*, August 15, 1993.

[505] "Streit über Kürzungen im Etat," *Süddeutsche Zeitung*, July 15, 1991.

[506] Probst, Joachim, "Erholungskur für Spaniens Staatshaushalt," *Nachrichten für Außenhandel*, July 23, 1992.

[507] Oliveres, Aradi, "Juniorpartner mit ambivalenten Ambitionen. Das Spanische Eurofighter-Program," in Michael Brzoska and Werner Voss, eds., *Auswirkungen und Alternativen des Eurofighter 2000*. Baden Baden: Nomos Verlag, 1996, pp. 166-167.

[508] "Haushaltsplan 1993," *España 92*. October, 1992.

[509] Ibid; Vieweger, Hans-Joachim, "Spanien will das Haushaltsdefizit drastisch begrenzen," *Blick durch die Wirtschaft*, August 4, 1992.

Spending cuts and budget restrain were the PSOE's means of attempting to maintain confidence in the country's commitment to membership in the European Monetary System, which in turn, held the prospect of ensuring investment and putting pressure on domestic inflation. Pressure increased as the Danish and French referendums on Maastricht put EM in question. The PP provided an alternative in 1992 as the exchange rate crisis deepened, that the PSOE should devalue and lower interest rates to encourage economic recovery.[510]

The recession of 1992 to 1994, coupled with the election of 1993, strengthened the left wing of the party before the election, and the centrists and reformers afterward. Attempts to trim unemployment insurance spending in 1992 reflect the search for methods that would spare serious harm to recipients. When the Gonzales government cut unemployment insurance benefits to save money, wage replacement remained significantly above the EU norm. The government did not attempt to justify closing the gap between Spanish and European benefits in order to keep the fund solvent or to keep the country on track for membership in the ECB, as it did with the general budget. Instead, the government assumed the debt that INEM had run up in 1993.[511]

1993 posed serious budgetary challenges for the PSOE, with a tight election to fight. The recession worsened, unemployment grew, inflation continued, and the deficit expanded out of control. Centrists wanted to avoid worsening the deficit, but had no ideas how to counter the PP's popular complaint that the government was doing to little for growth. Aznar made unemployment an election issue in 1993. His party's solution was to continue with the national plan for economic convergence, but soften the methods. The deficit could be cut without touching the benefits of unemployment insurance recipients, for example.[512] This call came as unemployment broke the three million mark.

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[510] "Sparprogramm in Spanien," *Neue Zürcher Zeitung*, September 27, 1992; "Finanzplanung Solchagas löst Hagel der Kritik aus," *Handelsblatt*, October 9, 1992.

[511] "Madrid legt ein Programm gegen die Arbeitslosigkeit auf," *Handelsblatt*, February 26, 1993; Peter Bruce, "Spanish debate on jobless adds pressure on Gonzales," *Financial Times*, March 2, 1993.

[512] Pradera, Javier, "Alarma Máxima," *Domingo*, February 21, 1993.

In response, the Gonzales government promised to devote public resources to job creation and investment projects. Yet to avoid worsening the deficit, the government planned to divert the entire sum, one trillion pesetas, from other unspecified budget items. In reality, the PSOE was counting on a planned increase in structural development funds from the EU to cover a large portion of the costs of infrastructure projects.[513] The PSOE also protected entitlements for most in early 1993 as it increased the qualifying period for unemployment insurance benefits from six months to a year. Most workers with temporary contracts had protection. The previous year's switch to temporary work contracts with a minimum one year duration ensured this.[514]

After the 1993 election, the PSOE's left wing had been considerably weakened, allowing centrists more control over budgetary policy. Furthermore, the PSOE's minority position in the Cortes required it to cooperate with two reform-oriented regional parties, the CiU and the PNV. These supported a combination of tax and budget reductions, but still relied significantly on growth expectations. The regional parties in particular remained attached to the idea that consumption growth following income tax cuts would restore sales tax revenues and balance in government finances.

After the election, the Gonzales government attempted to take public action to fight unemployment that stressed inflation control rather than either spending or cuts. Again, economics minister Pedro Solbes began linking progress on wage talks in a proposed "Social Pact for Employment" and budget cutbacks, without achieving an agreement.[515] Productivity increases, he suggested, would restore economic growth, improve the government's fiscal

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[513] *España en la Union Europea: Diez años desde la firma del Tratado de Adhesión.* Madrid: Ministerio de la Presidencia, 1995, pp. 45-47.

[514] "Madrid legt ein Programm gegen die Arbeitslosigkeit auf," *Handelsblatt*, February 26, 1993; Peter Bruce, "Spanish debate on jobless adds pressure on Gonzales," *Financial Times*, March 2, 1993.

[515] Bole-Richard, Michel, "Le gouvernement espagnol tente de conclure un pacte sociale avec les syndicats," *Le Monde*, October 8, 1993.

position and render cuts unnecessary.[516]

Solbes' bid for a social pact broke down by September. With it, his bid for a negotiated real wage reduction of six percent over three years[517] went unfulfilled. Instead, he exploited the parliament's shift to the political right and reached a deal with the CiU to pass spending reductions, public sector salary freezes and tax increases aimed at improving the budgetary balance. The budget taxed unemployment insurance benefits for the first time. Pension increases for 1994 would be tied to the predicted inflation rate of 3.5 percent for the first time, rather than the past inflation rate. In exchange for supporting restrictive measures, the CiU won a 15 percent share of regional income tax and the end of Spain's high inheritance tax on family businesses.[518]

The PSOE experienced shortfalls during 1994, leading to impromptu cutbacks in summer. Once again, Solbes emphasized that he intended to bring the deficit within reach of the EMU membership criteria by 1997. The 1994 adjustments would be part of that plan.[519] As in 1993, household spending and VAT receipts remained low, reflecting a higher sense of insecurity in the Spanish population.[520] By 1995, good news about a smaller, if still large deficit in 1994 became public. Payouts remained stable for the first time, while tax and premium receipts rose slightly. Unemployment insurance payment reductions had accounted for 40 percent of the burden reduction.[521]

Given the continuing need for cutbacks, Solbes was reluctant to agree to a CiU proposal to promote job creation with lower social security premiums in exchange for a

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[516] Burns, Tom, "Spain seeks accord on budget deficit cut," *Financial Times*, July 28, 1993.

[517] "Kürzung der Staatsausgaben in Spanien," *Neue Zürcher Zeitung*, October 4, 1993.

[518] Alcaide, Carmen, "El presupuesto de 1994," *Negocios*, October 10, 1993; "Durchbruch im Feilschen um Spaniens Budget," *Neue Zürcher Zeitung*, October 16, 1993; "Parliament stimmt Sparetat zu," *Süddeutsche Zeitung*, October 23, 1993.

[519] "Madrid will einige Löcher im Staatshaushalt stopfen," *Handelsblatt*, July 14, 1994.

[520] "Haushaltsausgaben stark rückläufig," *Nachrichten für Außenhandel*, March 8, 1994.

[521] "Geringe Budgetabweichungen in Spanien," *Neue Zürcher Zeitung*, March 17, 1995.

higher VAT. The government feared that the measure would worsen the budget, and cause a needless public backlash, particularly with regional and European elections looming.[522] By autumn, however, the PSOE gave in to the CiU's demands, and received an important *quid pro quo*. The CiU supported a PSOE plan to peg social entitlement and public salary increases for the first time to the government's predicted inflation rate of 3.5 percent.[523] Both PSOE and CiU proclaimed the final result to be a significant step in reducing the country's sizeable unemployment rate.[524] For the government, it meant significant improvement in the budget's financial prospects without making deep cuts into social payments.

The key problem in 1994 continued to be the PSOE's insistence on expecting much larger increases in growth-related government revenue than independent assessments allowed for. The 1994 plans for 1995 expected income to grow more than seven percent, which would outpace spending increases, avoiding the need for spending cuts. In fact, the PSOE planned to spend more than seven percent more in health and public works, and up to 20 percent more in agriculture, to meet matching structural funds from the EU. Meanwhile, it expected to reduce the deficit from well over six percent to below five percent.[525]

The final budget deal impressed no one, and underlined the problems of consolidating the deficit when the need to stimulate growth was so pressing. After striking the budget deal with the CiU, the government's deficit target for 1995 rose from 4.6 to 5.9 percent, nearly double the Maastricht target. This attracted the criticism of the IMF, which called on the government to undertake more sweeping budget reforms to consolidate finances.[526] Meanwhile, both the PP and the IU criticized VAT increases as a blow to consumption-led economic growth. While the IU proposed increased anti-tax evasion measures as an alternative to raising tax rates, the PP continued to press the government for a lower deficit

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[522] "Madrid will einige Löcher im Staatshaushalt stopfen," *Handelsblatt*, July 14, 1994.

[523] Aranciba, Salvador, "Combate de fondo," *El País*, October 23, 1994.

[524] "La 'Mordaza de Pujol'," *El Economista*, November 9, 1994.

[525] "Madrid verfehlt die Kriterien von Maastricht noch deutlich," *Handelsblatt*, October 4, 1994.

[526] "Solbes kündigt Einsparungen an," *Handelsblatt*, November 21, 1994.

that would improve the chances for economic recovery.[527]

In 1995, the PSOE worked on improving administrative efficiency. Line ministries were required to send monthly cost reports to the finance ministry for the first time,[528] and the government launched a new initiative to combat tax evasion.[529] In addition, state industry was restructured in July to relieve the cost of subsidies for the government, if temporarily. Profitable enterprises were grouped into a holding company that absorbed many of the costs incurred from loss-making firms (SEPI), which, with the exception of oil and gas production, were grouped into another holding company (AIE). In 1996, the OECD confirmed that SEPI's profits would be able to cover the debt servicing charges of unprofitable state firms, allowing the PSOE to lower industrial subsidies from 519 billion pesetas to 366 billion for the period 1996 to 1998.[530]

The PSOE also continued to rely on negotiations with unions, employers and regional governments to control inflation, health and social spending increases. As before, there were no plans to alter access to entitlements, or the basic calculation of benefits.[531] However, Solbes intended to maintain only nominal payments to individuals for 1996, thereby eliminating the inflation factor. He emphasized that this measure was a necessary sacrifice if Spain were to have a chance at membership in EMU.[532]

The PSOE was in such political trouble by the end of 1995 that it could not pass the budget for 1996. The previous budget's terms extended through early 1996 according to Spanish law. This task was left to the PP after it formed the government following March elections.

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[527] Aranciba, Salvador," Combate de fondo." *El País*, October 23, 1994.

[528] "Spanisches Werben um die Märkte." *Neue Zürcher Zeitung*, January 16, 1995.

[529] "PP y IU critican el reajuste de 550.000 millones en el gasto público." *El País*, January 29, 1995.

[530] *Spain*. Paris: OECD Economic Surveys, 1996, pp. 45-46.

[531] *Spain*. Paris: OECD Economic Surveys, 1996, pp. 29-31.

[532] Oppenheimer, Walter. "Solbes admite que el Gobierno congelerá el gasto social en los Presupuestos de 1996." *El País*, April 2, 1995.

Through 1995 and into 1996, the PSOE's concern with bringing the deficit into line with the EMU standards took precedence over reforms to the labor market. With time running out running up to the decisive membership criteria year of 1997, Solbes appeared to prefer to delay labor market reforms that could have raised unemployment and government spending commitments. Instead, despite criticism from the European Commission at the EU's Madrid Conference in late 1995,[533] Solbes increased spending on job creation for the 1996 budget,[534] and continued to protect large penalties for layoffs, and retained a basic commitment to indefinite work contracts.[535]

By the end of 1996, the PSOE's determination to fight inflation through wage agreements began to pay off by reducing inflation-indexed spending commitments, albeit too late to help the PSOE win the 1996 election. The price moderation which began in 1994 and took hold in 1995 also allowed the Bank of Spain to loosen its grip on the national money supply. This, in turn, meant that the government reaped some relief from interest payments on the national debt.

The People's Party under Aznar stressed economic convergence throughout the 1990s, but real convergence (i.e. economic development) with the rest of the EU rather than nominal convergence with the entrance criteria for Maastricht. Aznar stressed that tax cuts and privatization would be the first step in attracting investment, jobs, and a modern economic structure for the country.[536] Furthermore, he campaigned to introduce labor market reforms that would open up new opportunities for unemployed Spaniards to find and keep new jobs, meaning reducing job protection that benefits uncompetitive sectors.

The PP blamed the PSOE's apparent inability to control spending or reduce unemployment during the 1990s on its alleged disregard for promoting investment and

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533 "Bekannte Rezepte für Madrid," *Blick durch die Wirtschaft*, October 17, 1995.

534 "Solbes prevé la creación de 300.000 empleos durante este año," *El País*, September 3, 1995; "El Inem dará más ayudas al empleo de parados de larga duración," *El País*, September 10, 1995.

535 "Solbes asegura que el PSOE no hará una nueva reforma laboral," *El País*, February 11, 1996.

536 "Hay que desmantelar el Inem," *El País*, May 17, 1992.

economic development which followed from its attempt to pursue nominal convergence with the membership criteria for EMU. It characterized the Gonzales government's attempt to bring the Spanish inflation rate in line with the European average quickly as "economic suicide," that could only lead to "financial bankruptcy."[537] The PP won considerable support for criticizing the government's decision to clamp down on inflation rather than gradually ratcheting it down and giving industries time to adjust, arguing that the PSOE was forcing more businesses into bankruptcy and more employees out of work than necessary, and simultaneously destroying the tax base on which the government budget depended.

In contrast, the PP offered a program of privatization, lower taxes on savings and wages, and reduced public spending, without cutting into social entitlements. The platform appealed even more strongly than that of the PSOE to middle class taxpayers and the unemployed, while engaging in more confrontation with public sector workers, which bore the brunt of the PP's austerity policy with wage freezes.

In spring of 1996, the new Aznar government took quick action on its promise to reduce the deficit, while avoiding cuts that could alienate its supporters. Rodrigo Rato, the new finance minister, assured voters that social spending would remain untouched. His first measure cut spending by 200 billion pesetas across the board rather than targeting specific programs. The cut was significant, but less than either the newly created budget office wanted (500 billion) or what the CiU had in mind (400 billion), and much less than the one trillion peseta reduction that EMU membership would have required.[538]

Rato and the foreign minister, Abel Matutes, attempted free budget policy from the restrictions of pursuing EMU membership, without abandoning the country's ambitions to join. In May, Matutes called on the EU to delay EMU's launch. This would allow Spain to fulfil the criteria without undermining or strangling economic growth. In addition, he argued that the EU should not apply the convergence criteria stringently to the Spanish membership

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[537] Bole-Richard, Michel. "Le gouvernement espagnol tente de conclure un pacte social avec les syndicats." *Le Monde*, October 8, 1993.

[538] "Aznar setzt den Rotstift bei den Staatsausgaben ein." *Handelsblatt*, May 13, 1996; "Madrid pourra satisfaire en 1997 à quatre des cinq critères de Maastricht." *Le Monde*, May 12, 1996.

bid. Meanwhile, Rato was attempting to limit the political impact of restraint by targeting only a 3.3 percent deficit for 1997.[539] Moderate intentions also showed in Aznar's decision to reject calls for the complete and immediate privatization of all state firms from the independent industry minister, Josep Piqué.[540] This spared the government having to face massive opposition to its plans.

Four months later, after having failed to alleviate pressure on the budget from either the criteria or timetable for EMU, the PP drastically increased its spending cuts to 800 billion pesetas, and targeted a three percent deficit in 1997, to fully meet Maastricht's deficit criteria. The budget plan pre-committed the government to maintaining social benefits. The CiU also won a commitment from the PP to increase health spending by six percent. Meanwhile, the PP planned further savings with a wage freeze for civil servants, including doctors and nurses.[541]

Rato also changed the tax structure with the hope of increasing investment and jobs. He raised taxes on services (6%), insurance policies (4%),[542] and on tobacco and alcohol (allegedly for their low impact on inflation)[543] In return, the budget abolishing the tax on savings. Aznar claimed that the savings rate rose significantly as a result, funneling more than 240 million pesetas into investment funds for the benefit of the economy.

Finally, the budget for 1997, and in particular tax cuts, depended on public sector salary restraint, followed by changes to labor laws to stimulate hiring, boost income tax revenue, and reduce social insurance premiums. Rato emphasized that the threat of a public sector strike would not weaken the government's determination.[544]

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[539] "Aznar setzt den Rotstift bei den Staatsausgaben ein," *Handelsblatt*, May 13, 1996; "Madrid pourra satisfaire en 1997 à quatre des cinq critères de Maastricht," *Le Monde*, May 12, 1996.

[540] "Aznar setzt den Rotstift bei den Staatsausgaben ein," *Handelsblatt*, May 13, 1996.

[541] White, David, "Spain slashes spending by $6 bn," *Financial Times*, September 28, 1996.

[542] White, David, "Spain slashes spending by $6 bn," *Financial Times*, September 28, 1996.

[543] "Kein Sonderweg für Spanien," *Der Spiegel*, December 2, 1996.

[544] "Keen Sonderweg für Spanien," *Der Spiegel*, December 2, 1996.

In December 1996, the Aznar government faced down a public sector strike designed to break its will to impose a wage freeze. The measure was intended to provide a large part of the government's savings to qualify for EMU membership, about 200 billion pesetas, and covered one and a half million civil servants, including functionaries, postal workers, firefighters, garbage collectors, airport workers, and television and radio employees. It would also cover airline, rail and bus workers.[545] Government and unions gave widely different reports of the turnout, between 20 and 80 percent. The strike lacked an impact comparable to that in France, primarily due to the fact that transportation industry workers struck later, rather than in conjunction with other public sector workers.[546] The political impact was also mitigated by the fact that many Spaniards simply stayed home rather than strike.

By the end of 1996, the Aznar government had taken the country farther into budget reform by intensifying conflict with public sector workers and employees in recession-prone industries in order to maintain the coalition of middle-class and unemployed voters who stood to gain the most from their policies. When asked whether the decision to meet EMU's convergence criteria on time was hurting Spanish job prospects, Aznar replied that deficits, debt and economic chaos hurt employment prospects and had to be replaced with low inflation and higher productivity before the country's economy could develop. Spain's real problem, he suggested, was that the PSOE had failed to reform tax policy and labor market policy to promote employment and stable prices. Furthermore, he accused the PSOE of failing to take the pressure of EMU's membership criteria seriously. The PP's plans for 1997, he stated, would focus on overhauling state industries and on creating jobs for youth. Aznar emphasized his support for strong entrance criteria and announced the PP's determination to make the criteria with the first wave of participants.[547]

The overall pattern of economic policy shows a tendency, particularly in the PSOE, to promote adjustment of the real economy through indirect pressures and incentives. Trade

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[545] White, David. "Aznar faces strike challenge," *Financial Times*, December 11, 1996.

[546] "Spanish strike over pay curb," *Financial Times*, December 12, 1996.

[547] Ibid.

competition was increased and investment opportunities in Spain introduced through EU membership, but labor market protection, particularly layoff protection, was never seriously tampered with, even though the PP supported a more vigorous liberalization in principle.[548] Social spending commitments proved too politically explosive to cut, with the exception of unemployment insurance in 1994. For this reason, efforts focused on reducing inflation, and in the final run-up to EMU, on resorting to across-the-board cuts that diffused opposition.

This could be considered a failure of both the Gonzales and Aznar governments to confront the interests of workers in uncompetitive industries directly, and a partial let-down of those in the labor force working from one temporary contract to another. On the other hand, neither party, and particularly the PSOE, was willing to risk a considerable increase in unemployment that relaxing layoff penalties could permit. Furthermore, Spanish employees did not see indefinite contracts as a problem to be eliminated, but something to aspire to. Consequently, the PSOE promoted indefinite work contracts by offering incentive payments of 500,000 pesetas to employers who signed temporary contract workers and trainees on to permanent contracts. For workers aged 45 and over, this measure was normally enhanced by waiving 50 percent of the employer's social security premiums for the employee.[549]

EMU Policy

The priorities of Spain's EMU policy begins with its approach to EMS membership. The Gonzales government entered the EMS in 1989 in part to put pressure on inflation, which would attract investment capital and help control public borrowing. Stability took a back seat to economic and job growth goals, however.[550] Similarly, inflation reduction

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[548] *Spain*. Paris: OECD Economic Surveys, 1996, pp. 63-66.

[549] "El nuevo mercado laboral," *El País*, February 26, 1995.

[550] Solchaga was particularly concerned about the disproportionate influence of the German Bundesbank in setting European interest rates, and the possibility that poorer countries would bear the full cost of adjusting to exchange rate turbulence. In doing so, Solchaga placed his government

would allow Solchaga to protect the social spending commitments made in 1990 by making payments manageable, if the policy worked. Therefore, a policy of EMS membership and disinflation provided the prospect of balancing commitments to social generosity through the welfare state, and fiscal responsibility, as a path toward developing the country's economy.

The PSOE's decision to enter the EMS stands out because both unions and the majority of the business community opposed it. Unions saw the anti-deficit and anti-inflation implications of membership as an attack on the wages and social entitlements of working Spaniards.[551] Businesses were much more interested in manipulating the exchange rate to retain competitiveness than in controlling their own costs or improving their efficiency.[552] For voters in 1989, the EMS policy meant a strong currency that would support a continued boom in consumer spending, particularly for imports from the European Union.

By the time Economic and Monetary Union came into serious discussion in 1990, the Gonzales government was concerned that monetary union would proceed so quickly (following France's priorities) and with such strongly stability-oriented membership criteria (following Germany's priorities) that Spain would have to choose between exclusion and a radical attempt to control inflation and deficit spending simulataneously. While the shock-treatment approach was unattractive, exclusion meant that confidence in the peseta would drop. This in turn would force either the same high interest rates and spending cuts required for membership, or cost the country investment, which would avoid Spain on account of the exchange rate risk.[553] The earler the launch date and the stricter the criteria, the more likely that international currency markets would dump the peseta. The PSOE feared in particular

with those that wanted ECOFIN (the EU's Council of Economics and Finance Ministers) to decide monetary and fiscal priorities for Europe. See "Minister Solchaga fürchtet deutsche EWS-Hegemonie." *Handelsblatt*, July 7, 1988.

