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Angela O'Mahony

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# Escaping the Ties That Bind

## Exchange Rate Choice Under Central Bank Independence

Angela O'Mahony

*University of British Columbia, Vancouver*

Central bank independence has been seen as an effective way to achieve low inflation. However, by increasing the likelihood that the government will adopt a fixed exchange rate rather than maintain domestic control over monetary policy, an independent central bank may be a victim of its own success. Because monetary policy set by an independent central bank may result in what the government considers to be adverse distributive consequences, governments may look for ways to mitigate the central bank's control over monetary policy, turning to a fixed exchange rate as one possible solution. The author examines the implications of this argument through an analysis of the British, German, and French governments' preferences on joining the European Monetary System in 1978.

**Keywords:** *central bank independence; exchange rate regime*

If the goal of central bank independence is low inflation, then by increasing the likelihood that the government will adopt a fixed exchange rate rather than maintain domestic control over monetary policy, an independent central bank may be a victim of its own success. In a world of international capital mobility, governments are forced to choose between a fixed exchange rate and domestic control over monetary policy.<sup>1</sup> By reducing the government's ability to manipulate monetary conditions, I argue that central bank independence may diminish the value of domestically determined monetary policy to the government. This suggests that, all else equal, as central bank independence increases, governments may become more likely to

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forego domestic control over monetary policy in favor of a fixed exchange rate. Although the conventional view is that central bank independence ties the hands of the government, the government in turn may seek to tie the hands of the central bank through the adoption of a fixed exchange rate.

Central bank independence has become a popular policy prescription, prescribed as a preventative for the opportunistic behavior perceived to bedevil discretionary monetary policy. The allure of an independent monetary policy is evident in the recent trend among both developed and developing countries to adopt more independent central banks (Maxfield, 1997). However, although central bank independence may remove domestic monetary policy from the government's control, governments do not cease to care about the distributional consequences of monetary policy. As more countries adopt independent central banks, the likelihood that a government will attempt to sidestep the central bank and achieve a more accommodative monetary policy through a fixed exchange rate may also increase.

As Sargent and Wallace (1975) first observed, policy makers face a time inconsistency problem when setting monetary policy. Since then, analysts have searched for institutional fixes to overcome this problem, pointing to both independent central banks and fixed exchange rates as effective commitment mechanisms. Within this framework, central bank independence provides a theoretically elegant solution to the time inconsistency problem and appears to be relatively costless in real terms.<sup>2</sup> However, such an approach to central bank independence implicitly assumes that monetary policy is mainly used for opportunistic reasons. Approaching central bank independence simply as a means of overcoming a government commitment problem ignores the distributive aspect of monetary policy. Although many scholars have studied the opportunistic uses of monetary expansion, monetary policy is not used solely for opportunistic reasons.<sup>3</sup> Monetary policy also allows governments to cushion the economy during economic downturns and affect distributive outcomes within the economy. Although the only impact of a fully anticipated increase in money supply is to increase inflation, with no accompanying increase in employment, when responding to an unanticipated economic shock, such a policy may serve to cushion the economy and lead to lower unemployment. When monetary policy making resides with an independent central bank sworn to a noninflationary monetary policy, governments no longer have the ability to manipulate the economy opportunistically, but they no longer have the ability to use monetary policy as an economic safety valve either.

From a monetarist view of the world, the rational expectations revolution put paid to the notion that monetary policy had real effects. However, recent

work has called into question the assumption that monetary policy has no real effects. Iversen (1999) reviews this literature and argues that there are real economic effects to monetary policy—suggesting that the use of monetary policy is not simply opportunistic and implying that central bank independence is not necessarily the “free lunch” as it has at times been portrayed.<sup>4</sup> Furthermore, Franzese (2002) demonstrates that not only is monetary policy not neutral but also that the anti-inflationary policies adopted by independent central banks can adversely affect employment. It is not a surprise, therefore, that this has at times led to conflict between governments and their independent central banks (Goodman, 1992; Henning, 1994; Oatley, 1997). Thus, although the work done on opportunistic monetary policy and the benefits of central bank independence is important, it is insufficient to explain governments’ monetary regime preferences.

In a world of international capital mobility, a fixed exchange rate also removes the government’s ability to manipulate monetary policy, as domestic monetary policy is consigned to maintaining the value of the exchange rate peg. As such, Clark and Hallerberg (2000) argue that central bank independence and a fixed exchange rate act as substitutes with respect to overcoming the time inconsistency problem inherent in determining domestic monetary policy. How effective either institution is in vouchsafing a credible monetary policy is a function of each country’s political environment. Broz (2002) argues that central bank independence will only constrain democratic governments. Keefer and Stasavage (2002) argue that within democracies, an independent central bank can lead to credible monetary policy but is more likely to do so in the presence of multiple veto players, a factor that has little effect on the credibility of a fixed exchange rate. In a similar vein, Hallerberg (2002) finds that governments feel less need for a credible commitment mechanism when there are few veto players, but as the number of veto players increases, the likelihood that a country will adopt a fixed exchange rate also increases.

What each of these studies shares is an implicit assumption that, when the commitment mechanism is credible, both an independent central bank and a fixed exchange rate will result in the same nonaccommodating monetary policy, and as a result, the distributive effects of the resulting monetary policy are irrelevant as a basis for comparison. This article calls into question this assumption, suggesting that although both central bank independence and a fixed exchange rate may overcome the time inconsistency problem inherent in a discretionary monetary policy, on a second distributive dimension, they may differ in a context-specific fashion. When faced with a choice between monetary policy determined by an independent

central bank and monetary policy imported from abroad through a fixed exchange rate, I argue that the government will prefer the one that produces a monetary policy closer to its own preferences. As such, the difference between central bank–dictated monetary policy and the monetary policy needed to maintain a fixed exchange rate may play a large role in the government's adoption of a fixed exchange rate.

The goal of this article is to highlight one unanticipated effect that central bank independence may have on a government's choice of exchange rate. Because central bank independence removes the government's ability to control monetary policy, foregoing a fixed exchange rate to maintain domestic control over monetary policy becomes less attractive to the government. And in the extreme, where monetary policy set by an independent central bank results in what the government considers to be adverse distributive consequences, governments may look for ways to mitigate the central bank's control over monetary policy. Adopting a fixed exchange rate may provide one solution for the government. Although conventional wisdom suggests that many governments adopt a fixed exchange rate to lock in anti-inflationary monetary conditions, I demonstrate that under certain circumstances, governments may turn to a fixed exchange rate to escape from anti-inflationary monetary conditions.<sup>5</sup>

In the following section, I present an interest-based explanation for a government's monetary policy preferences and analyze how a government might achieve its preferred monetary policy in the face of international and institutional constraints. I then test the hypothesis derived from this argument through an analysis of the preferences held in Great Britain, Germany, and France for joining the European Monetary System (EMS) at its inception.

## **Monetary Regime Choice When Institutionally Constrained**

Societal preferences over monetary policy tend to reflect a class cleavage.<sup>6</sup> Although capital prefers that the government adopt a nonaccommodating monetary policy (i.e., one that “adheres to a low-inflation target,” labor prefers that the government adopt an accommodating policy—one more concerned with “avoid[ing] a reduction in real demand” (Iversen, 1999, p. 2). Under a nonaccommodating policy, the monetary authority will not deviate from an announced monetary policy, even when this results in an increase in unemployment. In contrast, an accommodating policy is

more concerned with full employment than with price stability. As such, the monetary authority will deviate from the previously announced policy if doing so will prevent rising unemployment, even though it may also result in a higher than expected rate of inflation. The difference in the behavior between these two policy stances will not be seen in the baseline inflation preferences but rather in the policy maker's willingness to deviate from the announced policy in light of changing economic conditions. For theoretic ease, the status quo monetary conditions considered throughout this section will be the result of a previously announced nonaccommodating monetary policy, with inflation expectations normalized to zero.

The basis for the difference in labor's and capital's preferences over the choice of monetary policy stems from the differential effects unanticipated inflation has on labor's and capital's real income, which is most commonly understood through the logic of a short-run, rational expectations-augmented Phillips curve.<sup>7</sup> Although unexpected inflation erodes the real income of both labor and capital, for labor, it also increases the probability of employment. Therefore, a more accommodating monetary policy may have a positive effect on labor's expected income—while the real income that labor would receive is lower, the likelihood of receiving that income is greater. For capital, however, the only effect an accommodating monetary policy has is to lower capital's real return.