[551] "Discipline for the over-strong peseta." *Financial Times*, June 19, 1989.

[552] "Mit gutem Beispiel voran." *Handelsblatt*, June 19, 1989.

[553] This effect was shown after the 1992 collapse. See "Gonzales-Boom am Ende." *EG Magazin*, May, 1993.

that this effect of exclusion would entrench Spain's relative underdevelopment in the EU.[554] Furthermore, before the expansion of regional development funds in 1994, the structure of taxation and spending within the EU would funnel money away from poor countries and toward the rich (particularly countries with capital-intensive agriculture who would benefit most from the Common Agricultural Policy), exacerbating the disadvantages for Spain.[555]

Indeed, it was difficult for either Gonazales or Solchaga to convince the cabinet that the country could and should achieve early membership in the hard core of the EMS, much less in the ECB. Even the Bank of Spain, generally more insistent on low inflation and restrained borrowing than the government, expected that it might take a few years before inflation had been conquered and the prospect of EMU membership could be broached.[556] The government expected an even longer period of time before the country's economic structure was modernized enough to support a strong currency on its own. In 1991, much of the PSOE cabinet considered Solchaga's plans to bring the peseta into the narrow exchange rate band of the EMS by 1994 to be optimistically early.[557] So economically and politically, Franco-German plans for EMU were less preferable than an arrangement that would allow Spain to gradually ratchet down inflation and promote economic adjustment before a monetary union in Europe was launched.

The problems that EMU could cause for Spain were demonstrated even before the Maastricht Treaty was ratified. The market tended to value the peseta a great deal more for the political expectations of its membership in the EMS and a subsequent participation in EMU than in the state of the economy. After the Danish rejection of the Maastricht Treaty put a continuous transition from ERM to EMU into doubt, international currency markets

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[554] Gardner, David, "Southern discomfort," *Financial Times*, June 18, 1991.

[555] Ibid.

[556] "Spain counts the cost of joining the club," *Financial Times*, June 20, 1990.

[557] Bruce, Peter, "Missed targets on Spain's road to ERM," *Financial Times*, August 12, 1991.

forced the peseta into its first devaluation, despite intervention by the Bank of Spain.[558] After the French referendum literally split the country over the commitment to EMU, markets dropped the peseta even further.

As international currency markets made the pursuit of membership more costly, Gonzales remained convinced that the political and economic costs of being left out would be even worse. In particular, long-term plans to buttress economic reconversion efforts (reducing inflation and enhancing the structural development of the economy) with the external commitment to a stable exchange rate could collapse.[559]

Knowing that it would be difficult for Spain to fulfil the type of membership criteria within the time frames being discussed by the Council of Central Bank Presidents in Brussels, the government sought to make membership less costly and more possible in several ways. It did what it could to extend the time frame for establishing economic convergence. It questioned strict application of the membership criteria. It demanded intervention on currency markets from strong currency countries to protect exchange rates from speculative attacks until EMU began. Finally, and most importantly, the government demanded that the EU actively invest large sums of money in restructuring and building up the Spanish economy. This would be necessary to ensure that the Spanish economy could generate economic activity comparable to that elsewhere in Europe under a common monetary policy.

In 1991, while the structure of the EMU agreement in the Maastricht Treaty was being discussed, Spain made its first move to bide for as much time as it could to prepare for membership in the ECB. The Spanish delegation suggested that the second stage of the monetary union begin in 1994.[560] This suggestion showed that the Spanish government wanted to bide for time, while it worked on shaping up for membership. France and Belgium

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[558] Bruce, Peter and Tom Burns, "Spain tries to avoid interest rate rise," *Financial Times*, September 18, 1992.

[559] Ammann, Beat, "Bruch mit den Gewerkschaften," *EG-Magazin*, September 1991.

[560] Bruce, Peter, "Missed targets on Spain's road to ERM," *Financial Times*, August 12, 1991.

in particular had been pressing for as swift a transition as possible, even asking for an impromptu monetary union again in 1993.

In the wake of the 1992 devaluations and a subsequent devaluation in 1993, Gonzales began lobbying other European governments again to suspend the EMS and to delay EMU. He wanted to avoid the disgrace of having to exit the EMS alone. Furthermore, he felt that the path to reform would be halted if the external pressure of exchange rate discipline were removed from the Spanish political economy.[561]

Gonzales was also bitter about the Bundesbank's decision to protect the franc during the exchange rate crises of 1992 and 1993, while leaving the peseta to the mercy of the markets. Gonzales argued vigorously but unsuccessfully again for stronger currency countries to come to the aid of weaker currencies during speculative attacks.[562]

During the height of Spain's economic crisis before the 1993 election, Luis Rojo, the Governor of the Bank of Spain, backed Gonzales in calling for looser criteria for membership in the ECB. Rojo's first preference was different than that of the government--he preferred that EU currencies be allowed to float rather than stand firm within the EMS. On the second-best option, he agreed with the government that Spain should strive for EMU membership, but demand that criteria be re-interpreted.[563]

The centerpiece of Gonzales' EMU policy was the expansion of financial transfers at the EU level from richer to poorer states. The principle behind them would be an expanded commitment to 'economic and social cohesion' that had to exist alongside the EMU project.[564] He justified increases to the EU's structural development and social funds as financial compensation for the impact of converting the economy to qualify for EMU in such a short period of time. The structural funds which had been established in 1988 to aid passage of the 1992 program had benefitted the EU's more developed countries, and left

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[561] "Stalwart Spain suffers sense of 'betrayal'." *Financial Times*, August 3, 1993.

[562] Ibid.

[563] Görtz, Rolf, "Euro-Baisse in Spanien." *Börsen-Zeitung*, February 13, 1993.

[564] "Madrid fordert mehr Mittel für die armen EG-Länder." *Handelsblatt*, March 12, 1991.

Spain once again as a net contributor. Research and development funding tended to bypass Spain, due to its weakness in this field, leaving no compensation for Common Agricultural Program payments that favored producers of high value-added products in other countries.[565] Gonzales emphasized that Spain could not accept being a net payer into the EU when its per capita income was less than 80 percent of the EU average.[566]

In November, after he had not yet achieved a breakthrough against German, Dutch and British resistance to increased structural funds, Gonzales bolstered his own commitment to standing firm on the increases. He emphasized that he simply couldn't justify to voters why the country should be locked into being a net payer to the EU, while undergoing a painful transition process to qualify for EMU. He described the EU's existing system of structural aid as "insufficient, inefficient and unfair," and reiterated his demands for the funds to be doubled, as well as for changes in the manner that funds were allocated and spent.[567]

In May 1991, the Gonzales government made three proposals at the intergovernmental conference on establishing financial transfers among member states. The first was to establish a fund providing financial transfers to countries with GDP per capita below 90 percent of the EU average for investment in 'physical and human capital.' Second, it proposed that the EU derive twice as much income from taxes, and that the tax burden be distributed according to the 'relative prosperity' of member states. Third, the requirement of the structural fund that recipient countries invest a matching sum of money should be replaced by a sliding scale that allows poorer countries to contribute less of their own money. At the same time, it rejected the Commission's counterproposal, which foresaw a 50 percent increase in structural funds for the 1994-1999 period, plus increases in regional development funds to include inner city renewal, rural development and education.[568]

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[565] "The strain of Spain," *The Economist*, April 27, 1991.

[566] See interview with Gonzales in "A better chance for rich and poor," *Financial Times*, May 9, 1991.

[567] "España se la juega en Flandes," *El País*, November 17, 1991.

[568] Gardner, David, "Southern discomfort," *Financial Times*, June 18, 1991.

Throughout 1992, Gonzales worked on the theme that solidarity among the peoples of Europe had to be entrenched in the final version of the Maastricht Treaty. He widened his defense of increasing payments by pointing out that the EU's richest countries had been able to buy some of Spain's most profitable industries after the country entered the EU in 1986, and to export large amounts of goods into a previously closed market. In return, they needed to do more to prevent 'the gap between poor and rich in the EC" from increasing. Eventually, he added, the structural funds would help Spain to achieve real economic convergence, and then a fully contributing member of the Union.[569]

The standoff between Spain and Germany lasted through the end of 1992. Gonzales continued pressing for the increase in structural funds, buttressed by support for a cohesion package by Portugal, Greece, and Jacques Delors, the President of the Commission. Kohl eventually conceded the increase at the Edinburgh Summit, subject to unanimous ratification of the Maastricht Treaty. [570]

The external pressure of exchange rate discipline remained a very important part of the PSOE's economic policy throughout the 1990s. Despite four devaluations between 1992 and 1995, the government made it clear that floating the currency, as Italy and the UK had done, was out of the question.[571] The pressure on economic actors, however weak, had to be maintained.

After the agreement to increase structural funds in the Maastricht Treaty for 1994-1999, the PSOE and the PP split principally on the question of whether Spain could afford early membership in EMU. The PSOE held to its position that EU investments in Spain's economic structure would make it possible to increase prosperity and achieve EMU membership. However, the PSOE's almost frantic desire to remain in the EMS, in contrast to Italy and the UK, demonstrates that it had little confidence in its ability to meet the

[569] Knipper, Hans-Josef, "Der Traum vom großen Geld," *EG Magazin*, August, 1992.

[570] Cembrero, Ignacio, Pilar Marcos, "Robin Hood en Holyrood," *El País*, December 20, 1992.

[571] "In Spanien und Portugal gilt die Währungskrise als überstanden," *Frankfurter Allgemeine Zeitung*, April 13, 1995.

convergence criteria without running into serious domestic opposition. Miguel Boyer, the PSOE's finance critic, demonstrated this concern shortly after the 1996 election, when he began arguing that the Maastricht criteria should be applied liberally to make allowances for the structural weakness of Mediterranean economies.[572] This meant that for a short time in late spring and early summer of 1996, both the newly elected PP government and opposition were calling for EU governments to set aside the entrance criteria for Maastricht. Given that this call coincided with German plans to force a stability pact for EMU in December of 1996, the Spanish pressure to prevent the pact is unmistakable.

The PP's reversal from condemning the PSOE's haste to meet the Maastricht criteria took only a few months, from the time it tabled the first draft of the budget for 1997, to the second draft in autumn of 1996, which was geared toward qualifying for membership. Within that short period of time, the PP's long-standing claim that the country was not in economic shape changed to the goal of EMU as Spain's "one historical chance," to consolidate its status as a first rate European country. Behind the scenes, however, reports continued to suggest that the Spanish government saw the switch to easier criteria at the decisive moment as self-understood.[573] These details confirm the prospect that German insistence on a stability pact for EMU members was firm enough to change the official Spanish policy on membership criteria. By the time the stability pact was being hammered out, the Aznar government not only stood behind the German proposal, but rebuked the Italian government, which was uncomfortable with the new measure.[574]

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[572] Potthoff, Christian, "Madrid und Lissabon gibt es nur im Doppelpack." *Handelsblatt*, December 31, 1996.

[573] Ibid.

[574] Ibid.

4.5 Conclusions

Spain's domestic and foreign policy behavior reflect governments struggling to convince societal actors of the benefits of low inflation and government spending restraint. Neither the business community nor unions paid much attention to the effects of wage agreements on international competitiveness before 1994, despite membership in the EMS and the European common market. Consequently, in the sense that the Gonzales government supported EMS and EMU membership, and lower inflation and budget reform, it committed itself to reforming business and union preferences rather than following them. In part, this reform would be undertaken directly, through national negotiations on wage agreements. In part, it would be made possible by encouraging investment in new industries that would more readily accept the PSOE's economic policy agenda. To the extent that the government was unsuccessful in ensuring change in the nation's inflation rate and indexed spending commitments, it was because it had not broken business and union resistance, rather than because the latter had influenced government preferences.

Electoral motives, combined with institutionalized spending commitments, constituted the main reason why the PSOE, and later the PP, refrained from ensuring a rapid reduction of inflation and public borrowing requirements. Public support for the personal income transfers introduced in 1989, primarily for the benefit of Spaniards outside the core of the national labor market, rendered them politically untouchable for a party seeking a majority. Given the role that inflation played in determining the size of these payments, it made more political sense to continue pressuring businesses and unions to control wage increases than to cut benefits for Spaniards who were less well off to compensate. Electoral motives also played a role in shaping a key justification of its reform program. The promise of reducing unemployment, and in particular, creating jobs for Spain's chronically unemployed youth, was an important factor in the government's strategy to push for reform through the social pacts.

Through the late 1990s, therefore, a pattern in which the government placed voter concerns ahead of business and unions can be confirmed. Entitlements were neither severely cut, as businesses demanded, nor did the government back away from fighting inflationary wage demands with high interest rates, if it thought that it could stabilize spending commitments and set the foundation for future economic growth.

The speed of the EMU challenge caused the most pressing problems for Spain, and illustrate the persistent impact that business and union behavior, electoral priorities, and institutionalized spending commitments can have on national economic policy commitments. The short timetable within which to control inflation and spending demanded intensified conflict with unions, public enterprises, and obsolete industries over wage policy, interest rate policy, and given their resistance, an even tougher challenge as interest rates restricted economic activity.

Furthermore, the *speedy* launch of an EMU that embodied *long-term* goals of the Spanish government's economic policy threatened to undermine the latter's credibility if the country missed the first wave of membership, and doubly so once international currency markets began attacking the exchange rate. Under these circumstances, it is not surprising that neither the PSOE nor the PP expressed any strong degree of comfort for establishing a central bank with membership criteria likely to shut the country out.

The most unequivocal demonstration of Spain's priorities for growth lies in its tenacious demand of financial compensation for the economic pain of converting the economy to meet the Maastricht criteria. As early as 1992, the PSOE calculated that only a massive increase in EU structural development funds, a demonstration of European solidarity, would allow the PSOE to sell the EMU program at home. In fact, the government's published assessment of EU membership for public consumption in 1995 placed great emphasis on the financial benefits of the expanded EU program. The suggestion of both the PSOE and the PP in mid-1996 that EMU's entrance criteria be weakened to allow Spain to enter without enduring further economic and political pain confirms the underlying position of both major Spanish parties toward the priorities of the European Central Bank, particularly given the pending negotiations on a Stability Pact for future members.

5 International Negotiations on EMU and the ECB

The ECB project forced the European Union to grapple for the first time with the relative importance of growth and stability in European and national economic policy. The most important conflicts between 1991 and 1998 focused on how the membership rules of monetary union, the mechanisms for setting European monetary and economic policies and treaty-based commitments would impact the relative balance of growth and stability in the euro zone. Since other works have already mapped out the Maastricht negotiations,[575] this chapter concentrates on disputes that erupted after the signing of the TEU.

This basic conflict over economic policy preferences manifested itself in five disputes over the terms of EMU and the structure of the ECB. In 1991, EU countries grappled with whether social solidarity among rich and poor member states should be further developed alongside the efforts to prepare for a stability-oriented monetary union. In concrete terms, this meant whether richer countries, which faced fewer costs preparing for monetary union, would help poorer countries to qualify with financial transfers.

After the Treaty on Monetary Union was signed in 1992, member countries unofficially reopened talks on how stringently the membership criteria would be applied. A weakening of the criteria as a prerequisite for membership was implied in the French and Belgian proposals to launch monetary union as early as 1993, and in persistent but unofficial reports through 1998 that the French, Spanish, Italian and Belgian governments were demanding a relaxation of the entrance criteria. In contrast, Germany, supported by the Netherlands and Luxembourg, sought to ensure that permanently institutionalized, stability-oriented criteria for membership. This stand is reflected in the Stability Pact signed in December 1996, and the Stability Declaration signed in May, 1998.

The prospect of delaying monetary union until all countries could fulfil the entrance

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[575] Baun, Michael. *An Imperfect Union: The Maastricht Treaty and the New Politics of European Integration*. Boulder: Westview Press, 1996; Colette Mazzucelli, *France and Germany at Maastricht: Politics and Negotiations to Create the European Union*. New York: Garland Publishing, 1997.

criteria strained relations between France and Germany from 1995 onward. In 1997, the prospect of institutionalizing political involvement in monetary policy in the form of a Growth and Stability Council put the independence of the ECB at stake. Finally, in 1997 and 1998, France's president used the nomination procedure for the ECB president for domestic electoral purposes, thereby placing its independence in question. The choice of a location for the Bank also had PR consequences, and became the source of dispute. The central stake was the balance of growth and stability features into the institutional framework of monetary union. The secondary stake was the impression that the terms of EMU would make on voters and their interests.

Most of these disputes had distributional consequences for the countries involved, despite the fact that Germany, France and Spain had committed themselves publicly to the criteria for membership laid out in the Maastricht Treaty[576] and to adhere to the criteria after entering monetary union. The provisions of the Maastricht Treaty were comprehensive enough that additional agreements and commitments would have been superfluous, if each government could take these public commitments at face value.

The frequency and intensity of subsequent attempts to alter the terms of the Maastricht Treaty or to attach supplementary agreements was rooted in a concern that monetary union might have a politically undesirable impact on the national economy. Germany feared that membership rules, ECB institutional rules or political pressure from voters in other countries could lead to higher inflation and a weaker currency. Spain feared that a stability-oriented monetary union would destroy the economy's fragile reconstruction efforts without significant outside aid. France, in turn, feared that the stabilizing benefits of a monetary union could evaporate if German fears led to its delay or demise.

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[576] Furthermore (and this is very important in the German case) all three governments expressed confidence that all countries would achieve the membership criteria in 1997, when the last chance to qualify for the first wave of membership would present itself.

5.1 Spain and Germany: Trading a Stability Commitment for Structural Funds

Early in the negotiations to establish EMU, Spain and Germany fought over whether monetary union should focus solely on ensuring economic stability, and how EMU's launch would affect economic growth in the EU's poorer countries. While Spain did not challenge the price stability mission in principle, it underlined that the EU's poorer countries would experience an extended period of poverty if they were unable to borrow more investment capital or risk more inflation through the extension of credit.

Before the Treaty on European Union was signed, Spain spearheaded an initiative on behalf of the European Community's less developed members to make approval of EMU conditional on a substantial increase in economic development aid for poor EC member states. The Gonzales government demanded an increase in structural development funds and the creation of a social fund. The structural development fund provides investment capital for poorer EU countries, and is devoted to building up the country's stock of fixed capital.[577] The social fund provides assistance for social support programs in areas where income is low and the demand for support is particularly high. Both funds allocate resources according to the per capita GDP of regions, as designated by the European Commission. For the 1994-1999 period, Spain negotiated a settlement that guaranteed it more than half of these funds.

In Margaret Thatcher's view, the Gonzales administration's demands reflected its long-standing dissatisfaction with the amount of financial aid that the EC was transferring to its poorer member states. In particular, she suggests that the Gonzales government saw financial transfers within the EC as an essential requirement of its strategy to develop the country's economy to the point where Spaniards would be able to enjoy a standard of living closer to that of the EC average.[578] This corresponds to the thrust of Spanish economic

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[577] This means building up transportation networks, utility connections, industrial parks and other capital assets that enhance the ease with which goods and service providers can compete in the European market. It also includes the purchase of environmentally friendly manufacturing technology to comply with European environmental directives.

[578] Thatcher, Margaret. *The Downing Street Years*. London: Harper Collins, 1993: 546.

policy outlined in chapter four.

According to Mazzucelli, the Gonzales administration correctly assessed the link between financial aid and whether or not Spain would have been able to achieve real economic convergence with longer-standing EC members. In particular, he points out that Spain lacked the road, rail and telecommunications infrastructure in 1990 to take full advantage of improved access to the EC market, and to attract foreign investors who could diversify and modernize the structure of the economy. Without this influx of capital, Spain expected to experience an extended period of underdevelopment.[579] The lack of development would mean a persistently underdiversified and price-sensitive economy, and also a prolonged inability to commit to EMU's stability requirements.

The Spanish government also sought a larger EC commitment to directly supporting social welfare in poor areas of the Community. Spain faced the prospect of colossal unemployment levels as outdated industries lost the protection against competition that they continued to enjoy during the first years of membership in the EC.[580] Without outside aid, the government would be faced with political demands to ensure unemployment insurance and social assistance benefits through borrowing that could crowd out investment in economic development.[581] Financial transfers, on the other hand, could make it possible for Spain to invest in economic reconversion while dealing with the unemployment-related

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579 Mazzucelli, Colette. *France and Germany at Maastricht: Politics and Negotiations to Create the European Union*. New York: Garland Publishing, 1997: 183.

580 Spain's accession treaty to the European Community provided for transition periods in trade liberalization ranging from four to ten years, protecting the Spanish market from some manufacturing imports until about 1990, and protecting the old EC market from Spanish agricultural exports well into the 1990s. The end of protection for manufacturing industries from 1990, coupled with inflation in the late 1980s and the peseta's entry into the EMS in 1989, made it more difficult for Spain to take advantage of EC export markets during the 1990s than would have otherwise been the case. For a review of the trade restrictions, see Enrique Fuentes Quintan, *El Model de Economía Abierta y el Modelo Castizo en el Desarollo Económico de la España en los Años 90*. Zaragoza: Prensas Universitarias de Zaragoza, 1995.

581 This works from the premise that money attracted into government bonds floated to pay for spending commitments diverts funds away from investment in the economy. However, this effect only takes place if government borrowing is funding income transfers (i.e. consumption) rather than investment in infrastructure.

costs. According to Thatcher, the Gonzales government failed to win a substantial aid commitment during accession talks in the 1980s, but remained determined to secure it at a future date.[582]

As the discussions for EMU began, the Spanish government pushed for the increase in EC aid that they had been denied in 1986. Whereas the Single European Act of 1986 had elevated the Single European Market to the driving principle of the European Community, the TEU should enshrine social solidarity as a driving principle of the future European Union.[583] Solidarity would be expressed across regions through the structural development fund, and from richer to poorer individuals through the social fund.

Spain's decision to demand aid rather than not participate in monetary union was also prompted by a fear that EMU's rules would force the Spanish economy to contract and remain underdeveloped, whether or not the country took part. If Spain focused first and foremost on ensuring price stability, it could forsake badly needed opportunities to develop the country's economy by restricting the supply of credit. Furthermore, the inflationary tendencies of certain sectors in the Spanish economy could not be brought down quickly enough for EMU membership without having a harder impact on the overall economy, productive sectors included.[584] This concern is confirmed by the suppressive effect that high interest rates had on economic growth during the 1990s (see chapter four).

If Spain did not enter EMU, capital markets would likely react by demanding higher interest rates and speculating on the value of the currency. Both factors would further deter investment. Therefore, the country had a significant interest in participating, but lacked the resources to make membership politically feasible. Madrid stood before a choice in which it could accelerate sustainable development, guaranteed by a combination of EMU and financial transfers, or be left to the mercy of outdated industries and unforgiving financial

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[582] Thatcher, Margaret. *The Downing Street Years*. London: Harper Collins, 1993: 546.

[583] Knipper, Hans-Josef. "Der Traum vom großen Geld." *EG Magazin*. August 1992.

[584] "Spain counts the costs of joining the club," *Financial Times*. June 20, 1991.

markets.[585]

Spain's willingness to commit to the convergence criteria in exchange for financial transfers also seems to have enhanced the government's credibility at the bargaining table. According to Thatcher, Germany's Kohl government paid more attention to Spain's demands for increased funding than to those of Greece's government. Thatcher interpreted this different response as a result of the Kohl government's perception that the Greek government had little intention of undertaking reforms.[586]

The importance of ensuring financial transfers was demonstrated by the Gonzales government's approach to setting the entitlement criteria for EC structural development and social funds in the wake of German reunification during negotiations for the Maastricht Treaty. The EC's investment policy in 1990 gave priority to regions with less than 75% of the Community's average, which designated almost the entire country as a high-priority investment target. German reunification, i.e. the accession of extremely poor regions into the EC, jeopardized the investment priority status of some Spanish regions by closing the gap between Spanish income and the EC average. Madrid first demanded that the new German states be excluded from the financial transfer calculations. When it failed to find agreement, the Gonzales government began demanding that the eligibility threshold for financial transfers be raised from 75 percent to 90 percent of the European average.[587]

Spain's ability to force a deal can ultimately be attributed to the European Community's consensus rule for establishing new treaties among the member states. Without this rule, Spain would have been unable to hold the treaty hostage to its demands.[588] The importance of this requirement is demonstrated by Germany's later capacity to reject Spanish demands for either increased funding, or a guarantee of development aid levels to Spain

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[585] Instituto de Estudios Fiscales, *La Armonización Fiscal en la Unión Europea*. Madrid: Hacienda Pública Española, 1997: 5-7.

[586] Thatcher, Margaret, *The Downing Street Years*. London: Harper Collins, 1993: 761.

[587] Gardner, David, "Southern discomfort." *Financial Times*, June 18, 1991.

[588] Cembrero, Ignacio, Pilar Marcos, "Robin Hood en Holyrood." *El País*, December 20, 1992.

when East European countries enter the EU.[589]

5.2 Membership Criteria

The Maastricht Treaty sets membership criteria for monetary union that cover debt loads, deficit levels, inflation rates, interest rates, and exchange rate stability. Together, the criteria forced prospective members to achieve an unprecedented degree of economic and public policy convergence,[590] or be excluded from the project.

European governments unofficially reopened discussion over the membership criteria on several occasions between 1992 and 1998. Three key options were on the table. The first set of discussions focused on whether the criteria would be strictly applied when selecting the participants. The 1999 deadline to launch EMU, combined with the persistence of the 1990s recession made it increasingly likely that the EU would have to change either the schedule or the terms of membership. The currency crises of 1993 and 1995 underlined the difficulties. The possibility of loosening the criteria appealed to economically weak countries in particular, but also to France and Belgium, which wanted to speed up the process of monetary union, with or without the criteria.

The second set of discussions separated countries prepared to promote looser

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[589] Aznar, José María, (Interview)"Auf den Euro setze ich alles," *Die Zeit*, January 31, 1997; Christian Potthoff, "Madrid stellt Aufstockung des EU-Etats zur Diskussion," *Handelsblatt*, July 15, 1997; "Der Eurofighter," *Die Zeit*, April 29, 1998.

[590] As a reminder: the TEU required prospective members of monetary union to meet the following economic targets for two consecutive years. The national currency had to remain in the Exchange Rate Mechanism of the European Monetary System, without devaluation for two years prior to entry. Until 1993, this meant keeping the exchange rate within a narrow fluctuation band of plus or minus 2.5 per cent. From 1993 onward, the band increased to plus or minus 15 per cent. Second, the national inflation rate could not exceed a given formula, based on the average inflation rates of the three countries with the lowest inflation rates, plus 1.5 per cent. Third, national interest rates could also not exceed a given formula, based on the average interest rates of the three countries with the lowest inflation rates, plus two percent. In other words, the government could not support the exchange rate or suppress the inflation rate artificially with extraordinarily high interest rates. Fourth, government budget deficits could not exceed 3 per cent of GDP. Exceptions were allowed during economic recessions, after prior consultation with other EU governments. Fifth, public sector debt could not exceed 60 per cent of GDP.

convergence criteria into three subgroups: those who preferred a liberal interpretation of the criteria but not their rejection: those who preferred that the debt limit criteria be lifted: and those who preferred a major adjustment or removal of most or all of the membership rules. Each of these options reflected the relative political difficulty that governments faced in tying their hands on economic policy.

The third set of discussions focused on whether the criteria would apply only for qualifying as a member of EMU, or whether countries were expected to restrict debt, deficits and inflation on a permanent basis.

The new discussions were made possible not only by the fact that European governments had different interests with regard to the convergence criteria, but also because the exact figures of the convergence criteria were technically unimportant. The target levels set in the Maastricht Treaty were chosen with pragmatism for the negotiations in mind, rather than a firm preconceived notion of what criteria would be acceptable. At the time the treaty was negotiated, the average debt load for European governments was roughly 60 percent of GDP--the figure set as the limit in the treaty. Given expectations for economic growth, limiting deficit spending to 3 per cent of GDP was expected to stabilize the public debt load in Europe.[591] This type of calculation underlines the fact that while the figures set out in the TEU were not arbitrary, any reason for adhering to them strictly would have to be more political than technical. As the recession of the early 1990s persisted, this practical approach to setting the membership criteria allowed governments to question them again. The convergence criteria agreed to in 1992 reflect a clear bias in favor of a mutually-reinforcing package of price stability and budgetary consolidation. The inflation rate target formula compelled prospective EMU members to converge their inflation rates with those of the three EU countries with the lowest rates. During the recession of the 1990s, when countries with traditionally low inflation rates experienced virtually no price increases at all, pressure on inflation performance rose significantly for all prospective members, despite the negative impact that higher interest rates would have on already poor economic activity.

[591] This formula was explained by John Berrigan of the EC Commission (DG II: Economic and Financial Affairs) during a presentation on EMU in Brussels, March 30, 1998.

Countries with higher inflation rates pursuing convergence also faced higher deficit reduction challenges as higher interest rates required to control inflation imposed higher unemployment levels and lower tax revenues. In turn, these countries faced more intense debates over whether to reduce spending (the alternative being to stimulate the economy, employment and revenues), and if so, how. In effect, countries with histories of high inflation rates that pursued EMU membership faced far more difficult challenges in managing the economic and budgetary consequences of adjustment than other countries.

If strictly applied, full prior convergence to the criteria effectively ensured that national debates over price stability and its fiscal consequences had been decisively settled before EMU membership. The criteria collectively ensured that prospective members would be operating under similar monetary and fiscal policies before they switched from their respective national monetary policies to the single European one, thereby reducing the likelihood of a subsequent disagreement among EMU members over the fundamental priorities of European monetary policy. At the national level, this meant that national governments and electorates could live with the interest rates, growth rates, unemployment rates, wage patterns and spending restraints that membership implied.

For these reasons, the convergence criteria provide a good reference point at which one can determine a government's relative desire to ensure that price stability dominates monetary policy withing the euro zone. The inflation target is the most direct test, and best suited for evaluating a country's immediate commitment to price stability. Among governments that pursue low inflation, budget deficit targets present them with the next choice of locking in low inflation with spending reductions, or returning to a more growth-oriented monetary policy in the pursuit of economic recovery. Likewise, the priorities that governments placed on certain criteria, or their insistence that certain criteria were superfluous, reveal a great deal about the strength and depth of their commitments to a stability-oriented monetary union.

Germany

Germany's Kohl government devoted the lion's share of its activity in shaping monetary union into ensuring concrete inflation, deficit and debt targets for potential members. At the European level, convergence around concrete membership criteria could serve as a measure to build confidence among prospective members that all were committed to introducing price stability and to adjusting state finances accordingly. As outlined above, this package of inflation and deficit targets would serve to build confidence in both a prospective member's short term and medium-term commitment to these norms.

At the domestic level, the inflation, debt and deficit targets allowed the Kohl government to build confidence among voters that monetary union would bring together countries in which the public had accepted the full range of consequences of choosing price stability, and exclude countries in which higher inflation rates or budget deficits left doubts about their future demands on European monetary policy.

Indeed, German voters' low confidence in monetary union revolved around the difficulty that other EU governments had in meeting the convergence targets during the recession of the 1990s. There also seems to be no doubt that voter judged foreign suggestions to apply the criteria liberally as an attempt to undermine the German preference for price stability in EMU.

Germany's first initiative on membership criteria was to insist on concrete economic and budgetary targets as part of the original agreement for proceeding with monetary union.[592] From the German viewpoint, it was important that the criteria require a considerable degree of economic convergence among the participants, rather than just a history of stable exchange rates. Thus, the national commitment to restraining prices and deficits was more important than the actual figure, even if the German government wanted targets that kept inflation and deficits modest. Bundesbank President Hans Tietmeyer suggested, for example, that France and the Netherlands, not Germany, took the lead in

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[592] Baun, Michael, *An Imperfect Union: The Maastricht Treaty and the New Politics of European Integration*. Boulder: Westview Press, 1996, p. 50.

setting the specific criteria agreed to in Maastricht. Once they were set into the treaty, however, the Kohl government clung to them ferociously, even when it had difficulty reducing its own budget deficit later on. The criteria could not serve the role of a transparent benchmark if they were loosely defined.

From 1994 onward, the Kohl government appears to have used its insistence on strict deficit limits to reassure its pro-stability supporters that it was serious about restoring balance to public finances in the wake of reunification. A debate flared up in the final years before EMU's launch over whether the government would consider candidates for membership who had achieved budget deficits of more than the 3.0 percent set out in Maastricht, but less than 4 percent. Particularly in the run-up to selecting members, when it was likely that many EU countries might have deficit targets in this range, the Kohl government defended its insistence on 3.0 out of concern for the fears of its own public about the commitments of other countries to controlling their deficits. The CSU, led by finance minister Waigel, emphasized this concern in talks over the Stability Pact (see below).

Underlying the tenacious adherence to a strict interpretation of the convergence criteria on the part of the CSU, the FDP, and traditional western conservatives within the CDU, seems to be a fear that Kohl himself would allow the EU level criteria to soften, to accommodate a permanent shift in Germany from low deficit and inflation performance to higher deficits and inflation as the price of funding reconstruction in the new German states.[593] Instead, economic conservatives wanted to ensure that government dealt with the budget effects of higher public spending and tax expenditures, and of unemployment before entering a monetary union with relaxed criteria that could diminish the need for inflation and budgetary adjustment.

The insistence on promoting and defending stability at the European level that the CSU and FDP ensured, found popular support in the Bundestag, and in the enabling legislation for German EMU membership. Accordingly, the Bundestag kept the government on a short leash with regard to final approval for entering EMU. The enabling legislation

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[593] See, for example, Waigel fighting against line ministries in chapter two.

that ratified the TEU underlined the importance of the convergence criteria for German confidence in the EMU project. The Maastricht targets were entrenched in the enabling legislation in 1992 as a clear expression of the terms on which Germany would later accept partners in EMU. Furthermore, the Bundestag would have to re-affirm Germany's entry into EMU, after the European Commission, the European Monetary Institute and the German Bundesbank had presented complete assessments of each candidate country's performance, and made recommendations in favor of or against each country's membership.[594] Reports by the Commission and the EMI on the economic performance of potential EMU candidates were foreseen in the draft treaty as prerequisites to the final EU Council decision choosing the final list of members.

Once the Maastricht Treaty was signed, Germany insisted consistently at the EU level on a strict interpretation of the convergence criteria. The Kohl government never placed the inflation targets in question, and expressed confidence that countries with inflation-reduction ahead of them could and would meet the targets before the launch of EMU, despite persistent differences into the mid-1990s.

The German commitment to exchange rate performance (i.e. holding EMS parities for at least two years) also remained firm. The main exchange rate policy question was whether Germany should aid other countries in defending their exchange rates against the mark against speculative attacks. In these cases, relative inflation performance seems to have been a decisive factor in the magnitude of the exchange rate difficulties.[595] The exchange rate crisis of 1993 hit southern Europe hardest on account of its chronic inability to control inflation. Spain had to devalue the peseta three times and Italy had to leave the EMS altogether. The crisis also destabilized the franc in France, where public sector unions continued to extract large wage increases from the state, worsening both prospects for

[594] Conrad, Berndt, "Europa-Währung soll so stark wie die Mark sein," *Die Welt*, December 2, 1992.

[595] Although not the only one. In addition to inflation, political doubts about EMU's launch undermined confidence in the commitments of national governments to their exchange rates. The doubts were generated by two referendums. Danes rejected the Maastricht Treaty in 1992, and French voters accepted it, but with a razor-thin majority.

inflation and deficit spending. Furthermore, the franc suffered under weak commitment to economic reforms. The Balladur government's failure to reduce the national deficit as it had planned, combined with Chirac's ambiguous commitment to economic reforms during the 1995 presidential elections, and the Juppé government's confrontation with public sector unions at the end of 1995, renewed economic instability and led to another exchange rate crisis in 1995. The French experience, but also the lagging progress of Italy and Spain at fighting inflation, led to such public apprehension in Germany about the inflation criteria, that a weakening of Germany's demands was never even discussed. At the same time, however, the Bundesbank intervened to support the franc, where the government had already made considerable progress at controlling inflation.

Different internal commitments to low inflation within Germany underline the importance of political parties in organizing the electorate around a low inflation commitment during this period. Germany's traditional commitment to low inflation was strong in the old states of the Federal Republic, where it had always been strong, and which continued to form the political majority, with three quarters of the entire population. It also helped that two minority parties within the coalition which represented western voters almost exclusively retained an important influence over economic policy through their independent status and their control of the finance and economics ministries. In the new states, in contrast, emphasis was on increasing wages and state benefits to levels paid in the west. This emphasis on catching up with western living standards as quickly as possible resembled Spanish preferences much more than German preferences from the old states, but the overall political majority remained in the hands of western voters.

By late 1994, Germany began to pay more serious attention to EU progress at attaining the budget deficit criteria. This refocusing on the part of Germany reflected several developments. First, inflation rates appeared to be less of an issue with respect to membership. Most EU countries had converged their inflation rates by 1994 to ensure price stability, and no one in Germany expected that countries that were still battling persistent inflation, i.e. Spain, Italy and Greece, would have a chance at membership at any rate. Second, EU countries that had made the transition to low inflation, such as France, Belgium and Italy had done so at the price of a deep economic recession and high unemployment levels. The result was that budget deficits worsened considerably across the EU, attracting more attention and demands for spending reform.

The most conspicuous aspect of the German policy on deficit criteria was the enormous political symbolism that it generated for the German electorate after the TEU had been signed. Until EMU membership was agreed in 1998, the German government insisted repeatedly that they would exercise zero tolerance on the deficit criteria of 3.0 percent of GDP. Although reports continued to leak out in 1996 and 1997 that the government was prepared to accept countries with deficits up to 3.2 percent of GDP, public opinion had attached itself to the criteria as sacred, and the government could not possibly have publicly entertained even a mild relaxation of the criteria. The enabling legislation, which required the Bundestag to review national compliance across the EU with the criteria before proceeding with stage three, ensured that a public display of the government's position would be unavoidable.

The criteria also constituted the central argument against an early monetary union, or even a mini-union between France and Germany, as discussed in 1993 and 1995. Waigel stressed that the criteria had to take priority over the schedule.

Ultimately, the deficit criteria took precedence over the schedule as well when the prospect of delaying monetary union was discussed publicly. Gerhard Schröder, while campaigning to lead the SPD in 1995, criticized the government's hasty approach to realizing monetary union, drawing attention to the lack of progress in meeting the criteria, and calling for a later launch, when European economies had recovered.[596]

In 1996 and 1997, the German government persistently rejected pressure from Spain, Italy, and then from France's Jospin government to relax the deficit criteria. In all of these cases, the affected governments argued that they needed more time to recover from the effects of the recession. High unemployment and slow growth continued to depress tax revenues and increase costs, making budget cuts extraordinarily painful. During a 1996

[596] Norman, Peter, "SPD fails to find one voice on Emu," *Financial Times*, November 15, 1995.

election campaign, the Spanish finance minister promised to fight for a liberal application of the convergence criteria for EMU membership, considering Spain's relative poverty within the EU.[597] Germany's resolve proved convincing enough to crack the alliance and end discussion of weakening the creature. Even the Gonzales government in Spain, knowing the potential cost of retreating on its campaign pledge, felt compelled to adopt an official defense of the German position, and bolster confidence in its own ability to meet the criteria. In a surprising move, the Gonzales government went so far as to publicly chastise the Italian government of Romano Prodi, after he argued that the entrance criteria should be set aside to allow Italian membership in EMU.[598]

The only criteria on which the German government was willing to compromise was that of national debt levels. In part, this willingness to compromise prevented a diplomatic embarrassment within the European Union. The debt levels would have automatically disqualified Italy and Belgium, two long-standing members of the European Community with debts in excess of 120 percent of GDP. Even massive sales of central bank gold reserves (Belgium alone sold 140 tonnes of its reserves during the 1990s) had not brought the countries within range of the 60% of GDP target. By the end of 1997, however, they had made significant enough progress on inflation rates and exchange rate stability to support their claim that the EU should admit them on the basis of the Maastricht Treaty's provision to admit prospective members on the basis of 'significant progress' toward the convergence criteria. Rejection on the debt criteria would have been considered a slap in the face after the countries had submitted themselves to the pain of an austerity program. Being shut out could also have undermined the political capital that governments in the two countries required to continue with institutional and policy reforms to ensure future compliance with the criteria.

The prospect of allowing Belgium or Italy into the monetary union met fierce resistance from German voters that showed up in the German position on enforcing the full

[597] Potthoff, Christian, "Madrid und Lissabon gibt es nur im Doppelpack," *Handelsblatt*, December 31, 1996.

[598] "Spanien läßt sich nicht vom Euro abdrängeln," *Tageszeitung*, February 7, 1997.

set of criteria. German commentators referred to the Italian case in particular as a 'horror scenario', since the country in 1996 continued to suffer from political and financial instability, despite painful reform efforts. The attempts of the Italian finance minister. Campi, to pass off sales of gold reserves as a deficit reduction in 1997, among other measures, worsened the credibility of its commitment to the targets set out in the TEU,[599] as did Prime Minister Prod.'s repeated calls for the EU to set aside the criteria all together. The last of these calls came as late as December 1997, when Italy had no opportunity to improve its performance for the qualifying year.[600] Belgium had a different card to play. It would have been an embarrassment for the EU for monetary union not to go ahead in its own capital city. The German position was supported by another gatekeeping country the Netherlands, in which members of the coalition government threatened to take the country out of the EMU project if Italy were admitted.[601] The deadlock was broken just a week before members were to be selected for monetary union in May 1998. The German government was willing to allow Italy and Belgium into the monetary union, provided that they made the other criteria, and that they committed themselves publicly to reducing the national debt. This was the Stability Declaration, discussed below.

Overall, the Kohl government's positions on inflation, debt and deficits had more to do with the domestic political consequences of various terms of membership than it did with the merits of the criteria themselves. Voters feared the consequences of rules on membership, and of membership on stability enough to constrain government in many instances. Where the government felt compelled to follow another path, as in the case of considering the debt criteria, it took great pains to reassure voters with extra public commitments from potential EMU members. This is particularly evident in the German government's insistence on highly visible, contractual commitments among EMU

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599 Oldag, Andreas. "Italien schmückt sich für den Euro." *Süddeutsche Zeitung*. February 7, 1998.

600 "Italienischer Unmut gegen «Neun bis Elf» Formel." *Neue Zürcher Zeitung*. December 11, 1997.

601 Münster, Wilfried. "Den Euro bitte ohne Italien." *Süddeutsche Zeitung*. January 15, 1998.

participants to make every effort to ensure that periodically high deficits and debts would be reduced and controlled. These superfluous additional agreements were necessary for the government to sell voters on the use of the 'progress clause' within the TEU, that allowed for exceptions to a strict application of the membership criteria.

France

France's policy on membership shared Germany's preference for stability-oriented criteria. Unlike their German counterparts, successive French governments viewed the convergence criteria as guidelines for assessing which countries' economies had converged sufficiently to permit a monetary union, rather than as stringent performance requirements. This viewpoint was apparent during negotiations over how EU countries would be selected for EMU membership. France insisted that EU governments collectively retain the political discretion to grant membership to countries that had either come close to meeting the criteria, or were making 'significant progress' toward those goals.