$$Y_{RK} = \left(1 - \frac{\pi^2}{2}\right) Y_{NK} \quad (1)$$

$$Y_{RL} = \left(1 + \gamma\pi \frac{\pi^2}{2}\right) Y_{NL} \quad (2)$$

The effect of a more accommodating policy on capital's and labor's real income is presented in Equations 1 and 2, in which  $Y_R$  is real income for capital ( $_K$ ) and labor ( $_L$ ),  $Y_N$  is nominal income,  $\pi$  represents actual monetary conditions (as captured by unexpected inflation), and  $\gamma$  is the employment gain from unexpected inflation,  $\gamma \geq 0$ .<sup>8</sup> Following from Equations 1 and 2, capital's preferred monetary policy is one that results in no unexpected inflation ( $\pi = 0$ ). In contrast, labor would prefer a more accommodating monetary policy, in which  $\pi = \gamma$  (derived from Equation 2). It is important to note that, although labor may prefer a more accommodating policy than that preferred by capital, labor's preferences are not unbounded. At high levels of inflation, the erosion of labor's real income  $\left(-\frac{\pi^2}{2}\right)$  quickly outweighs the employment gain ( $\gamma\pi$ ).

The foundation for any interest-based explanation of policy making is the assumption that the government's choice of policy reflects the demands of specific interest groups—in this case, labor and capital. In navigating between labor's and capital's preferences, the government's monetary policy preference is a combination of labor's preference for an accommodating policy ( $\pi = \gamma$ ), weighted by labor's political importance, and capital's preference for a nonaccommodating policy ( $\pi = 0$ ), weighted by capital's importance to the government. As a result, the government's preference will fall in between labor's and capital's preferences. In a country in which labor is more (less) important than capital, the government's monetary policy preferences will more closely resemble labor's (capital's) preferences.

This logic is captured in Equation 3, in which  $\pi_G$  is the government's preferred monetary conditions and  $P$  is labor's political importance to the government,  $P = [0, 1]$ , whereas capital's political importance is  $1-P$ . Equation 4 elaborates on the logic behind Equation 3, demonstrating that the government's utility with respect to monetary policy increases the closer actual monetary conditions ( $\pi$ ) are to the government's preferred monetary conditions ( $\pi_G$ ).

$$\pi_G = \gamma P \quad (3)$$

$$U_G = -(\pi - \pi_G)^2 \quad (4)$$

In a policy-making environment in which the government faces neither international nor institutional constraints, the actual level of monetary accommodation would be the same as the government's preferred level ( $\pi = \pi_G$ ). However, when governments face a tradeoff between a fixed exchange rate and domestic control over monetary policy or when the government's ability to set monetary policy is constrained by an independent central bank, actual monetary conditions may differ from those preferred by the government.

In a world of international capital mobility, governments face a trade-off between domestic monetary policy autonomy and a fixed exchange rate. The cost of a fixed exchange rate in an internationally open economy is losing domestic control over monetary policy. Conversely, a decision to maintain domestic monetary policy autonomy is tantamount to a decision to forego a fixed exchange rate. This is captured in Equation 5, in which  $\pi_D$  represents the monetary conditions that would exist if domestic monetary policy were determined solely by the preferences of the domestic policy maker,  $\pi_W$  represents the domestic conditions that must exist to maintain a fixed exchange rate, and  $\alpha$  is domestic control over monetary policy, in which  $\alpha$ : 1 represents complete domestic control over monetary policy and

$\alpha$ : 0 represents complete lack of domestic control over monetary policy ( $\alpha = [0, 1]$ ).<sup>9</sup> Actual monetary conditions ( $\pi$ ) are a function of the monetary conditions that would exist if the domestic policy maker were unconstrained by exchange rate commitments ( $\pi_D$ ) and the monetary conditions necessary to maintain a fixed exchange rate ( $\pi_W$ ). The extent to which the domestic monetary policy maker is constrained depends on the fixity of the exchange rate ( $1 - \alpha$ ).

$$\pi = \alpha\pi_D + (1 - \alpha)\pi_W \quad (5)$$

Although the government has little control over what conditions exist in the anchor currency country, when unconstrained by an independent central bank, the government is the sole domestic monetary policy maker. Thus, in deciding whether to adopt a fixed exchange rate, based solely on its monetary policy preferences, the government chooses between its preferred monetary conditions ( $\pi_G$ ) and the conditions required to maintain a fixed exchange rate peg ( $\pi_W$ ). When faced with such a decision, the government will prefer to maintain domestic control over monetary policy and secure its preferred monetary conditions rather than adopt a fixed exchange rate and subordinate domestic monetary policy to maintaining a pegged exchange rate.<sup>10</sup>

Central bank independence changes the choice facing the government. As central bank independence increases, domestic monetary policy is no longer solely controlled by the government but rather is increasingly a function of the central bank's preferences. Assuming that the central bank, like capital, prefers a nonaccommodating policy, an increase in central bank independence results in a lower level of accommodation than that preferred by the government.<sup>11</sup> This is captured in Equation 6, which models the determinants of domestic monetary policy ( $\pi_D$ ), where  $\eta$  is central bank independence;  $\eta = [0, 1]$ .