France fully supported the low inflation rate targets of the Maastricht Treaty. Its domestic commitment was also firm. Both socialist and conservative governments had been using monetary policy to fight inflation since the mid-1980s, with success. Private sector prices were under control throughout the 1990s, although public sector wage settlements continued. However, privatization during the mid-1990s helped to contain the broad economic impact of these increases. Even the Jospin government, which had been elected on a promise to stimulate jobs and growth, never endorsed inflation as a suitable price for social gains.

The strong economic and social policy implications of EMU's membership rules contradict the hypothesis that France promoted monetary union in order to loosen the hegemony, and conservativeness of the German central bank. The line of reasoning, which follows President Mitterand's personal preferences but not the actions of the French government, emphasizes that France found German monetary policy too restrictive and wanted to loosen it. Following this argument, the French stance on monetary union should have led to a more growth-oriented monetary union, with a less inflation-oriented European Central Bank. Instead, it supported membership rules that placed even more restrictions on government spending than existed under the EMS. In fact, the French government, in conjunction with the Dutch government, had proposed the convergence criteria that found their way into the treaty.[602] The French government's support for a conservative monetary union is further emphasized by the fact that France had the opportunity to use its veto on German reunification in 1990 to dictate more growth-friendly terms for the EMU criteria and the ECB. Given France's negotiating advantage, the simplistic proposition that EMU and the ECB were designed to weaken the Bundesbank and replace it with a less conservative institution is unbelievable.

The liberal approach to the convergence targets reflected the difficulties that France had in meeting them domestically. Until 1995, Socialist and Conservative governments were unwilling to adjust public spending commitments to reflect lower levels of economic activity after 1990. They counted on economic recovery and marginal savings to improve economic finances. They gave the sense that stability and reform were important, but not important enough to be critical. Rhetorically, French governments favored low budget deficits and did not suggest loosening the deficit criteria until the Jospin government took office in summer 1997. In reality, however, they made no serious effort to cut spending until 1995. This timidity reflects a bleak economic situation, a series of attacks on the currency, and the prospect of elections in 1993 and 1995. Neither the Cresson nor Bérévogoy governments (1992-1993) were in office long enough to attempt an overhaul of government finances. They sought to compress the budget by realizing efficiency gains in French administration. In addition, each was preoccupied with a deep recession and a currency crisis that posed a significant threat to the franc's exchange rate. The turbulence of this period led to the first prospect that France would abandon the criteria and push for an early monetary union without having met the convergence criteria, or at least a mini-union with Germany.

The Balladur government (1993-1995) was committed in principle to the deficit

[602] "Der Termin steht im Vertrag," *Der Spiegel*, December 2, 1996.

criteria and made the first concrete proposals to restrict spending. With the prospect of running for President in 1995, however, Balladur was unwilling to impose savings plans when public sector unions, who would have lost most under the plans, led protests against them. Budget reform measures gave way to tax expenditures designed to promote economic growth. Balladur's later statements indicate that he viewed the criteria as guidelines, emphasizing that they were not 'holy.'[603]

The Juppé government, appointed under President Chirac from 1995 to 1997, was the only French government that unequivocally both accepted the sanctity of the budget criteria and undertook spending cuts in order to fulfil them. Juppé not only insisted that the criteria remain intact, but focused domestic attention on the goal of meeting the criteria without condition. Of course, Juppé also had difficulty implementing cuts in the face of public sector union resistance, but held his course, with presidential support, until his electoral defeat in 1997. Chirac reinforced the Juppé government's line on strict interpretation by supporting the separation of countries that had met the criteria from those which had not. He explicitly demanded a two-speed monetary union that would protect the criteria at the Turin Intergovernmental Conference in March 1996.[604]

During the course of 1996 and 1997, the increasing thinness of the internal agreement in favor of a stability-oriented economic policy began to show in both of the main coalition parties in the National Assembly, the RPR and the UDF. Giscard d'Estaing's call for an end to the restriction policy, downplaying the criteria in favor of rejuvenating growth through a lower exchange rate and interest rates, carried a great deal of weight, given his central role in establishing the EMS, and given his previous support of EMU. By early 1996, Juppé's foreign minister was calling for the criteria to be set aside to make room for 'French

[603] "Kritische Stimmen zum Rendezvous 1999," *Handelsblatt*, January 29, 1996.

[604] "Paris drängt auf ein prägnantes Gesicht," *Handelsblatt*, March 27, 1996.

interests',[605] as was the industry minister.[606] In this light, Chirac's 1997 election call was as much to ensure that the government and caucus supported a commitment to the convergence criteria as it was to bolster support from the general public. This underlines the manner in which public discontent filters up through elected representatives to have an impact on economic policy and EU policy priorities. During the 1997 election, both RPR and UDF were too divided on the criteria and too fearful of a public backlash to mention the convergence criteria in their platforms.[607]

The 1997 National Assembly elections confirmed the weakening support among the voting public for the budget criteria in the Maastricht Treaty. After Juppé failed to attract majority support in the first round of elections, Chirac dropped his support for Juppé and the policy of hard convergence that the election had been meant to legitimate. Instead, the surprisingly strong performance of the Socialist Party forced a shift in EMU policy. During the runoff elections, Chirac threw his weight behind Philippe Séguin, who had led the right wing of the RPR in opposing both a restrictive monetary policy and hard EMU convergence criteria. With this move, the French alignment on monetary union moved decisively toward a relaxed view of monetary discipline within EMU, and a more urgent desire to promote growth.

Lionel Jospin defeated the Juppé government on the latter's desire to interpret the Maastricht criteria strictly, and to impose a restrictive budgetary policy to achieve that goal. In contrast, Jospin was elected on a set of promises to spend money to alleviate poverty and increase employment. After the election, Jospin underlined his mandate to oppose the Maastricht criteria that had formed the centerpiece of the campaign, and the strength of his own mandate over President Chirac's.[608] Shortly after the new government had been sworn

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605 "Streit in der französischen Regierung über die Währungsunion." *Frankfurter Allgemeine Zeitung*, January 27, 1996.

606 "Kritische Stimmen zum Rendezvous 1999." *Handelsblatt*, January 29, 1996.

607 "Euro spielt im Wahlkampf kaum eine Rolle." *Süddeutsche Zeitung*, May 20, 1997.

608 "Jospin weist Kritik Chiracs zurück." *Frankfurter Allgemeine Zeitung*, July 18, 1997.

in, Finance Minister Strauss-Kahn fired the first shot by announcing that France's budget deficit for 1997 would be no less than 3.6 per cent of GDP, with full knowledge that 1997 was the qualifying year for EMU,[609] thereby challenging Germany's position. At the same time, Jospin attempted unsuccessfully to form an alliance with Spain and Italy against Germany that would demand a relaxation of the convergence criteria for EMU membership. The alliance was meant to upgrade solidarity between rich and poor, and employment and growth ahead of stability concerns within monetary union. The Jospin government only accepted the deficit targets after German refused to consider the alterations.[610]

The most direct attack on the deficit criteria, and the most striking link between electoral politics and conflict at the EU level was a concerted attempt by Jospin to construct a coalition in favor of loosening the criteria against Germany and her allies. Jospin led a public campaign during and after the election to promote membership for Spain and Italy, whether or not they had fulfilled the criteria.[611] The political principle of solidarity and a more growth-oriented monetary union was the goal.

France had no overt objections to the convergence criteria for total public sector debt levels. Correspondingly, France was one of the few countries that managed to enter monetary union within the reference target of 60 percent of GDP. The criteria itself never managed to arouse public attention in France as it had in Germany. Implicitly, France's support of a two-speed monetary union supported the debt criteria. Until Jospin's lobbying for Italian membership in 1997, there was no attempt to support setting the debt criteria aside.

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609 "Frankreich kann Defizit-Kriterium nicht erfüllen. *Frankfurter Allgemeine Zeitung*, June28, 1997.

610 Graham, Robert, "France claims budget victory," *Financial Times*, November 20, 1997; "Careful with the purse strings," *Financial Times*, December 10, 1997.

611 "Sozialisten fordern für die EWWU Solidaritäts- und Wachstumspakt, *Handelsblatt*, December 17, 1996; "Euro spielt im Wahlkampf kaum eine Rolle," *Süddeutsche Zeitung*, May 20, 1997.

Spain

In Spain, both the Gonzales and Aznar governments adopted EMU membership policy that tied the principles of stability and social solidarity. The TEU's emphasis on inflation control and budget reform dovetailed nicely with the Spanish attempt in the 1990s to accelerate reform of the economy and public finances in the effort to attract foreign investment. In turn, both governments justified economic and budgetary reforms to voters as the first steps toward attracting investment, creating jobs and revitalizing a national economy that had been showing disappointing growth and employment since the beginning of the 1990s.[612] Furthermore, the Aznar government, which undertook extensive budget reform in the run-up to EMU member selection, explicitly continued the Gonzales administration's decision to link its commitment to stability-oriented convergence criteria to fiscal transfers from the EU to poorer member states that would make possible a wide EMU membership.[613]

Spain's emphasis on trading development funds for a stability commitment extended beyond the 1991 negotiations on the Maastricht Treaty. It came out later in 1997 when governments began discussing the EU budget plan for 2000-2007. The Aznar government not only rejected an attempt led by Germany and France to reduce the EU's structural development fund as a violation of the 1992 Edinburgh guidelines for managing structural assistance,[614] but demanded that the fund receive even more money than before.[615]

Alongside Spain's position on transfers, its actual intentions on the application of membership seem to have been far more flexible than its official position supporting hard interpretation. Several sources report that Spanish delegations to the EU began arguing in

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[612] Instituto de Estudios Fiscales. *La Armonización Fiscal en la Unión Europea.* Madrid: Hacienda Pública Española. 1997.

[613] Ibid.

[614] "Der Sparkurs stößt in der EU auf Widerstand." *Frankfurter Allgemeine Zeitung*. July 25. 1997.

[615] Potthoff, Christian. "Madrid stellt Aufstockung des EU-Etats zur Diskussion." *Handelsblatt*. July 15. 1997.

1996 and 1997 that Spain should be admitted as a member on the power of the TEU's 'good progress' clause, based on receding inflation and interest rates, and a declining deficit.

Furthermore, Gonzales' finance minister, Miguel Boyer, outlined a position on membership that closely resembled the French strategy. Boyer emphasized that EMU membership would facilitate full economic convergence after the launch of monetary union by removing all doubt in about the permanence of the government's commitment to price stability and low deficits. This in turn would give the government more negotiating power on outstanding issues that were dragging on the Spanish economy and state finances, such as labor market reform, and free it from the exchange rate pressure of international currency markets[616] that could derail reform efforts financially or politically.

Spain's public support for a strict application of the membership criteria was strengthened by the fear that Germany would oppose membership for southern European countries in order to preempt a backlash by German voters over the government's EMU policy. Therefore, it was important for the Spanish government to emphasize its commitment to price stability. Certainly, there were good reasons for Germany to doubt this commitment. Spanish inflation rates and budget deficits were extraordinarily high until 1996, and not close to the criteria until 1997. The only way to pre-empt a pre-judgement of Spain's candidacy was to foster as much outward confidence in the government's reform policies as possible.

Given Spain's instrumental and flexible support for the membership criteria, the Aznar government's decision to support a strict application of the convergence criteria in 1997 can be better explained by EU-level factors than any domestic source of influence. In particular, Spain's support for strict interpretation was enhanced by fears that France and Germany would shut out the entire southern rim of the EU, whether or not Spain had reached the criteria. Of course, this would have undermined the government's economic and European policies. This led the Spanish government to demand repeatedly, both in public and personally to the French and German governments, that the convergence criteria in the

[616] Interview, "Seid vernünftig, vertagt den Euro!" published in *Die Zeit*, January, 1996.

Maastricht Treaty be respected as the sole measure of suitability for membership.[617] Thus, while the government would have preferred a flexible interpretation of the criteria, its ability to emphasize this point was circumscribed by the difficulties that other southern rim countries were having, and the response of the EU's richer members.

The reason that France and Germany were considering such an option revolved around the politically difficult question of Italian membership in EMU. Even through mid-1997, Italy was widely expected to fail the convergence criteria for EMU by a broad margin. Although inflation had been controlled, the exchange rate had only been stable since the end of 1996, the budget deficit was still huge, and the government's attempts to reform spending commitments kept failing. Italy's attempt to force the EU to abandon the convergence criteria in favor of a political decision for membership created a nightmare for Madrid. The predictable refusal from Bonn and Paris was accompanied by rumors that the EU's 'Club Med' countries, (Italy, Spain, Portugal, Greece) would be forced into the EMS II system, whether or not they had met the criteria. This was considered a means of preventing Italian humiliation within the EU over monetary union.[618] Rome repreatedly emphasized that as a founding member of the EEC in 1957, it had to be in the group of countries that launched EMU. The embarassment of not qualifying would have been emphasized if more recent EU members qualified and Italy did not. Therefore, Spain had to fear that EU politics could shut the country out, even after qualifying, and undermining the government's justification for economic reforms.

In this context, the strength of Spanish government fears about the reaction of the German government to any suggestion of tampering with the membership criteria is demonstrated by the Spanish Finance Minister's concern that even the French proposal for a stability council would open the door to looser criteria for the euro zone.[619]

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[617] Burns, Tom and David White. "Spain aims for big cut in deficit." *Financial Times*. April 4, 1997.

[618] Potthoff, Christian. "Der Euro rückt für Spanien immer näher." *Handelsblatt*. March 17, 1997.

[619] Burns, Tom and David White. "Spain aims for big cut in deficit." *Financial Times*. April 4, 1997.

The membership criteria debate reveals three distinct patterns, all of which were determined by voter concerns and the politics of convergence reviewed in chapters two, three and four. Hard convergence before EMU membership was a condition for German participation. A liberal interpretation of the convergence targets proved politically important for France, and particularly for the Jospin government. A liberal interpretation was also preferred by Spain, which demanded financial transfers in addition, to make it possible to meet both the convergence criteria and domestic expectations to promote economic growth.

In sum, Germany, France and Spain had differing positions on the convergence criteria for monetary union that reflected their domestic capacities to reach them and their overall needs from the EMU project. Germany did not have an easy time meeting the membership criteria, but this can be attributed to dealing with the effects of reunification, and the political will existed nevertheless to implement reforms at home and insist on them abroad.

France also signed the TEU with the perception that the criteria were reasonable and fulfillable. Had the country not attempted to conduct the reforms while keeping the exchange rate against the German mark unreasonably high between 1992 and 1994, reforms could probably have been undertaken with a great deal less unemployment and considerably stronger economic growth and tax revenues. The unemployment and the pain of even further cuts ultimately led to the collapse of the center-right coalition and its commitment to restrictive membership criteria. As we shall see below in the section on the timetable for monetary union, it was the French governments' strong desire to attain a monetary union as quickly as possible that led to this painful course of events.

Spain, in contrast, had a limited set of diplomatic cards to play, with which it could gain access to development funds. Not only did Madrid hold up EMU in return for development funds, money from the EU and economic restraint became irrevocably linked for Spain, both domestically and at the EU level. Domestically, EU development and social funds were supposed to compensate for the pain of restructuring and restraint. At the EU level, Madrid was only too aware that the flow of money, principally from Germany, depended strongly on Spain dispelling any doubt of its commitment to meeting the criteria, and on publicly supporting their strict application.

5.3 EMU's Timetable

The timetable for monetary union reflects the growth-stability cleavage by forcing a choice between criteria performance and the simple desire to establish a monetary union quickly. Unlike a strictly criteria-led decision on EMU membership, a scheduled monetary union's orientation to stability or growth depends on the degree of latitude exercised in selecting participants at a given point in time.

In the EMU project, there were three issues of contention that revolved around its schedule. The first issue was whether there should be a firm deadline to proceed with monetary union. This was settled to France's satisfaction in the Maastricht Treaty. All countries were committed to begin with the process of introducing economic convergence with the beginning of stage two, which would begin no later than January, 1994. Stage three would begin no earlier than two years after the beginning of stage two, but no later than January 1999.

The final result bore Germany's stamp as well, however. The convergence criteria would be used to select members for 1999. France's agreement is exemplified by the fact that none of its governments, until Jospin in 1997, dropped its public commitment to a two-speed monetary union that would preserve the integrity of the membership criteria.[620]

The second issue was whether EMU should be delayed beyond 1999 if EU countries could not fulfil either the legal (convergence criteria fulfilled by a majority of countries) or political requirements (either France or Germany failing to meet the criteria) of launching it. This issue was rendered moot by an economic upswing in 1997 that allowed most EU countries to fulfil the membership criteria on both inflation and deficits.

[620] For an account of the negotiations before conclusion of the TEU, see, Michael Baun, *An Imperfect Union: The Maastricht Treaty and the New Politics of European Integration*. Boulder: Westview Press, 1996, p. 60-75.

Finally, in between the signing of the TEU in 1992 and the selection of members in 1998, French and Belgian commentators brought up the prospect of an accelerated or early EMU, with only limited consideration of the convergence criteria. This was settled to Germany's satisfaction, with a decision to emphasize domestic reforms and criteria performance until the 1999 deadline, and to reject both a mini-union with France and an early monetary union, along Belgian proposals.

EMU was designed to proceed in three stages, of which only the last two contained serious challenges or points of contention for prospective members.[621] The tasks reflect German requirements first and foremost, with stability guarantees in mind. Deviations from the original plan serve as a good indicator of a country's commitment to prior convergence. In stage two, prospective members were required to establish independence for the national central bank and to demonstrate compliance with the membership criteria for no less than two years before proceeding with the third stage of monetary union.

In practice, stage two demanded a sweeping package of economic, institutional, and constitutional reforms for most prospective members. They had to amend their constitutions to accommodate new laws establishing political independence for their central banks, sole central bank authority for monetary policy, and a specific central bank mission to promote price stability. Amendments were also required to integrate national central banks into the ESCB - the European System of Central Banks - through which they would participate in the workings of, but also be subordinated to the ECB.

In addition, the work of reducing budget deficits forced governments to decide who would pay for adjustment during stage two. For governments striving unsuccessfully to bring the budget deficit within three percent of GDP, the certainty of a commitment to EMU meant that it would be impossible to avoid tough decisions about *how* to contain inflation and public spending. Committing to a stability-oriented monetary union therefore kept up the pressure on domestic constituents to accept a stability-oriented monetary policy and budget cuts at some point in the future. However, for frustrated governments trying to

[621] For an overview, see '*When will the 'Euro' be in our pockets?*" 2nd ed. Brussels: European Commission, 1997.

achieve durable stability, the prospect of remaining indefinitely at stage two until reforms were completed was less attractive than limiting its stage two's duration (regardless of the success of reforms) and introducing common mechanisms of monetary union as quickly as possible. For governments sure of their own capacity to adjust, stage two was the crucial test of whether government, voters and societal actors would accept the adjustments at all. Therefore, the length of stage two and the presence of a firm time limit have distributional consequences, both within prospective states and among them.

For countries like France, which were undertaking politically controversial reforms of spending commitments, an early monetary union, or one launched ahead of full convergence would have facilitated and likely shortened the reform process. In addition to setting monetary union goals, it was also designed to end pressure from international currency markets on national interest rates, and as a consequence, shore up the credibility of a political difficult reform program.[622]

Another important advantage for promoters in pursuing monetary union quickly lies in relieving pressure on national reform efforts from international currency markets (the cost of interest rate increases that follow market sales of financial assets denominated in the national currency), since a currency devaluation can undermine the credibility of a stability-oriented policy. The incentive for an early monetary union is particularly high when the country has already experienced significant success at controlling the exchange rate, but when uncertainty persists over the government's political commitment to continuing its economic policies. If circumstances reach this point, as they did in France from 1993 onward, then the national currency, and the legitimacy of the government's economic policies, are more vulnerable to disruption than at any other point. The next paragraph explains how this happens.

International currency and security markets compound the political difficulties of adjusting inflation rates and spending programs to the requirements of price stability by speculating on the currency's future value. Speculation only pays, however, if there is a

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[622] "Historischer Irrtum," *Wirtschaftswoche*, January 1, 1993.

doubt about the future commitment of public authorities to price stability and a stable exchange rate. Ironically, the importance of political commitment to international currency markets rises as the country attains more success in controlling inflation and deficits. That is to say, the impact of faltering confidence is much larger. This happens because investors and speculators hold more currency and financial instruments denominated in the country's currency as its stability increases.[623] If they flee the currency at a later date, it is more difficult and more costly to prevent an exchange rate collapse than it would otherwise have been. This makes a subsequent monetary union a valuable stabilizing element in the final stages of a tough domestic reform program, such as a typical promoter profile would be undertaking. In the realm of domestic politics, it would also prevent a rebuke of the government's austerity efforts to date. This scenario reflects the problem that France, among other countries, was facing in 1993 and 1995.

Stage three marks the end of the convergence process for monetary union, and the beginning of monetary union proper. In the EMU case, the third stage is divided into three sub-stages. In stage 3A, the member states are chosen, exchange rates fixed, the European currency is made available for the banking system, and the ECB begins managing European monetary policy in conjunction with national central banks, which become members of the European System of Central Banks. Exchange rates are fixed permanently and intervention among euro-zone currencies ends. In stage 3B, private and public sector actors prepare for the transition to the single currency. In the final stage, the new currency replaces national currencies as legal tender. The entire process takes place from January 1, 1999 to July 1, 2002.

Early discussions on the timetable for EMU took place as early as 1990, and extended through 1991. At this time, the French government was determined to set a date at which monetary union would begin, regardless of the progress reached in achieving the

[623] This was the case for France as well. See William Dawkins, "French franc pays price for partnership with D-Mark," *Financial Times*, September 29, 1992.

convergence criteria.[624] In addition, it was clear that France was in a hurry to establish the European Central Bank. According to its original plans, supported by the European Commission, the European Central Bank would have been erected at the beginning of stage two, after which national governments would continue the process of consolidating their inflation rates and government deficits.

In wake of the currency crisis of 1992, a series of French commentators began suggesting that France and Germany establish a monetary union between the two countries as a precursor to EMU. Essentially, it would have institutionalized the cooperation between the two countries' central banks that had preserved the exchange rates of the franc and the mark in previous months. According to an unnamed French official, the government never seriously considered such a move, expressing concern that "secret agreements" could cause a backlash.[625] Since there was no public concern in France about defending the franc's exchange rate, however, it is likely that the official had a German backlash in mind that would scuttle any mini-union. The Bundesbank, for its part, responded sharply and quickly that it would organize opposition to any proposal that would set up the European Monetary Institute as an institution to protect exchange rates artificially.[626]

The centrality of the ECB's function as a shield against speculation on the French franc was emphasized when the French government, after agreeing to the establishment of the European Monetary Institute during stage two rather than the ECB, pushed for the EMI to acquire "its own capital reserves and an independent role in foreign exchange intervention."[627] Germany rejected this option out of hand out of fear that intervention

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[624] For an account of the negotiations before conclusion of the TEU, see, Michael Baun, *An Imperfect Union: The Maastricht Treaty and the New Politics of European Integration*. Boulder: Westview Press, 1996, p. 60-75.

[625] Fricke, Rolf, "Ein Schulterschluß mit Bonn und Frankfurt geplant." *Handelsblatt*, April 19, 1993.

[626] "Bundesbank zeigt ECU kalte Schulter." *Süddeutsche Zeitung*, April 10, 1992.

[627] Baun, Michael, *An Imperfect Union: The Maastricht Treaty and the New Politics of European Integration*. Boulder: Westview Press, 1996: 66.

without prior national reforms could lead to an uncontrolled expansion of the European money supply.[628]

Germany, supported by the Netherlands, resisted the imposition of a firm deadline for the third stage of monetary union, but eventually traded agreement to a deadline for the prospect of a two-speed monetary union that would shut out countries that had not met pre-set criteria. On principle, convergence had to come before the schedule.[629]

If the criteria were met, however, stages two and three could be launched in advance of the final deadlines for the stage in question. France consistently did what it could to ensure progress through the stages as quickly as possible. Based on the supporting evidence below, it can be concluded that France wanted the ECB established as quickly as possible in order to shield itself from external shocks during the reform process. Given France's failure to achieve the establishment of the ECB during stage two, the second best option was to push for an early launch of stage two, followed two years later by the launch of stage three. This option was less than some public opinion leaders were suggesting, but as much as the French government could manage to achieve within the terms of the TEU.

Within the terms of the Maastricht Treaty, France's speediest option lay in launching stage two in 1993, instead of 1994, with stage three beginning in 1995. This was the first possible opportunity, considering the scarcity of time within which to ratify the treaty, overhaul public finances and undertake the statutory and constitutional reforms necessary to ensure independence of the national central banks.

Its second option was to proceed with stage two as scheduled in 1994, and then to seek a launch date as quickly as possible thereafter, from 1996 onward. In January 1995, Balladur's Finance Minister Edmond Alphandéry announced that the government would use the country's upcoming Presidency of the European Union to promote achievement of the

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628 Ibid.

629 Ibid: 74-75.

third stage of EMU by 1997.[630] Given the upcoming elections for the French Presidency and Balladur's lack of success at reforming public spending during his tenure as Prime Minister under President Mitterrand, Balladur's open discussion of a rapid monetary union can be interpreted as an appeal for a mandate to proceed rapidly. His enthusiasm for rapid reform at home, however, was not terribly contagious. Balladur did not win support from the RPR to run as the party's candidate. In addition, Bundesbank President Tietmeyer publicly judged the proposal as unrealistic three months later, based on the poor prospects for holding to the convergence criteria.[631]

German reunification proved to be as much an obstacle to France proceeding rapidly with monetary union as was opposition to internal reforms. In particular, France had to maintain the exchange rate to the German mark within the bands of the EMS for two continuous years before it could consider beginning with the third stage of monetary union. In light of Germany's high interest rates and appreciating currency, France was faced with choosing between devaluing the franc against the mark, which would have made more economic sense as well as pleasing the business community,[632] and maintaining the exchange rate in order to keep the chances open that stage three of monetary union would not be pushed further into the future.

An additional reason for committing publicly to the existing exchange rate was the fear that international currency markets would make a controlled devaluation against the mark impossible. Thus, Giscard d'Estaing of the UDF warned that the EMS would collapse entirely under the weight of speculative sales once Paris and Bonn opened up the parities.[633] This would have undermined the disciplinary (anti-inflationary) effect of the exchange rate.

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630 "Frankreich will Währungsunion 1997 verwirklichen," *Frankfurter Allgemeine Zeitung*, January 16, 1995.

631 "Das Zieldatum 1997 halte ich für unrealistisch," *Neue Zürcher Zeitung*, April 15, 1995.

632 Ridding, John and Alice Rawsthorne, "Franc faible could fortify the French," *Financial Times*, August 3, 1993; Dominique Gallois and Martine Orange, "Les industriels français redoutent surtout la faibless du dollar," *Le Monde*, March 8, 1995.

633 "Historischer Irrtum," *Wirtschaftswoche*, January 1, 1993.

and shifted the burden on to higher interest rates, which would have damaged the economy even more severely.

There is evidence that the French government feared that international currency speculators would contribute to precisely this result. During the mid-1990s, the government repeatedly complained that speculative pressure on the French franc was not based on economic fundamentals, but on a type of casino-type speculation on how far down speculators themselves could collectively force down the exchange rate. The work that the French government had done to force inflation down and bring the budget deficit under control had been a success, but was being ignored by the markets. The result, they emphasized, was that the franc was being attacked unfairly, and that the country was being forced to pay interest rates that were far too high, given the country's performance.[634] In fact, during this period, the French talked increasingly of the franc replacing the German mark as the "anchor," the hardest currency of the EMS. If the government agreed to a devaluation within the EMS, the financial markets would have an opportunity to define how far down the exchange rate would be pushed. At a certain point, the exchange rate and interest rates could be too low to keep inflationary demands in check.

The leaders of France's RPR-UDF coalition forged a delicate consensus between 1993 and 1997 in favor of a strong currency and monetary union at the earliest possible opportunity that supported the government's stance, despite misgivings among the party's nationalist members. Only the Juppé government's poor standing in the first wave of the 1997 National Assembly elections undermined this approach decisively, since Chirac had made the government's EMU policy the only real election issue. In preparation for the 1997 run-up elections, Chirac displayed the split in the party by putting forward both an economic liberal and a major opponent of EMU as part of the conservative team.[635]

634 For an overview of the franc's exposure, see William Dawkins, "French franc pays price for partnership with DM," *Financial Times*, September 29, 1992. See also "La bataille du franc," *Le Monde*, December 30, 1992. The same phenomenon occurred later in 1993 and again in 1995. See John Ridding, "French franc makes a comeback," *Financial Times*, December 11, 1993; James Cooper and Kathleen Modigan, "The Franc Fort is under siege," *Business Week*, January 30, 1995.

635 "Left and right attack Séguin-Madelin 'team'," *Financial Times*, May 30, 1997.

By 1995, French political leaders began calling for a delay of monetary union to allow economic recovery. Both Jacques Chirac, the RPR candidate and Lionel Jospin, the PSF candidate, pled for a delay during the 1995 Presidential election campaign..[636] The Socialist Party had already made the change from supporting the full slate of monetary union policies to rejecting them in 1994 with the ouster of Michel Rocard as party leader.[637] However, both Chirac and Jospin later withdrew their demands to delay EMU's launch. Chirac began stressing the importance of internal reform and the EMU deadline in December 1995, and continued to do so after Jospin's election victory in 1997.[638]

In sum, most European governments, and certainly the German and Spanish governments, preferred a delay of launching EMU, but submitted to French demands for monetary union sooner rather than later, at least until Jospin's election in late 1997.

5.4 The Stability Pact and the Stability Declaration

In 1995, the German government proposed a Stability Pact among EMU members that would strengthen their commitment to the deficit limits of the Maastricht Treaty after entering monetary union. The German government feared that other members might defect from the original agreement after accession. This fear was informed by public concern that the government had done too little during the negotiation of the TEU to prevent this possibility.

This public concern was fueled in turn by the inability of many European governments to meet the deficit criteria, with little time left before the final qualifying period. As a result, there existed a widespread belief within Germany that many other EU countries

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636 "Chiracs Kurswechsel erschüttert Vertrauen in den Franc," *Frankfurter Allgemeine Zeitung*, April 20, 1995.

637 Machin, Howard, "The 1995 Presidential Campaigns," in Robert Elgie, ed., *Electing the French President*. London: MacMillan Press, 1996, p., 35.

638 "Chirac will Datum und Bedingungen für den Euro respektieren," *Frankfurter Allgemeine Zeitung*, July 15, 1997.

were not able to make a durable commitment to low budget deficits and low inflation.

Germans had already rejected the idea of an EMU with members who could not commit themselves permanently to the criteria. They feared inflation most, but deficits were considered a sign of lacking discipline, and an indirect source of inflation itself. "Irresponsible" members of a monetary union could cause interest rates to rise to painful and unjustified levels in "responsible" countries. Alternatively, a large enough group of 'irresponsible' countries could undermine the ECB's commitment to stability altogether. After all, national central bank presidents would constitute the majority on the ECB's monetary policy council, and these could be chosen, they feared, with political agendas in mind.

The German government's solution was a set of automatic sanctions for 'deficit sinners' known as the Stability Pact. Its publicly stated purpose was to prevent EMU members from defecting from the Maastricht criteria.[639] In addition, the pact's terms could only deter countries with weak commitments to lowering deficits from attempting to enter EMU in the first place. The terms of the sanctions that Germany sought were so unacceptable to governments struggling with deficits that this motive must be considered.

Germany's decision to shift its demands for an adjustment-inducing mechanism from political union to the Stability Pact reveal the urgency to Germany of ensuring compliance with the convergence criteria. ECOFIN would have been able to oversee economic and social policies, identify the need for adjustment, and instruct a national government to take corrective action under the terms of the Maastricht Treaty. The original version of the Stability Pact would have replaced the uncertainty of the political process with the certainty of corrective action when certain limits had been reached. It would also have guaranteed punishment for defectors for the first time.

The pact focused on the deficit criteria. Most of the convergence criteria would no longer be relevant after monetary union had begun. Exchange rate and interest rate differentials would disappear. Inflation was only a contingent concern, having been under

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[639] Waigel, Theo, "Das Gipfeltreffen von Dublin hat den Durchbruch gebracht," *Handelsblatt*, December 31, 1996.

control in almost every EU country since 1995. The long term prospects for containing inflation depended primarily on restraining the spending habits of the monetary union's members. Here, most countries had to undertake reforms to ensure that they could not only limit spending but keep in down. Most countries had debt loads within manageable limits, with the exception of three countries that Germany did not seem to consider serious contenders for membership in 1996--Italy, Belgium and Greece.

The depth of Germany's concern was underlined by the somewhat absurd political implications of the proposal it made to the other EU states. Finance minister Waigel demanded that EU governments be forced to pay a fine, based on a percentage of GDP, if their budget deficits exceeded 3.0 percent of GDP in a given fiscal year. Furthermore, the penalty would increase with the extent to which the deficit had exceeded the benchmark.[640] This meant, in effect, that the EU would have made it policy to single out governments with difficulties controlling their budget deficits and make it even more difficult and painful to adjust spending commitments, when the time came.

Negotiations reached a head at the Dublin Intergovernmental Conference (IGC) in December, 1996. Germany lobbied for the full implementation of the plan, with the support of the Netherlands, while France objected to the plan's automatic sanctions. Unlike Spain or Italy, France did not oppose the convergence criteria as much as it refused to place the sanction mechanism beyond political control. In addition, it wanted allowances made to waive the criteria and adjustment pressure during periods of economic hardship. This reflects the Juppé government's desire to prevent the Stability Pact from making a difficult position even worse through sanctioning governments in trouble. Certainly, the French government could have imagined that it might also be put in this position given the strikes under way in France during the talks. It also reflects the government's attempts to balance spending restrictions with job creation measures, some of which could demand higher spending levels from time to time.

France won both of these concessions at the Dublin IGC. The Stability Pact was

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[640] "Der Streit um den Stabilitätspakt geht weiter," *Süddeutsche Zeitung*, October 12, 1996.

negotiated to allow governments to exceed the deficit benchmarks during a recession. In deference to German needs for some measure of certainty, EU governments spent a great deal of time discussing a quantifiable formula that would allow transparency in the process of allowing or sanctioning deficits in excess of three percent of GDP. They eventually settled on a figure that accurately reflected a "severe recession," a downturn of no less than two percent of GDP.[641]

In addition, sanctions would be applied only after a corresponding vote by ECOFIN, rather than automatically. France accepted the Stability Pact only as a guideline on future deficits, rather than as a binding rule in itself. Sanctions would not be automatic, but decided politically, in ECOFIN. They would also not come into discussion during periods of economic hardship. Thus the French government worked to ensure that the reinforcement of the criteria was given political support, while defanging the German proposal for automatic sanctions. The government rejected complaints from both the political right and left that the government was agreeing to entrench deflationary policies in France.[642]

The Stability Declaration, discussed throughout 1996 and signed in December, was also a German proposal, dealing with national debt levels rather than budget deficits. Just as Germany had been concerned about the admission of members who might disregard the deficit criteria into monetary union, it was concerned in 1998 about the possibility that pressure would build across the EU to admit countries with debt loads far in excess of the benchmarks set in the Maastricht Treaty. The circumstances that made such a prospect possible, discussed below, had not existed before the end of 1997, which explains the late emergence of the Stability Declaration proposal in 1998.

Even by the end of 1997, most experts believed that countries with high national debt loads would not be realistic candidates for membership in monetary union. This was because they also tended to have high deficits, and were expected to be shut out of the euro zone

[641] "In den Keller. *Wirtschaftswoche*, December 19, 1996.

[642] The comments came from Philippe Séguin and Charles Pasqua of the RPR, and from Laurent Fabius of the PS. See Lionel Barber, "Emu bandwagon gathers speed in Dublin," *Financial Times*, September 23, 1996.

before considering their debt levels.[643] This applied to Italy and Greece, while Belgium, with its equally high debt load, was considered a special case, both for its better, if not enviable success at controlling deficits, and for Brussels' status as the capital of the EU. Consequently, debt loads remained unimportant to the German government, and it did not propose any additional agreement on debt management.

Another significant reason for avoiding the debt issue was that most EU countries would have debt loads in excess of the benchmark by 1997, even Germany. Therefore, there was no incentive to open up the debt issue before Italian membership became an issue.

Italy's surprise success at meeting the deficit criteria created a political nightmare in Bonn when it became known in 1998 that could only be solved with the Stability Declaration. Rome claimed the right to membership, while France's Jospin government was inclined to support the claim, if not solidly behind it.[644] In addition, it would be impossible to shut out Italy solely on the basis of its debt load without also shunning Belgium and embarrassing the entire EU, even if there were doubts about the Italian commitment to low deficits. Meanwhile, German voters didn't want to belong to a monetary union that had Italy as a member.

Faced with the probability that Germany would have to accept Italian membership, and after meetings between the Italian and German finance ministers over the debt question,[645] Waigel pursued the Stability Declaration as a means of reassuring its own electorate about the stability commitment of the Italian and Belgian governments.

The substance of the Stability Declaration was that signatory governments would commit themselves to reducing national debt whenever it exceeded the 60 percent of GDP figure. The contentious implication was that governments would be committing themselves spending all surpluses on reducing the debt until the 60 percent limit had been attained, rather than dividing up the surplus at their discretion to pursue other political and economic

[643] "In den Keller." *Wirtschaftswoche*, December 19, 1996.

[644] "Italienischer Unmut gegen «Neun bis Elf»Formel." *Neue Zürcher Zeitung*, December 11, 1997.

[645] Oldag, Andreas, "Italien schmückt sich für den Euro." *Süddeutsche Zeitung*, February 7, 1998.

priorities.

The German proposition met resistance from France, Italy, and Belgium, even though the latter two had already handed the European Commission a written commitment to reduce their debt loads in exchange for being recommended for EMU membership.[646] All three governments, plus Spain and Portugal, insisted on the importance of retaining the political independence to manage their finances to the extent that the Maastricht Treaty did not already restrict them. The latter two governments went even further, arguing for more financial transfers from the European union instead to prevent the need for immediate cuts to the deficit.[647] At the end of the conflict, EU governments signed the Stability Declaration as a statement of intent rather than a binding commitment. The public relations value for Waigel had been achieved, however.

Like the Stability Pact, the Stability Declaration was technically superfluous. EMU members were committed to the debt criteria already through the Maastricht Treaty. For that reason, Germany's insistence on the Stability Declaration underlined the extent of German fear that partner governments would not be willing to respect their commitments after entering monetary union. Furthermore, it served to indicate to German voters that the admission of Italy and Belgium would not undermine the stability of the new European currency.

5.5 The Euro-X Council

In principle, European Union governments agreed from the beginning that they needed a political body to determine common economic policies for the countries participating in EMU. The TEU did not establish such a body or council, but mentioned that participating governments could form a special group to discuss matters of common interest. However, there was significant disagreement about its main purpose, its membership, and

646 "Empfehlung der Europäischen Kommission," *Frankfurter Allgemeine Zeitung*, March 26, 1998.

647 "Feiern für den Euro," *Der Spiegel*, April 27, 1998.

its political relevance in economic policy alongside the ECB.

The form, membership and powers of an economic council became embroiled in a larger debate about the extent that monetary union would focus on stability or growth. At stake were the future priorities of national economic policies, the guidelines of an economic policy for the entire European Union, and consequently, the degree of political independence that the ECB would enjoy. Proposals ranged from a council that would enforce the terms of the stability pact to an economic government that would actively guide ECB behavior within the limits of the price stability commitment, to an informal discussion group with no decision-making powers.

The disagreement over an economic government or council for the euro zone covered the extent to which an economic council would be responsible for formulating an authoritative EU-wide economic policy and whether it would decide by qualified majority voting. An authoritative economic government for the EU would have had powers far in excess of that which the Union had or has. Before the agreement for economic and monetary union had been established, EU-wide economic policies and their implications for social and labor policies were discussed primarily in two forums: the EU's Council of Economics and Finance Ministers (ECOFIN); and the Economic and Social Committee (ESC).

ECOFIN is the body in which European governments negotiate and coordinate economic policy for the Union, within a delimited scope. Had the Treaty on European Union included the provisions for political union as Germany initially desired, ECOFIN would have begun deciding economic and financial policies for the entire EU on the basis of qualified majority vote. However, when the German government developed its plans for a stability pact in late 1995, its plans for a council resembled a body whose sole mandate would be to oversee compliance with the pact and ensure corrective measures. With respect to the latter, ECOFIN would focus on ensuring adjustment of economic institutions that were generating excessive inflation, unemployment or deficits. Flexibility at the national level would be aided with more frequent and effective pressure from the European level, from which qualified majority voting would generate binding directives on economic policy for the first time.[648] Therefore, the Kohl government, and finance minister Waigel in particular, did not envisage a fully-fledged political union, but nevertheless one which would have intrusive powers to adjust national spending commitments and regulate national wage patterns.

Waigel's early insistence on EU responsibility for economic policy reflected the German belief that an independent central bank would be insufficient on its own to promote adjustment of spending and inflation in the individual EMU member states. It would also be necessary to ensure that political decision-makers had the will to undertake reforms when necessary, and to prevent protracted conflict between the political goals of national governments and the stability goals of the ECB, such as the conflicts continuing within France. Political union would make this possible by submitting the national commitment to outside scrutiny and outside demands for corrective action, if necessary. With stability buttressed institutionally (through the ECB), administratively (through the oversight function of the European Commission), and through a political process (ECOFIN's oversight and management function), Germany could be assured that defection from the stability commitment was unlikely, and that monetary union would prove to be a case of sustainable integration.[649] On the other hand, the political sensitivity of social and economic policies ensured that the German proposal had little support among its European partners.

Without the authority to make decisions through qualified majority on most aspects of economic policy, ECOFIN remained incapable of forcing national governments to adjust their policies in order to converge with the membership criteria of EMU. Nevertheless, ECOFIN remained the forum in which EU governments discussed compliance with the Stability Pact in the run-up to stage three of EMU. Intergovernmentalism and national sovereignty in the realm of economic policy remained largely intact, leaving responsibility for attaining the membership criteria for EMU in national hands.

The fact that ECOFIN did not develop into an economic government is all the more striking when one considers the heightened importance that economic policy acquired in the

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648 "Stabilitätsrat," *EU-Magazin*, April 1997.

649 Waigel, Theo, Das Gipfeltreffen von Dublin hat den Durchbruch gebracht, *Handelsblatt*, December 13, 1996.

Maastricht Treaty. The TEU continued with the Economic and Social Committee[650] and introduced the new Committee of Regions [651] as focal points for discussion about European economic policy. The Economic and Social Committee is an advisory body that allows employers, unions, farmers, consumer representatives and small and medium-sized business representatives to voice their positions on the development of European economic policy. In the 1980s, it was seen as a forum in which societal groups could monitor the impact of transition to a single market, and advocate measures to reduce friction or unintended consequences. In the 1990s, it advocated stronger solidarity between the EU's richer and poorer members. Under the terms of the TEU, it gained an advisory role on decisions taken in the Committee of Regions, which is responsible for advising the Council of Ministers on decisions covering investment through the Cohesion Fund to reduce inter-regional economic disparities and build inter-regional transportation and communication networks.[652]

Germany's support for political union was not preceded by electoral pressure. Voter fears that anything but an ironclad guarantee could undermine EMU's stability orientation led the government to drop its proposal and pursue the Stability Pact instead. In addition, by 1996, French proposals for a European economic government (below) were fueling renewed concern that political union would undermine the ECB's independence, and hardening German resistance to political union in economic policy. In contrast, the Stability Pact provided for less interference in national social and labor market policies (which were very politically sensitive), but led to the imposition of concrete controls and penalties as an alternative to the political negotiation and dispute settlement process.

Beginning in September 1996, around the same time as the Stability Pact was being negotiated, Jean Arthuis, the French finance minister, began proposing the establishment of a Growth and Stability Council, which would act as an economic government, responsible for deciding exchange rate policy and taking binding decisions on the EU's overall economic

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650 *Treaty on European Union*, Articles 193-198.

651 *Treaty on European Union*, Article 198a-c.

652 *Das Parlament*, April 8, 1994.

policy. The Juppé government was suffering from eroding public support for its budget reform agenda, was having trouble completing the membership requirements for monetary union, was under increasing pressure by voters and the unemployed to stimulate the economy, and was desperate to show that there was more to EMU than painful restraint. The proposal, if adopted, could have connected EMU to growth as well as stability in public discussion, and deflected criticism that EMU policy neglected the needs of the French population, as discussed in section 3.4. In addition to its proposals for an economic government for the EU the Juppé administration emphasized that the responsibility of national governments for the European currency's exchange rate in ECOFIN made economic government unavoidable in any event.[653]

However, German officials feared that an economic government with an explicit mission to promote growth and stability simultaneously could undermine the ECB's independence and its stability mission. Moreover, since the proposal had come from a country that was still struggling with the political commitment to low inflation and low government borrowing levels, the Kohl government feared that German voters would perceive the council as an attack on the ECB's independence, and lead to voter rejection of EMU.[654] The German government took some time to reject the proposal, and only after the coalition's smaller and more conservative members the CSU and FDP, along with the Bundesbank, announced that they fundamentally opposed the proposal as a potential attack on the ECB's independence. These parties were least willing to risk voter backlash against the proposition.

The German government's paranoia with regard to the Euro-X Council was emphasized publicly on several occasions, when critics pointed out that the Bundesbank, despite its relative independence, was also required to operate within the parameters of the government's economic policy. The French proposal, in effect, would have re-created the relationship between political authority and the ECB that existed between the Bundesbank

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[653] Klau, Thomas, EU-Konsens über Stabilitätsrat zeichnet sich ab," *Börsen-Zeitung*, December 24, 1996.

[654] "Stabilitätsrat," *EU-Magazin*, April, 1997.

and the German government. Nevertheless, voter fears, buttressed by the Bundesbank's opposition to the idea of a European economic government, hardened the government's determination to ensure that the Euro-X council remained informal and without any powers.

After Lionel Jospin's socialist coalition replaced the center-right in the 1997 National Assembly elections, it renewed pressure on Germany to accept an economic government for the EU, but with even more emphasis on stimulating the European economy and job creation. It proposed a 'Growth and Solidarity Council' that would be responsible for boosting employment and social welfare across the EU by setting the economic policy context within which the ECB would operate.[655] The proposal made no mention of the ECB's stability mission, and reinforced the Jospin government's initial intent to demand a liberal interpretation of the EMU membership criteria to permit France, Italy and Spain to join with less restraint. This stance was consistent with the electoral campaign that the government had employed to win office, but served only to harden German insistence on the criteria.

Toward the end of 1997, however, the Jospin government tried to allay fears about the Council undermining stability. In November, the Jospin administration launched a new public offensive in support of the council, stressing both political and economic advantages. Finance minister Dominique Strauss-Kahn pointed out that holding to the terms of the Stability Pact of 1996 after EMU's launch would require formal coordination of national economic policies, through "common diagnosis and joint action." Regular meetings of the council would provide information and allow coordination at an earlier stage, allowing earlier adjustment, and avoiding the higher interest rates that would result from poor coordination. Politically, Strauss-Kahn emphasized that the council would play an essential role in preserving the ECB's independence, by shielding it from accusations of defying the will of the people:

> (without a) "visible and legitimate political body, the ECB might soon be regarded by the public as the only institution responsible for macroeconomic

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[655] Strauss-Kahn, Dominique, "We're in this together." *Financial Times*, November 27, 1997; "Die Stunde der Wahrheit." *Der Spiegel*, July 7, 1997.

> policy.. In the absence of a counterpart, citizens in the euro zone might soon make the bank responsible for growth, employment or even unemployment, whereas its mandate is to focus on the narrower objective of price stability. This discrepancy between the legal mandate of the ECB and its perception by European citizens would ultimately limit its room to maneuver. In this respect, emphasizing the collective responsibility of the minister of the euro zone could in fact protect the bank from misplaced pressures."[656]

The Kohl government finally responded by supporting the establishment of an informal council. However, the Euro-X Council, as it came to be known, would be limited to countries participating in monetary union.[657] This was a sore point among Britain, Denmark and Sweden, which opted out of the first wave of membership in fear that the euro zone would not be able to resist a rise in inflation, and who feared that the Euro-X Council would begin constructing an inflation-prone European economic policy in their absence. The three countries even tried to block the formation of Euro-X as an informal group, to prevent it from acting as a block within ECOFIN. The countries that were planning on participating rejected complaints from Denmark, Sweden and the UK that they couldn't be shut out and underlined the basic need for members to discuss policy from time to time.[658]

On balance, the Euro-X Council's development provided a compromise that allowed both the German and French governments to claim to voters that they had protected and promoted the aspects of monetary union that were most important to them. The Jospin government emphasized that the council constituted the seed of an economic government for Europe that could be used to promote growth and employment for the country and the Union. The Kohl government, meanwhile, was able to reassure voters, with the confirmation of the Bundesbank, that nothing in the council's existence questioned or threatened the ECB's independence or stability mission.

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656 Strauss-Kahn, Dominique, "We're in this together," in *Financial Times*, November 27, 1997.

657 "Kompromiß über Koordinierung der Wirtschaftspolitik," *Handelsblatt*, December 15, 1997.

658 Hellman, Rainer, "Stabilitätsrat für den Euro," *EU-Magazin*, October 1997.

5.6 EMS II

As in other cases, EMS II emerged as an afterthought to the Maastricht Treaty, and was informed by a specific set of electoral interests. In contrast to the many other debates, however, it was relatively easy for EU governments to agree on the development of a mechanism to bind the currencies which did not participate in monetary union in the first wave to the euro. This new mechanism would be known as EMS II, as the successor of the European Monetary System that had been the basis of exchange rate management in the EU since 1979.

The idea for EMS II originated in France, where voters, business groups and subsequently government were eager to prevent countries that did not participate in EMU from devaluing their currencies. Since 1992, France had lost business to the three countries that had either devalued their currencies or left the EMS altogether: Spain, Italy and the United Kingdom.

This was a sore point of protest against the Juppé government's plans for monetary union. In contrast to Germany, which nevertheless embraced the advantages of EMS II, it was necessary for the French government to propose the measure in order to consolidate support for the EMU project within the country and even within the governing coalition. Both the RPR and the UDF were feeling increasing pressure from economic nationalists championing the interests of exporting industries and jobs, and rejecting EMU as a consequence.[659] This mounting threat to Juppe's coalition was informed in turn by the rising fortunes of the Front Nationale, which fed on the spread of unemployment during the early 1990s. EMS II at least suggested that the government was looking out for the interests of its vulnerable industries.

ECOFIN and the Council of Central Bank Governors agreed to the terms of EMS II fairly early, in 1996. It was designed to ensure that the cost of future adjustment would fall

[659] Montvalon, Jean-Baptiste de, "M. Giscard d'Estaing appelle à une relance de la construction communautaire," *Le Monde*, February 22, 1996.

on the shoulders of countries with weak exchange rates.[660] France went even further by advocating fines for EU countries that devalue their currencies against thte euro. Germany and Belgium supported this measure without hesitation, but the Commission rejected it, arguing that it could not make the release of EU funds conditional on the state of its exchange rate.[661]

France's position on fines in conjunction with EMS II parallels the German demands for fines in conjunction with the Stability Pact. For countries experiencing great economic difficulty and speculative attacks, the fines would have constituted a politically insupportable attack for weak EMS II countries. The harshness of the French proposals reflect the importance to the government of generating cert·inty for constituents that EMU would not hurt their interests.

5.7 Selecting the ECB President

The terms of the TEU dictated that the president of the ECB should be chosen on the basis of experience and reputation as a guarantor of price stability. In this way, the Treaty's framers had attempted to ensure that ECB Presidents would favor price stability out of conviction rather than a loose monetary policy out of political pressure by one or more governments. At the same time, however, EU governments had to choose the ECB President unanimously, and this increased the room for political motives to play a significant role in the selection of a candidate. This in turn could reopen questions over the commitment of member states to EMU's stability goals and the ECB's independent capacity to pursue price stability.

The political importance of this possibility was underlined in late 1997 and the first third of 1998 in a dispute between France and the rest of the European Union over who

660 "EU-Finanzminister wollen neuen Wechselkurs-Mechanismus installieren," *Süddeutsche Zeitung*, April 15, 1996.

661 "Bruxelles et Paris s'affrontent sur les dévaluations compétitives," *Le Monde*, August 1, 1996.

would serve as the ECB's first president. When Wim Duisenberg was appointed to the President of the European Monetary Institute, he was expected to serve subsequently as the first president of the European Central Bank when it began operating in June 1998. Duisenberg enjoyed widespread support from EU governments as the appropriate candidate for the position. As the former governor of the Dutch central bank, he had successfully contributed to bringing down inflation and urging the national (Labor Party) government to reduce its budget deficit. He was considered competent, firm, and capable of working with politicians of all stripes. In this light, his appointment as President of the ECB was considered a testament to the willingness of national governments to refrain from using the nomination process to undermine the independence of the ECB.

In April 1997, Chirac made the first official move to challenge the consensus in favor of Duisenberg. At that time, he suggested that Michel Camdessus, President of the International Monetary Fund, and a French national, would be a good choice for the first president of the ECB. Germany and the Netherlands retorted that Chirac was needlessly reopening an issue that all other EU members had resolved by supporting Duisenberg, and fueling speculation that France intended to place the final candidate under unjustified political pressure.[662] However, more than one French official saw it as self-understood that a French citizen should lead the ECB. A member of the Bank of France's Monetary Policy Council, Paul Marchelli, claimed as early as January 1997 that Germany had already promised to support a French candidate in exchange for locating the ECB in Frankfurt.[663] After Chirac's proposal in April, a French official defended the position by arguing that it was very important to the French government that voters be faced with an ECB President who could 'speak French' directly to the population.[664] The fact that Duisenberg could speak

[662] "Row over new central bank," *Financial Times*, April 16, 1997.

[663] "Die Deutschen müssen Wort halten," *Frankfurter Allgemeine Zeitung*, January 14, 1997.

[664] Münchnau, Wolfgang, "Fiercely independent institution," *Financial Times*, September 19, 1997.

French fluently[665] underlined the political importance to the Chirac in particular of having a French ECB president who could reassure the French population that he nor the ECB council was ignoring the country's interests. Chirac emphasized this point even more forcefully after the issue was sorted out more than a year later in May 1998, when he stated that France was defending its interests as a nation state by demanding that a French national as president of the ECB.[666]

Despite Chirac's statement in April, the council of EU central bank governors, who were required to recommend a candidate for ECB president to the EU governments under Article 109a of the TEU, voted unanimously on May 14, 1997 to support Wim Duisenberg. Jean Trichet, president of the Bank of France, reported afterward that he had telephoned to Paris before the vote to enquire about any possible objections the government might have to supporting Duisenberg. He received no answer, and proceeded to give France's support to Duisenberg. Only later did it become known that the government had been so preoccupied with a violent and debilitating truckers' strike that it had paid no attention to the election of the ECB president.[667]

Chirac stepped up his campaign against Duisenberg after the May vote, adding that he could not possibly support someone who had been selected in an attempted 'coup of central bank governors'. In contrast, the finance minister, Dominique Strauss-Kahn said that the French government felt compelled to ensure that the successful candidate was nominated and approved by elected governments, rather than "technocrats."[668] Neither of these attacks recognized the duty that the central bank presidents had under the TEU to provide a recommendation to the heads of government.

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665 Münchnau, Wolfgang, "Fiercely independent institution," *Financial Times*, September 19, 1997.

666 Barber, Lionel and Robert Graham, "Chirac laughs off suggestions of a farce," *Financial Times*, May 4, 1998.

667 Berger, Alois, "Der Euro Frührentner," *Die Woche*, May 8, 1998.

668 Strauss-Kahn, Dominique (Interview) "Wir wollen einen starken Euro," *Süddeutsche Zeitung*, May 4, 1998.

The attacks recognized, however, that public confidence in the policy of economic austerity, and a strong European currency was eroding quickly in 1997, and with it, support for both Juppé and Chirac. When Chirac's gamble to solidify support for this platform backfired in Juppé's loss to Jospin in the National Assembly elections in the summer, he not only renewed his insistence on a French national to head the ECB, but began insisting that Banque de France president Jean Trichet, not just any French national, assume the post.[669]

Although no other European governments or central bank governors had any objections to Trichet's commitment to price stability and qualifications, the context of his nomination raised suspicions among commentators that Chirac was using him as a political pawn in a play for national power as much as for influence on the European stage.[670] In particular, Chirac seems to have wanted Trichet out of the president's chair at the Bank of France at the next opportunity, and at the latest by the next presidential election, based on the following observations.

Chirac's first strategy was to insist that Trichet assume the Presidency of the ECB when it began operating in 1998. Trichet's transfer would open up the Presidency of the Banque de France before re-appointing Trichet became an issue in 1999, when Trichet's current term expired, and allow Chirac to appoint someone more in line with the new political alignment of less austerity than Trichet without attacking him directly. First and foremost, this would bring Chirac closer to the nationalist Séguin wing of the RPR, as discussed in section 3.4. If necessary, appointing a new central bank president could also smooth relations with Jospin, who also chafed against Trichet's strict approach to monetary policy.[671] Chirac had, after all, already switched from promoting Juppé's austerity plans to promoting a European economic government in the Euro-X Council by mid-1997,[672] and was

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669 French Prime Minister Jospin announced Trichet's candidacy in November. See Alan Friedman, "An EU bank showdown," *International Herald Tribune*, November 5, 1997.

670 Müller, Mario. "Wer hütet den Euro?" *Die Zeit*, November 14, 1997.

671 "Mit germanischer Farbung," *Der Spiegel*, November 10, 1997.

672 Biffand, Olivier, Henri de Bresson, Daniel Vemet, " Paris n'exclut plus un accord dur la pacte de stabilité à Amsterdam," *Le Monde*, June 12, 1997; Michel Noblecourt, "Le PS qualifie de

sensitive to complaints that the terms of EMU were bad for France.[673] He kept this line right into the May 1998 summit at which Chirac opposed the rest of the European Union's governments on Trichet's behalf.

Chirac's fallback option, that allowed a compromise, was based on a proposition put in concrete form by Duisenberg himself. Duisenberg would accept an appointment as the ECB President, officially for a full eight year term. At the same time, Duisenberg indicated that he would voluntarily resign before his term came to an end, citing his age (never before mentioned) of 62 years.[674] The EU governments would then be free, of course, to choose a replacement. Although Duisenberg did not discuss the reason for the formula, persons close to him speculated that he took seriously the possibility that monetary union would collapse altogether if he didn't provide a solution that saved the faces of the French and German governments, if not that of the ECB itself. What was certain from insider reports, however, was that Duisenberg had no intention of suggesting such an arrangement before the conference. He was reported as "very agitated" over the dispute.[675] On Chirac's insistence, the other EU governments were eventually willing to agree to accept Trichet as Duisenberg's successor, and for a full eight year term.

Duisenberg's open door was not enough in itself for Chirac, since it did not guarantee that he would be able to replace Trichet in the near future. After a lengthy and intense dispute, in which other EU governments stood firm in Duisenberg's right to be appointed without condition, Chirac again threatened to veto Duisenberg's candidacy once and for all if he was not given a written guarantee that Duisenberg would leave his post no later than early 2002.[676] This was the point at which the third stage of monetary union would finally

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«premier résultat» l'accord obtenue à Amsterdam." *Le Monde*, June 19, 1997.

[673] Graham, Robert, "Chirac claims victory scorned." *Financial Times*, May 4, 1998.

[674] Barber, Lionel, Wolfgang Münchnau, Robert Chote, "EU deal puts single currency to the test." *Financial Times*, May 4, 1998.

[675] Berger, Alois, "Der Euro FrühFrührenter." *Die Woche*, May 8, 1998.

[676] Preston, Robert, "Thankless weekend for chairman Blair." *Financial Times*, May 4, 1998.

be complete, when euro notes and coins would circulate and national currencies would be withdrawn from circulation. It would also be the point, however, at which Chirac would face his next re-election campaign.

Chirac's own political calculations did not fully explain the intensity and length of the conflict, however. After German Chancellor Helmut Kohl had demanded that Chirac demonstrate some flexibility at the summit, he agreed with Chirac before the summit that Duisenberg would be asked to step down early in favor of Trichet. The terms were not discussed, but Kohl assumed that Chirac would stop threatening to veto Duisenberg's candidacy. At the Brussels summit, EU and UK officials reported that both of Kohl's coalition partners, represented by the finance and foreign ministers, had been surprised by discussion of conditions on Duisenberg's candidacy, and demanded that Kohl ensure that Duisenberg be appointed without condition.[677] This unhappy surprise lengthened the negotiating session considerably, as Kohl was forced to negotiate positions repeatedly with finance minister Theo Waigel (CSU) and external affairs minister Klaus Kinkel (FDP).[678] Both of these parties, as discussed in chapter two, were the most committed to economic conservatism and central bank independence. For his part, Kohl was reported to be furious at both Chirac, and at Tony Blair, who had organized the meeting, on account of the negative impact he expected the public disagreement to have on his upcoming election campaign.[679] In practical terms, this meant that Kohl feared that a sacrifice on Duisenberg would increase German fears that monetary union would not be stability-oriented.

If Chirac's demands had been questionable in their attempt to manipulate the nomination of the ECB President before, the new demand won the outright contempt of other EU governments, of Duisenberg himself, and of much of the European press. In the end, Chirac used Duisenberg's statement that he would stay on at least until euro notes and coins were fully in circulation as the basis of claiming victory for France, and claiming that he had

677 "Ein Makel auf Europa," *Hamburger Abendblatt*, May 4, 1998.

678 Preston, Robert, "Thankless weekend for chairman Blair." *Financial Times*, May 4, 1998.

679 "Ein Makel auf Europa," *Hamburger Abendblatt*, May 4, 1998.

won an agreement to have Trichet replace Duisenberg by mid-2002.

In fact, however. Duisenberg had not. and according to the terms of the Maastricht Treaty. was forbidden to take political direction in setting a time limit on his term of office other than the eight year period prescribed in the TEU. Duisenberg emphasized this during his initial release to the press. and later. snubbed Chirac by revealing his intention to stay on in his post 'for at least six years.'[680]

5.8 Optics and Confidence: Locating the ECB, Choosing a Name and Monetary Policy

Optics can be thought of as the comprehensive view of an issue. project or event that the public develops. Optics play a considerable role in determining the willingness of the public to support particular policies. Although the issues that are dealt with at the international level may be of minor importance to determining EMU's relative orientation to growth and stability. they may nevertheless influence public acceptance of a government initiative. Before the launch of EMU's third and final stage. several issues were debated at the national level. principally with the intent of soothing German voter fears about the future of stability in the monetary union. They were not demanded by the public. but rather government initiatives in all cases.

The dispute over locating the ECB in Frankfurt was covered in chapter two. Its location in Frankfurt was designed to imbue German voters with the same confidence in the ECB that they had in the Bundesbank. as if the city's spirit were responsible for the bank's commitment to stability and independence. However. the only serious competition to Frankfurt came from Amsterdam. rather than Paris. Madrid. Brussels. or any other European city. This reflects the relative unimportance of the ECB's location to most countries. with the exception of Germany. There. Frankfurt's reputation as a center of stability constituted an important part of the political package necessary to convince the electorate that the ECB would remain independent of political influence.

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[680] Reported in *Tagesschau* television newscast. German ARD Television. June. 1998.

The second issue which underlined the importance of public confidence was the name of the single currency, which had not been decided when Maastricht was negotiated. The French government preferred the acronym ECU, which had until then served to designate the European Currency Unit, and which invoked images of an old French coin returning to take its place as the single currency of the European Union. The French government went so far as to conduct a public opinion survey across the EU in cooperation with the European Commission, to test support for the name, without success.[681] The ECU had already attracted poor press from those who had received payments from the European Commission in the currency unit, and reported its inability to hold its value against strong currencies. Consequently, the prospect of retaining the ECU name would have positively undermined the Kohl government's attempts to convince the German public that it was committing the country to a strong currency. By 1995, this was such a concern that the SPD and even the DGB were attacking the government for risking the country's monetary stability.[682] The political solution, provided by Theo Waigel and supported by Helmut Kohl, was to propose the name "euro." The French government and the Commission, with the disappointing results of their poll to support the ECU name, used negotiations to secure two commitments from Germany that would help entrench the new currency's use. First, in late 1995 they secured a date for a conference of EU governments in early 1998 to decide on membership, using performance data on the membership criteria for 1997. The use of data for 1997, rather than on the basis of several years, would help contain possible objections that inflation and deficit performance should be considered for several years running before the conference before the launch of stage three of EMU. Second, France and the Commission won agreement from Germany that the securities markets of the participating countries should be denominated in euros beginning on January 1, 1999. This would not only reinforce the sanctity of the fixed exchange rates from that date by preventing a divergence in prices

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681 "'Euro'- die neue Gemeinschaftswährung hat einen Namen," *Frankfurter Allgemeine Zeitung*, December 16, 1995.

682 Kirchengast, Josef, "Europa in der Prägeanstalt," *Der Standard*, 1995; "Diskussion über den ECU," Handelsblatt, February 10, 1992.

between euro and national currency-denominated securities, but also render withdrawal from the common currency economically unthinkable after the launch in 1999.[683] In France, public opinion accepted the new name without controversy, despite comments by Giscard d'Estaing that Chirac, Juppé and Arthuis had failed the country by not defending the ECU name. Meanwhile, polls showed that the euro had a higher acceptance rate in Germany than the ECU.[684]

The choice of a European monetary policy had real distributive consequences for Europe, but the choice of a monetary policy attracted little attention from the general public and therefore from governments for three reasons. First, the public simply did not pay much attention to the manner in which monetary policy was carried out. Second, monetary policy was the prerogative of the ECB, not of the national governments. Nevertheless, an early discussion of a desirable course of monetary policy could have consequences for the subsequent nomination of an ECB President and monetary policy council. Third, the two possible monetary policy models both supported price stability in principle. Consequently, the choice of monetary policy had only a limited public relations effect--that of continuity or change in the transition to monetary union.

Despite these similarities, there were marginal differences in the prospects for stability and growth that the choice of a European monetary policy model promised, based on the differences between policy in Germany and France. In particular, switching from one method to the other could affect the balance of growth and stability in the national economies somewhat.

One type of monetary policy is closely associated with the success of both the German and Dutch central banks in controlling prices. It seeks to ensure stable prices by controlling the supply of money in the economy over the medium term, rather than managing the inflation rate directly. Proponents appreciate that this type of policy sets transparent and

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683 "'Euro'-die neue Gemeinschaftswährung hat einen Namen," *Frankfurter Allgemeine Zeitung*, December 16, 1995.

684 Guha, Krishna, Andrew Jack, Andrew Fisher, Andrew Hill, "Opinion split on the euro," *Financial Times*, December 18, 1995.

predictable restrictions on the supply of money and credit over an extended period of time. By reducing expectations of inflation, they see this policy as setting the necessary environment in which economic actors keep their own demands in check. Detractors, however, complain that the policy restricts the supply of money without direct evidence of escalating inflation, robbing the economy of growth without improving on price stability. Financial markets in particular tend to feel penalized by this type of system, since periodic financial bubbles (a high-flying stock market, for example) reflect an increase in the money supply, triggering a restriction, even when inflation in the productive economy is low. This disadvantage for financial capital should not be conflated with a disadvantage for capital as a whole. Money placed in long-term investments is not included in the definition the money supply (M3) that practitioners of this method use.

The second type of monetary policy seeks to ensure stable prices by monitoring price developments in a wide range of economic sectors, and raising interest rates when evidence of inflation begins to show. It has the advantage of keeping the supply of money and credit fluid until evidence of inflationary pressures becomes evident. This is beneficial to financial markets and to businesses borrowing to expand. It can be beneficial to governments that seek to revive economic growth by spending money. It has the disadvantage of being untransparent and difficult to predict. Economic actors are unable to judge as easily how much of their own restraint is required to prevent an economic downturn. Actors most commonly complain that they are uncertain which developments triggered an increase in interest rates when it occurs. This approach has been more common in France, Britain, and Spain, with a more direct concern for the inflation rate.

Though EU member countries had granted independence to their national central banks by 1994, they were still not managing their economies in the same way. The relative attention to interest rates and the money supply reflected the political priorities of how economic growth and stability are best combined in each country. Overall, interest rate oriented countries had more fragile growth, employment and budgetary prospects. For this reason, they wanted to keep room for economic growth and interest rates as open as possible.

For this reason, gatekeepers favored a money supply orientation to monetary policy, while others were either lukewarm or opposed. The money supply strategy would hurt an unfettered financial sector from time to time (by limiting and punishing speculation) and hurt industry earlier when a fear of inflation arose.

By mid-1998, the ECB had not published its final decision on how to manage European monetary policy, although Duisenberg is known to support the money supply approach, based on the transparency.[685] This moved monetary union closer to hard controls on the European economy that gatekeepers preferred.

5.9 Conclusions

The disputes described above follow the same pattern of logic, and are oriented to the demands of domestic politics rather than pursuing international cooperation to build a common institution. Germany demonstrated an inordinate desire to control the budget and debt reduction policies of other European governments seeking to participate in monetary union. Spain demonstrated a keen interest in using the EMU process for as long as possible to prevent international investment from avoiding the country, and to extract financial concessions for economic development from its European partners. France demonstrated a constant uneasiness with committing unequivocally to institutional structures that locked in its commitment to price stability and conservative government financing before EMU was launched.

German positions revolved around applying and enforcing strict criteria of membership, so that German voters could feel secure that monetary union would not bring inflation. The grief through which the Kohl government put its European partners was the price of domestic ratification. At the same time, the intermediation of political parties created some room for the government to distance itself from its electorate and reach deals that might not otherwise have been possible. The Stability Declaration as a condition of membership for Italy, rather than outright rejection of EU pressure to admit Italy, is a good

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[685] Münchnau, Wolfgang, "Duisenberg backs German model," *Financial Times*, March 22, 1997.

example. In doing so, Germany was largely successful at promoting prior convergence to the TEU's membership criteria before monetary union's launch.

France divided its attentions between relaxing the restraints that Germany intended to place on the national economic policies of EMU member governments and promoting the idea of an economic government for the European Union. The first efforts were most notable during the discussions on the Stability Pact and on the Stability Declaration, during which France insisted on flexible, interpretive arrangements. The French government reaffirm its commitment to stability in these arrangements, without submitting the country to restrictions that could backfire politically during a recession. The corresponding exceptions to the terms of the Stability Pact, the limits on sanctions, and the political process for levying them, reflect this need.

The idea of an economic government dated back to the Rocard government, fell out of sight during the Balladur government and early Juppé governments, and then returned as the French public began to show dissatisfaction with the economic reform program of the RPR-UDF government. It enjoyed its most vigorous support, and the only concrete attempt to realize its establishment, after the National Assembly elections of 1997 in which the conservative coalition collapsed and Lionel Jospin began leading French policy on EMU. Overall, the economic government proposal ebbed and flowed with the hardness of the government's price stability and economic adjustment commitment, which in turn depended on the magnitude of unemployment and the success of spending reforms. None of the governments openly attacked price stability, but the balance of emphasis on adjustment and job creation was stronger in favor of job creation while the government was promoting a European economic government. Together, these measures added up to a French preference to accept the convergence criteria as guidelines, which implied that countries should be permitted to achieve the criteria after EMU's launch. Furthermore, the French desire to use EMU as a shield against the pressure of international currency markets on the exchange rate underlined the country's preference for launching EMU even without close convergence to the membership criteria, if the alternative were a delay.

The French position also stands out for its promotion of the EMS II system, which alleviated the concerns of exporters who might otherwise lose from a strong European currency. France had to worry more about the effects of devaluation by neighboring countries once it entered EMU--this had been an effective complaint in France since the currency crisis of 1992. Again, the extreme measures that the Juppé government proposed to punish EU countries which devalued their currencies underlined the political importance of taking care of this concern before launching EMU.

The Spanish position stands out for its instrumental commitment to price stability. The commitment was contingent on, and designed to secure, large increases in EU financial aid that would allow the Spanish government to realize a longstanding dream of increasing national living standards. In addition, both governments favored long transition periods, and the opportunity to adjust exchange rates when necessary. Correspondingly, the domestic economic policy reforms that would be necessary to meet the inflation and deficit targets for EMU membership were even more challenging than in France.

Madrid's determination to take part in the first wave of EMU is the one aspect of the puzzle which does not fit into the model described in chapter one, and which constitutes a point of interest for comparative studies of monetary unions. As described above, the fear that monetary union would divert international investment toward the new currency area away from investment in countries with weaker currencies such as Spain, played a decisive role in the persuading both the Gonzales and Aznar governments that membership was indispensable for the Spanish economy, if monetary union could not be delayed. This also had its roots in domestic politics, which counted on international investment to finance economic growth, particularly by increasing the interdependence of the Spanish economy with the rest of the EU. In this context, it would be interesting to know whether the price of economic adjustment for countries with weak economies would have been politically acceptable in the absence of financial transfers. The Spanish case suggests that it would not have been politically possible, and that an attempted monetary union in the absence of a possibility for transfers would lead to full defection (i.e. rejecting membership in a stability-oriented monetary union) for countries in which voters and economic institutions are oriented to economic growth rather than stability.

6 Conclusions

6.1 The Challenge of Commitment to the ECB

The key challenge of establishing a monetary union in Europe was constructing a set of rules that would meet the needs of voters in countries with divergent economic and institutional structures. Voters were not active participants, but in each case, they had expectations of their national governments that made it difficult for the latter to commit to certain requirements at the European level, or to live without explicit guarantees. Simply put, European Union countries had concrete interests that stood in the way of a smooth transition to monetary union. In some cases, governments were skillful enough to anticipate public needs and take an appropriate stand during discussions over the terms of monetary union. Just as often, however, governments underestimated public hostility to the implications of their decisions, and were forced back to the European bargaining table.

Success was not a matter of ideas, of spreading knowledge about the advantages of monetary union, or about constructing European institutions in such a way as to prevent defection among a group of governments. The concrete disputes over timing, membership criteria, and the structure of the European Central Bank had distributional consequences both among and within EU countries. This is why European governments effectively re-opened and almost killed the EMU project, even after having signed the Treaty on European Union.

The pattern of conflict also demonstrated a fallacy of contemporary thinking about the effect of globalization on national economic and social policies. Much has been made of the proposition that the globalization of international finance has forced countries to adopt the same anti-social economic policy priorities. In order to attract investment capital and prevent economic collapse, so the argument goes, governments are compelled to improve their creditworthiness on a competitive basis by containing inflation, reducing national debt and balancing their budgets. The case studies demonstrate, however, that voter demands and the needs of national economies in different stages of development generate different responses to the demand for competitiveness. In fact, the countries which should have been under the greatest pressure to adjust their economic and social policies, according to the globalization hypothesis, were the most stubborn in refusing to do so. When they eventually did take action, the incentive to introduce price stability, attracting international investment capital to fund growth and development was not enough to prevent public discontent. Instead, a series of politically negotiated income transfers within the EU that eased the cost of austerity were required to make membership possible.

Deep-seated political differences between countries, therefore, formed the basis of the disagreement over the terms of monetary union and the structure of the European Central Bank. Voter expectations and the different challenges of achieving economic convergence among countries with vastly different economic and institutional structures proved to be at least as important in determining the 'win sets' of a successful monetary union as the intentions of the governments themselves. In short, the domestic ratification process that we understand in the context of two level games literature includes more than the approval of key domestic actors. In international monetary relations, successful ratification and commitment encompasses the ability to adjust economic and social policy, and their corresponding institutions. That capacity, in turn, depends on voters and their willingness to accept the policies, as well as on well-organized clients of institutions that defend against change. While governments have some autonomy, it is constrained much more thoroughly in international monetary relations than we have considered to be the case.

6.2 Voters and Policy Decisions

Voters had a meaningful impact on economic policy and on the negotiating positions that governments represented at the European level. Voters influenced foreign economic policy in an indirect manner. At no time did voter demands initiate a particular EMU policy in any of the three countries. French voters demanded neither a speedy monetary union nor an economic government for the EU. German voters did not demand a Stability Pact. Spanish voters did not demand development funds or a delayed monetary union. Yet national governments launched each of these initiatives in the attempt to raise and consolidate public support for the monetary union project.

Similarly, voters exercised an indirect, restraining influence on the conduct of national economic and social policy, which in turn, dictated the parameters within which national governments would be able to commit to EMU. The politics of economic reform in France and Spain, and the prospects that monetary union would impose changes undesired by German voters after 1999 proved to be sticking points for the respective governments. The consequences for meeting the convergence criteria in time for the 1999 deadline and maintaining that discipline drove the series of subsequent disagreements over the timing of monetary union, the need for an economic council alongside the ECB, the need for a Stability Pact, the EMS II arrangement, and the ECB's relative attention to stability and growth. In the case of Spain, it meant a protracted conflict over the EU's commitment to funding economic development parallel to monetary union. Not only did voters make it more complicated to reach an agreement on monetary union, they made it more difficult to carry out the project after the initial agreement had been reached, and their divergent interests demanded a much more complex institutional structure than had originally been envisaged.

Institutional features that removed government from the everyday influence of party politics did little to reduce the impact of voters in the final analysis, since economic reforms and the final commitment to EMU required national legislation. Hence, commitments required party approval. An interesting question for further research would be to examine whether a division between government and parliament leads to an increased occurrence of 'involuntary defection' from international agreements. In other words, does the relative isolation of government negotiators from the party politics of parliament, coupled with the final importance of parties as decisive actors in the ratification process, lead to more frequent government miscalculations about the size of the domestic win set?

Efforts by the German Chancellor to circumvent political pressure from below could be identified in winning the final approval for entering monetary union in 1998, although they also proved unsuccessful. Helmut Kohl's decided to keep a tentative agreement with Jacques Chirac over splitting the ECB President's term secret while the Bundesrat and Bundestag voted to enter monetary union, and it is likely that the German parliament would have withheld approval if it had known of the pact. At the Brussels summit, the fact that Kohl's coalition partners could put an end to the deal once they learned of it provided the country with a substitute for control through the parliament. Both coalition partners acted in their own electoral interests to bring Kohl into line. Therefore, there is more than one way in which the electoral impulse can constrain and provide incentives for political decision-makers.

The research implications of this last case point to the need to study what type of mechanisms government leaders have at their disposal to circumvent the democratic process, and how different structures of interest representation make it impossible to do so. In the German case, final ratification was achieved under false pretenses, but that was only possible by a single government leader maintaining a facade for the coalition he led. Germany's representation at the Brussels summit, coupled with the electoral implications for the coalition partners, made it possible to narrow the win set even after the parliament no longer had an opportunity to interfere. Coalition governments, therefore, are one target of study. Other forms of divided responsibility, coupled with electoral incentives, such as the division in France between President, Prime Minister and National Assembly, are another. The independent oversight and criticism of parties in the National Assembly had a significant impact on government positions as well.

The political entrepreneurship of political parties provided a crucial link between voter interests and national or foreign economic policy. Not only did governments promote initiatives at the European level in order to attract support for the foreign policy initiative, they backtracked on commitments at the European level and demanded new side-agreements when it became apparent that voter backlash would make a European commitment untenable. Germany, as a country with a great deal to lose if monetary union did not ensure price stability, demanded the Stability Pact and Stability Declaration as prerequisites of participation in order to reassure voters that membership would not contradict their interests. Spain risked isolation at the European level in order to win structural development and social fund moneys that formed the centerpiece of its public relations campaign to sell its public on the benefits of monetary union. France's calls for an economic government alongside the

ECB, in contrast, varied with the degree of public uneasiness with the national austerity program that was required for membership.

The party systems of each country tended to reflect the basic priorities of the electorate in economic and social policy fairly well, as major contenders for office vied for the political center. This meant that there was no division in either Germany or Spain over the main priorities of economic and social policy that could be exploited as an electoral issue. Germany would not participate in a monetary union without stability, and Spain would not initiate a sweeping austerity policy without compensation to boost economic growth and development. In France, however, the party system reflected a preference for stability that was both weaker and more unstable than in Germany, and which was finally rebuffed in the 1997 National Assembly elections.

The flip side of political entrepreneurship and mediation between public and government on the part of parties was that governments retained a degree of autonomy from public preferences. In fact, this degree of autonomy made compromises possible at the European level by expanding domestic win sets marginally. National governments had to negotiate terms of EMU that were close enough to voter preferences to win public approval. In other words, the terms could not be far enough out of line to give the opposition an opportunity to threaten the government's position, or even more, its hold on office. At the same time, national governments had to negotiate terms of EMU among countries that were acceptable to all parties likely to participate. The challenge for each national government rested in navigating the fairly narrow win set between terms acceptable to potential partners, and terms acceptable to the national electorate. Their support would be necessary before the domestic reforms required for monetary union could be implemented.

In practical terms, this meant that all three countries made European commitments that were less than popular, without being out of line with public expectations of proper economic policy. Germans were still feeling uneasy about whether monetary union would preserve price stability as well as politicians were reassuring them it would, despite the ECB's independence, the Stability Pact and the Stability Declaration. Had voters had full control, they would likely have prevented Italy from joining EMU, rather than making Italian membership contingent on the Stability Declaration. To put it even more forcefully, it is conceivable that German voters would have preferred to postpone or even kill off the idea of monetary union altogether. Throughout the 1990s, however, the German government bent over backwards to bring voters proof that monetary union would protect their interests in addition to bringing modest benefits. This program was good enough to deny the opposition an opportunity to attack the government's EMU strategy. The SPD limited its criticism to the manner in which the government was going about trying to balance the budget.

Spaniards, for their part, would have preferred less austerity from the Spanish government, but it was difficult to argue with the fact that a great deal of foreign investment was pouring into the country as compensation. Within the PSOE, the same pattern was repeated, in which prominent party members chafed against monetary restraints and economic reforms while recognizing the benefits of transfers from the EU. This being said, the government sought to delay monetary union as long as possible or have the criteria relaxed so that internal tensions would remain under control. Government and opposition were united on these points, and again, conflicted more strongly on how domestic policies and institutions could best be reformed to promote future growth and development.

In France, of course, the parties' intermediary and leadership functions performed a particularly important role for the country's promoting behavior. Pro-stability politicians from both the Socialist and Conservative parties controlled of the economic policy portfolios of their respective parties, despite the fact that the members were not united on the course of economic policy. Thus, during the 1990s there was a great deal of continuity in economic policy among the Socialist governments of Rocard, Cresson and Bérégovoy administrations and the Balladur government. The Juppé government stands out only for the degree to which it pursued reforms. The Jospin government, in contrast, unequivocally chafed against the Maastricht requirements since reaching office.

6.3 Institutions and Policy Decisions

Central bank independence proved to be important for political as well as technical reasons in reinforcing the pursuit of price stability. On the technical side, it made it difficult and costly for governments to delay adjustment of institutions that were generating inflation or structural budget deficits. Germany was the only country of the three studied to have an independent central bank at the beginning of the 1990s. The Bundesbank played an active role in punishing the German government for a series of decisions related to reunification that threatened to erode price stability unless there were serious countermeasures. Public admonishments against government borrowing to finance spending on eastern redevelopment were accompanied by interest rate hikes and a monetary contraction that forced the government to take corrective action sooner rather than later. The results were seen in concerted action to reduce the deficit from 1994 onward.

The Bundesbank's success at defying not only the German government, but also other European governments on the issue of German monetary policy between 1990 and 1993, was made possible by the sympathetic audience it had in the German electorate, particularly those in the more prosperous states of the old federal republic. Faced with the legitimacy that the Bundesbank enjoyed among the political majority, the Kohl government was compelled to redouble its efforts to contain borrowing by 1994. Therefore, the Bundesbank's political advocacy role was an important factor in stimulating adjustment to German institutions sooner rather than later. The Bundesbank's activity was therefore an important part of why adjustment in Germany was initiated from within the country, rather than as the product of a commitment to monetary union, as in France and Spain.[686]

The central banks of France and Spain followed a similar pattern of behavior after

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[686] In the meantime, research has demonstrated a similar effect on private actors setting price levels. See Peter Hall and Robert Franzese, Jr. "Mixed Signals: Central bank independence, coordinated wage bargaining and European Monetary Union," *International Organization*, 52:3, pp.505-535. Torben Iversen highlights as well how wage negotiating patterns magnify or diminish the effect, in "Wage bargaining, central bank independence, and the real effects of money," *International Organization* 52:3, pp. 469-504.

achieving independence in 1994 and 1995, respectively. The determination to preserve price stability with a tight monetary policy was paralleled by taking public positions on budgetary and social insurance policy. These institutions did a great deal to keep the requirements for EMU membership in the spotlight and to encourage further action that might be required. Both also made a point of praising government for changes that improved the country's budgetary position, or less frequently, in labor markets. This behavior differs markedly from their lack of involvement in public policy debates before independence. In these two cases, however, public opinion support for the central bank's mission to promote stability and low deficits did not resonate in the same way as it did in Germany.

In sum, the case studies suggest that central bank independence has a noticeable effect on a central bank's behavior and its ability to put pressure on a government to undertake institutional reforms. In France, independence also held in the face of strong opposition to economic policy reforms, and also played an important role in supporting the reform efforts of a government that was otherwise working in a politically volatile environment. In particular, a reforming government and an independent central bank are able to reinforce one another in claiming that domestic reforms bring a payoff in the form of lower interest rates and stronger economic growth. However, a central bank's independent influence seems to be greater if it has a sympathetic public that supports it.

Chapter one focused on social insurance spending commitments as the most important adjustment-resistant institutions. The Spanish and French cases illustrate, however, that labor market institutions can also have a powerful, indirect impact on the ability to simultaneously control inflation and public borrowing requirements by influencing the severity and duration of unemployment, as well as the likelihood that wage agreements will stimulate inflation. These mechanisms can take different forms. In Spain, the most prominent is the system for determining the penalty that employers pay when laying off workers. In France and Spain, public sector workers, combined with the large size of the state sector, have led to relatively uncontrolled inflation-driving wage increases. In Germany, the insistence of unions on achieving large wage increases in the new states without corresponding advances in productivity had a similar effect on a regional basis, and was made possible by wage-setting rules that ensured that large wage increases spread through the economy, rather than remaining isolated in particular firms and sectors.

Labor market regulations that prevent wages and payrolls from adjusting to market conditions tended to have two effects. First, labor market rigidity strengthens the development of dual labor markets. In this situation, society is split between a core of employees with relatively secure employment and wages, and a periphery of workers who are relatively underpaid, and either underemployed, or chronically unemployed. If a country uses monetary policy to control inflation, as EU countries did during the 1990s, then the size of the periphery grows as firms balance wage rigidity and redundance protection with a greater proportion of contracted, temporary workers paid who can be paid less and shed easily.

In particularly extreme cases of polarization, as in Spain, wage restraint was virtually non-existent among employees with job protection, while peripheral workers bore the brunt of economic contraction through monetary policy. The Spanish case also shows that rules can be modified to change the balance of support for a policy of stability-oriented economic reform. Measures to allow contract workers to stay on the job longer increased their importance in the economy, and kept up the number of potential winners from an economic reform policy. Of course, the development of dual labor markets also reduces cash flow from income and payroll taxes available to pay for spending commitments. This has further social consequences, since the state is forced to reduce spending or raise funds with value added taxes, which hits the poor relatively harder.

The basic structure of the tax system proved to be a third type of institution that influenced a government's ability to combine price stability with balanced budgets, alongside labor market and spending institutions. In particular, payroll taxes as a financing system for social entitlements tended to exacerbate the development of dual labor markets.

In Germany, the tax structure's emphasis on payroll taxes to fund social spending led to a dynamic expansion of the peripheral labor market, first through unemployment, then a proliferation of low-wage and contract jobs. Each wave of peripheralization led to a larger pool of social transfer recipients and a smaller pool of premium payers, which led to a new round to payroll tax increases and a new round of peripheralization. The Kohl government was willing to top up payments with general tax revenues on an ad hoc basis, but on principle, it refused to back down on the linkage between premiums and benefits. Despite this, the premium-payment mechanism worked less as an automatic manager of income and payment needs, and more as a political reference point that could be used to solicit support for cutbacks when social insurance funds spent more than they collected.

In this light, the more fundamental challenge that the German government failed to meet, in contrast to the Netherlands, and in part in contrast to France, was to adapt the tax system to the changing structure of the economy. While the economy produced an ever-increasing portion of its income from capital investments (financial capital in particular was becoming more important), it refused to tax these factors to pay for social entitlements and continued to place the burden on the factor of labor, which could increasingly be replaced by foreign competitors. France suffered from the same problem, but made more progress in financing a portion of its social spending from taxes on financial, rather than labor income. Spain did not implement any transfer of taxes along these lines, but was also under less competitive pressure to do so while the peseta was still devaluing. Meanwhile, the Kohl government did not suggest a redistribution of this tax burden in its tax reform package in the run-up to the 1998 election.

Voter preference for stability (required to justify tax cuts) must have been higher than demand to sustain social spending in the face of a major economic shock, if the lack of tax reform is to be adequately explained. Therefore, policy priorities play a significant role in explaining the resilience of this institution. A topic of future study in this area would be to compare the need for reform in Germany, compared with partial reform in France and comprehensive reform in the Netherlands. Each of these countries began with a tax system that paid for social entitlements with payroll taxes. France and the Netherlands introduced changes in response to economic crisis, of which the development of a large structural labor market periphery may have been decisive. The fact that Germany had been so economically resilient until reunification, and that its peripheral labor market was relatively stable and contained, should indicate that the country is only now coming to a structural challenge to the finance of its social security system that other countries have already had to deal with. If this is so, it would detail the extent to which tax systems have an independent impact on adjustment, and their relationship to public pressure.

6.4 Economic Structure and the National Interest

Economic structure had a predictable impact on national priorities in economic and social policy. Consequently, it also had a predictable impact on the demands that governments made on the EMU project.

Germany's economic structure was still vastly different in east and west when EMU was launched. The western economy still carried its traditional strengths as a widely diversified, capital intensive economy with minimal sensitivity to exchange rate revaluations. Diversification weakened somewhat during the 1990s in response to the tax burden of reunification and a slowdown in investment, particularly in industries supplying components for high-end products, but the west continued to employ a greater proportion of the workforce in manufacturing than in most other western countries in 1998. Its traditional reliance on export surpluses in high-end manufactured goods and income from foreign investments was overwhelmed by imports of goods, services and capital to pay for eastern reconstruction after 1989, but was beginning to recover in the late 1990s. West Germans also depended on private pension funds for a considerable share of future retirement income, unlike France, Spain or the new states. The new states, in contrast, are typified by weaker, less diversified and less capital-intensive industry, heavier reliance on non-tradable services, and a lack of capital pension plans.

These economic interests were reflected in a persistent concern in west Germany about price stability, even during a hard recession and a period of record unemployment. Rather than consider a relaxation of monetary policy and a tolerance of both inflation and government borrowing to aid in the reconstruction of the former GDR, both government and opposition focused on reducing spending commitments and ensuring stability as the path to recovery and re-employment. Likewise, it is notable that when German public opinion leaders began suggesting that EMU should be delayed, few were deterred by the prospect that the mark could appreciate as a result. While some industry leaders suggested as much, politicians were reluctant to suggest such an incentive for proceeding with a 'soft' EMU.

France's economy had reached a stage in the 1990s at which it was exporting both goods and investment capital, but was not yet relying on income from investments abroad as a source of national income. Manufacturing constituted a smaller portion of the economy than in Germany, with a larger proportion of the population in service industries. It also had a much larger state sector than Germany, and a more serious case of chronic, long term unemployment. It also suffered more heavily from the devaluation of the lira, pound and peseta, as producers of standard products lost markets to their neighboring competitors, and an export industry sensitive to exchange rate fluctuations. Together, these indicators suggest that France was likely to have a less robust economy than Germany's with more vulnerability to exchange rate changes. Furthermore, direct interest in protecting investments through stability was developing, not fully built out. Capital pensions were introduced for the first time in the mid-1990s, and the popular capitalism model of privatizing the state sector was just beginning to shift some French savings from the guaranteed returns on Bank of France savings accounts to equities. Therefore, it had not yet developed a reliance on investment income that Frieden suggests would give it a strong direct interest in a strong exchange rate, although it was moving in that direction.

These economic interests were reflected back in the difficulty that each government had in trying to balance stability with growth requirements. With privatization, the job was becoming relatively easier, although several important public sectors, particularly transportation, continued to undermine efforts to contain inflation and reduce the deficit. The fact that the Jospin government had no privatization agenda at the time of writing should ensure that this tension is retained.

Spain was dependent on exports of standard products and a capital importer throughout the 1990s. Consequently, it benefited tremendously from the decisions to devalue in 1992, 1993 and 1995, as European manufacturers relocated some of their operations to

Spain to take advantage of lower costs. The country was in the process of building up its infrastructure as well as its manufacturing base, which is helping to balance out the country's relatively heavy reliance on agriculture and domestic services. Privatizations followed the French model of popular capitalism, in which shares are put up for purchase by employees and the general public. Capital pension plans have no history in Spain, as in France, but are developing, and should also prove an interesting subject of future research on whether Spanish voters develop an increasing interest in stability as private pensions become more common.

Spain's economic policy reflected the public's basic priorities in fiscal policy, but less so in monetary policy, as the Gonzales and Aznar governments tried to control the impact of the national inflation rate. Voters were attached to economic institutions that preserved and increased their standards of living, and the government was unwilling to single any of them out for cuts. Restraint came either through administrative cuts or through across-the-board cuts that were less efficient but easier to sell politically. While its deficits remained high, the government attempted continuously to control the inflationary effects with a restrictive monetary policy. Qualitatively, the restrictive nature was less impressive than that in Germany or France, given the inflation rate through most of the study period and the devaluations of 1993 and 1995, so the differential effect of voters is visible.

A course of future research should follow the development of capital holdings in the general population, and the course of economic policy across countries with different structures, and across time periods for countries in transition.

6.5 Lessons for Monetary Unions

Monetary policy is a great deal more political than we commonly assume. It affects the level of economic growth, employment levels, the degree to which government can promote economic welfare for its citizens through financial transfers, and the security of savings and investments. It stands to reason that countries which require different economic conditions in order to maximize their wealth and income will desire different monetary policies. These competing interests are bound to clash when governments seek to establish a monetary union. and EU states did in the case of EMU. They had much less room to maneuver in the pursuit of an agreement than they expected, due to the challenge of subordinating a wide range of economic and social policies to the demands of the new monetary union. Therefore, amending the rules of EMU became almost as likely a response as changing domestic policies to suit a durable commitment to the convergence criteria. This explains why disputes were so intense after the Maastricht Treaty had been signed, even years afterward. Ratification of membership in a monetary union is necessarily 'thick' rather than thin, and opens up the real opportunities for 'involuntary defection' long after the initial commitment has been made.

Establishing the monetary union is a dynamic process that is guided by the economic interests of countries, but that can also change it in the process. I expect the interests of gatekeepers to remain the most stable of all, since voters and institutions reinforce their priorities. To the extent that economic institutions adjust, I expect them to retain a strong interest in price stability.

Promoters, on the other hand, face the prospect of temporarily increasing the size of the labor market periphery (i.e. increasing unemployment) until they can complete the adjustment process. Nevertheless, high and growing long-lasting unemployment was a significant part of the problem for France and Spain in introducing institutional changes designed to entrench price stability. On the other hand, there are means by which they can erode the clout of growth-oriented supporters. France moved partially in this direction by privatizing state businesses. It also promoted a shift among savers from holding bank accounts to buying equities.

Gatekeepers, as their partners in monetary union, need to take more seriously the political consequences of Promoters' need to deal with unemployment as they attempt to adjust their institutions. French demands for a European economic strategy to combat unemployment without endangering price stability could have been a good starting point, but did not go very far in the run-up to stage three of EMU. Although the German government would likely have been right to suspect that additional spending on job creation would not have reduced unemployment, it also refused to launch a European initiative to boost employment. A European economic strategy would have increased pressure on the domestic opponents of reform in these areas, and perhaps have led to lower unemployment levels and improved public finances instead of higher unemployment and an increasing need to cut spending in a recession. Incidentally, it would also reduce the intensity and duration of opposition to austerity policies necessary for a stability-oriented monetary union by getting people back to work and keeping them there.

This last point underlines the fragile position in which Promoters find themselves, and the importance of outside help in committing to EMU. Since the commitment to monetary union is so 'thick,' requiring such a broad range of similar economic and social policy parameters, and since Gatekeepers require strong evidence of prior economic convergence before participating in a monetary union, Promoters need more than a goal of membership in monetary union in order to make the institutional changes they desire. Gatekeepers can help in this instance by doing precisely what Germany resisted--by legitimizing and participating in European-level programs designed to restructure labor markets and get people back to work. Gatekeepers would be in a good position to weigh the discussion in favor of institutional reform rather than inflationary wage subsidies. A successful adjustment process, prompted at the European level, would not only make the job of controlling public budgets easier, it would result in a more socially responsible and more stable means of committing the country to price stability, through fuller employment. In the medium and long term, it would also mean that less prior convergence would be necessary, to achieve the goal of stability that both Gatekeepers and Promoters desire.

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Table 2.10 Production by Kind of Activity, Germany (Million DM, 1991 Prices)°

	1991	1992	1993	1994	1995	1996
P	41.040	48.110	45.570	43.830	44.900	45.480
S*	987.110	978.900	919.200	948.510	957.740	952.430
T~	1.056.440	1.075.360	1.090.340	1.113.280	1.113.130	1.161.710
Total#	2.853.600	2.916.400	2.881.900	2.960.200	3.013.800	3.054.500

Source: OECD *National Accounts*. Table 12. Paris. 1998.
* Includes construction. Large increases in construction compensated partly for steep declines in other secondary industries. ~ Includes government services. # Includes non-productive adjustments such as value added taxes and import duties. °Reported data. Figures do not add to 100%.

Table 2.11 Employment by Kind of Activity, Germany (All Persons, Thousands)°

	1991	1992	1993	1994	1995	1996
P	1.424	1.212	1.115	1.067	1.026	970
S*	13.744	12.961	12.354	11.999	11.849	11.437
T~	13.601	13.591	13.413	13.246	13.021	12.824
Total	33.086	32.359	31.688	31.399	31.248	30.809

Source: OECD *National Accounts*. Paris. 1998.
* Includes construction. ~ Includes government services. °Reported data. Figures do not add to 100%.

Table 2.12 Productivity: GDP per Employed Person, Germany (DM, Current Prices)

	1991	1992	1993	1994	1995	1996
P*	39.616	39.695	40.870	41.078	43.762	46.887
S	71.821	75.527	74.405	79.049	80.829	83.276
T	77.674	79.123	81.289	84.046	85.487	90.589

Source: OECD. *National Accounts*, 1998.

Table 2.13 **GDP by Type of Expenditure, Germany.** (Million DM, 1991 Prices)

	Private Consumption	Government Consumption	Gross Fixed Capital Formation	Exports	Imports*	Total
1991	1,630,330	556,720	656,010	727,120	729,390	2,853,600
1992	1,676,380	579,370	679,270	724,880	744,060	2,916,400
1993	1,678,700	576,640	641,510	688,650	699,800	2,881,900
1994	1,698,960	588,890	664,160	742,800	753,970	2,960,200
1995	1,731,140	601,880	669,370	789,160	805,670	3,013,800
1996	1,753,540	612,630	661,290	824,430	823,640	3,054,500

Source: OECD *National Accounts*, 1998. *Reduces GDP.

Table 2.14 **Personal(& Country's) Financial Prospects for the Coming Year, Germany**

	1991	1992	1993	1994	1995	1996
Better	29 (33)	19 (13)	22 (16)	20 (39)	17(13)	11 (10)
Same	48 (36)	48 (27)	52 (32)	57 (34)	61(41)	58 (30)
Worse	14 (28)	31 (56)	23 (49)	21 (23)	19(43)	27 (57)
DK°	4 (4)	3 (3)	3 (4)	2 (4)	3 (3)	4 (3)

Source: Eurostat. *Eurobarometer* 36, 38, 40, 42, 44, 46.
°Don't know.

Table 2.15 **Personal (& Country's) Job Prospects for the Coming Year, Germany**

	1993	1994	1995	1996
Better	27 (16)	19 (25)	15 (9)	11 (8)
Same	56 (24)	63 (35)	56 (30)	50 (21)
Worse	12 (39)	18 (36)	10 (58)	14 (67)
DK°	3 (3)	0 (4)	20 (4)	25 (4)

Source: Eurostat. *Eurobarometer* 40, 42, 44, 46.
°Don't know.

Table 2.16 Personal (& Country's) Financial Prospects for the Coming Year, West Germany

	1991	1992	1993	1994	1995	1996
Better	22 (25)	15 (9)	19 (14)	19 (38)	16(12)	11 (10)
Same	53 (39)	50 (26)	53 (31)	58 (33)	63(41)	59 (31)
Worse	21 (31)	32 (62)	24 (52)	21 (24)	19(44)	26 (56)
DK°	4 (5)	3 (3)	3 (3)	3 (4)	3 (3)	4 (3)

Source: Eurostat, *Eurobarometer* 36, 38, 40, 42, 44, 46.
° Don't know.

Table 2.17 Personal (& Country's) Job Prospects for the Coming Year, West Germany

	1993	1994	1995	1996
Better	25 (14)	18 (25)	15 (9)	11 (9)
Same	59 (23)	68 (35)	59 (31)	51 (22)
Worse	11 (61)	15 (35)	9 (56)	13 (65)
DK°	4 (24)	0 (5)	19 (4)	25 (4)

Source: *Eurobarometer* 40, 42, 44, 46.
° Don't know.

Table 2.18 Personal (& Country's) Financial Prospects for the Coming Year, East Germany

	1991	1992	1993	1994	1995	1996
Better	54 (60)	34 (29)	32 (24)	23 (42)	20(17)	13 (11)
Same	29 (24)	40 (34)	47 (36)	54 (38)	55(42)	55 (25)
Worse	32 (13)	24 (34)	16 (36)	21 (17)	22(38)	28 (60)
DK°	4 (3)	3 (4)	4 (5)	1 (3)	4 (4)	3 (4)

Source: Eurostat, *Eurobarometer* 36, 38, 40, 42, 44, 46.
° Don't know.

Table 2.19 Personal(& Country's) Job Prospects for the Coming Year, East Germany

	1993	1994	1995	1996
Better	30 (22)	24 (23)	15 (8)	13 (6)
Same	47 (27)	47 (37)	51 (25)	47 (15)
Worse	13 (48)	29 (36)	14 (64)	20 (74)
DK°	5 (4)	0 (4)	20 (4)	20 (4)

Source: Eurostat, *Eurobarometer* 40, 42, 44, 46.
° Don't know.

Table 3.10 Production by Kind of Activity, France (Million FF, 1980 Prices)°

	1991	1992	1993	1994	1995	1996
P	164,471	180,944	168,637	168,203	168,669	179,539
S*	1,043,237	1,026,988	993,546	1,020,966	1,055,026	1,055,750
T~	1,975,617	1,935,018	1,944,788	2,266,912	2,303,419	2,345,518
Total#	3,572,769	3,614,329	3,566,247	3,667,016	3,743,418	3,799,603

Source: OECD *National Accounts*. Table 12. Paris, 1998.
* Includes construction. Large increases in construction compensated partly for steep declines in other secondary industries. ~ Includes government services. # Includes non-productive adjustments such as value added taxes and import duties. °Reported data. Figures do not add to 100%.

Table 3.11 Employment by Kind of Activity, France (All Persons, Thousands)°

	1991	1992	1993	1994	1995	1996
P	1,314.8	1,257.5	1,201.5	1,159.7	1,119.5	1,085.1
S*	6,297.3	6,096.2	5,862.9	5,704.7	5,651.4	5,586.5
T~	14,989.5	14,984.5	15,044.3	15,264.3	15,412.7	15,655.8
Total	22,501.5	22,338.2	22,078.7	22,062.7	22,283.6	22,287.4

Source: OECD *National Accounts*. Table 15. Paris, 1998.
* Includes construction. ~ Includes government services. °Reported data do not add to 100%.

Table 3.12 Productivity by Kind of Activity, France (Thousand FF)

	1991	1992	1993	1994	1995	1996
P	125.09	143.89	140.36	145.04	150.66	165.44
S	165.66	168.46	169.46	178.97	186.68	188.98
T	131.80	129.13	129.27	148.51	149.45	149.82

Table 3.13 GDP by Type of Expenditure, France, (Million FF, 1980 Prices)

	Private Consumption	Government Consumption	Gross Fixed Capital Formation	Exports	Imports*	Total
1991	2.158.815	656.280	807.434	924.058	992.992	3.572.769
1992	2.187.838	678.707	784.945	969.313	1.005.293	3.614.329
1993	2.191.318	702.495	732.537	965.383	969.825	3.566.247
1994	2.221.464	710.191	741.878	1.023.016	1.034.392	3.667.016
1995	2.258.256	709.994	760.262	1.087.815	1.087.178	3.743.418
1996	2.304.674	721.583	756.161	1.139.361	1.114.353	3.799.603

Source: OECD *National Accounts*, 1998. *Reduces GDP.

Table 3.14 Personal / Country's Financial Prospects, France

	1991	1992	1993	1994	1995	1996
Better	14 / 18	24 / 19	20 / 20	26 / 30	20 / 14	23 / 11
Same	43 / 36	46 / 35	45 / 30	53 / 44	40 / 24	46 / 29
Worse	40 / 34	25 / 39	31 / 46	17 / 19	36 / 60	29 / 56
DK	3 / 11	5 / 8	5 / 4	4 / 7	3 / 3	3 / 4

Source: Eurostat, *Eurobarometer* 36, 38, 40, 42, 44, 46.

Table 3.15 Personal / Country's Employment Prospects, France

	1993	1994	1995	1996
Better	25 / 11	21 / 27	21/14	22 /11
Same	43 / 24	58 / 37	59 / 29	12/63
Worse	24 / 61	22 / 32	12 / 55	58/25
DK	2 / 3	0 / 4	8 / 2	8/2

Source: Eurostat. *Eurobarometer* 40, 42, 44, 46.

Table 4.10 Production by Kind of Activity, Spain (Billion Ptas, 1986 Prices)°

	1991	1992	1993	1994	1995+	1996
P	2,260.8	2,240.1	2,218.9	2,012.7	1,579.1	1,932.7
S*	14,047	13,862.9	13,406.6	13,872.7	12,452.7	12,367.4
T~	23,458.2	23,698.0	23,651.7	24,039.7	5,266.0	5,317.2
GDP	39,903.3	40,177.6	39,710.0	40,592.3	41,699.7	42,646.2

Source: OECD *National Accounts*. Table 12. Paris. 1998.
* Includes construction. Large increases in construction compensated partly for steep declines in other secondary industries. ~ Includes government services.+ Break in data from 1995, some unavailable. °Reported data. Figures do not add to 100%.

Table 4.11 Employment by Kind of Activity, Spain (All Persons, Thousands)°

	1991	1992	1993	1994	1995+	1996
P	1,349	1,253	1,188	1,139	1,051	1,081
S*	4,155	3,985	3,735	3,649	3,643	3,671
T~	7,223	7,275	7,197	7,267	2,092	2,124
Total	13,202	12,999	12,616	12,552	12,758	12,946

Source: OECD *National Accounts*. Table 15. Paris, 1998.
* Includes construction. ~ Includes government services. +Data break in 1995, some information unavailable. °Reported data. Figures do not add to 100%.

Table 4.12 Productivity by Kind of Activity, Spain (Million Pesetas)

	1991	1992	1993	1994	1995	1996
P	1.676	1.788	1.868	1.767	1.502	1.787
S	3.381	3.479	3.589	3.802	3.418	3.369
T	3.247	3.257	3.286	3.308	2.517	2.503

+Data break in 1995. some information unavailable.

Table 4.13 GDP by Type of Expenditure, Spain (Billion Pesetas, 1986 Prices)

	Private Consumption	Government Consumption	Gross Fixed Capital Formation	Exports	Imports	Total*
1991	25.556.4	6.543.7	10.065.8	8.221.1	10.852.3	39.903.3
1992	26.121.8	6.808.1	9.618.4	8.828.3	11.604.5	40.177.5
1993	25.542.8	6.971.5	8.608.9	9.579.6	11.000.6	39.710.0
1994	25.780.7	6.948.1	8.814.1	11.180.3	12.248.7	40.592.1
1995	26.200.6	7.072.0	9,504.4	12.296.1	13.594.2	41.699.7
1996	26.708.4	7.079.9	9.593.1	13.509.6	14.439.9	42.646.2

* Adjusted for inventory stocks. Source: OECD *National Accounts*. 1996.