$$\pi_D = (1 - \eta)\pi_G \quad (6)$$

Increasing central bank independence reduces the value of domestic control over monetary policy to the government. When the government controls policy, it will always prefer to maintain domestic control; with an increase in central bank independence, this will no longer always be the case. Under central bank independence, when deciding between domestic control over monetary policy and a fixed exchange rate, the government no longer chooses between its own preferred monetary conditions and the conditions dictated by its international commitments but rather must choose



between less favorable central bank–dictated conditions and those necessary to maintain the exchange rate peg. This increases the likelihood that the government will adopt a fixed exchange rate rather than safeguard domestic control over monetary policy.

More rigorously, by substituting Equations 3, 5, and 6 into Equation 4 and maximizing with respect to  $\alpha$ , Equation 7 specifies the conditions under which the government is more likely to adopt a fixed exchange rate to achieve more favorable monetary conditions than those that would exist if domestic monetary conditions were determined solely by domestic monetary policy. These are examined in detail in the following comparative static (CS) results.<sup>12</sup>

$$\alpha = \frac{\gamma P - \pi_w}{(1 - \eta)\gamma P - \pi_w} \quad (7)$$

CS1: ( $\uparrow P \rightarrow \downarrow \alpha$ ): As labor's political importance increases, the likelihood that the government will adopt a fixed exchange rate increases.

CS2: ( $\uparrow \gamma \rightarrow \downarrow \alpha$ ): As the employment benefit of unexpected inflation increases, the likelihood that the government will adopt a fixed exchange rate increases.<sup>13</sup>

CS3: ( $\uparrow \eta \rightarrow \downarrow \alpha$ ): As central bank independence increases, the likelihood that the government will adopt a fixed exchange rate increases.

CS4: ( $\uparrow \pi_w \rightarrow \uparrow \alpha$ ): As the monetary conditions necessary to maintain a fixed exchange rate become more accommodating, the likelihood that the government will adopt a fixed exchange rate decreases.<sup>14</sup>

The punch line of the model developed in this section is that high levels of central bank independence may increase the government's propensity to adopt a fixed exchange rate. As central bank independence reduces the government's ability to dictate monetary policy, the value the government places on maintaining domestic control over monetary policy decreases. This effect is constrained by two factors: how important labor is to the government and how accommodating are the monetary conditions necessary to maintain a fixed exchange rate. Labor's political importance matters, because it dictates how close or far apart the government's monetary policy preferences are from those held by the central bank. As labor's political importance increases, the government's monetary policy preferences and those of the central bank diverge, thereby increasing the government's unhappiness with central bank control over monetary policy. Conversely, when labor's political importance is low and that of capital is high, then the government and the central bank share similar preferences for a nonaccommodating monetary policy. As a result, high central bank independence

should only result in a greater likelihood of a fixed exchange rate when labor's political importance is high.

What monetary conditions are necessary to maintain a fixed exchange rate also matter. If these conditions are further away from the government's preference than those that would exist under an independent central bank, then the government would prefer to forego a fixed exchange rate. This suggests that the more accommodating the monetary conditions are in the anchor currency country, the further away these conditions will be from the government's preferences. As a result, when inflation in the anchor country is high, an increase in central bank independence should have little effect on the government's choice of monetary regime. It is only when the monetary conditions necessary to maintain a fixed exchange rate are relatively nonaccommodating but more accommodating than those advocated by an independent central bank, that the government would prefer a fixed exchange rate to domestic monetary policy autonomy.

In sum, governments are most likely to adopt a fixed exchange rate to achieve more accommodating domestic monetary conditions when labor is politically important, there is an independent central bank, and the monetary conditions necessary to maintain a fixed exchange rate are relatively nonaccommodating. In the next section, I examine whether these considerations affected countries' decisions to join the EMS.

## The EMS

Negotiated in 1978 and adopted in 1979, the Exchange Rate Mechanism of the EMS was an attempt to reduce exchange rate uncertainty and increase monetary integration in Europe. At its inception, membership included all European Economic Community member states except Great Britain.<sup>15</sup> The EMS was viewed by its prospective members as a fixed exchange rate system in a world of international capital mobility.<sup>16</sup> The impetus for the EMS sprang from exchange rate concerns; however, the implications the EMS held for domestic monetary conditions played an important role in countries' decisions to join. Here, I analyze how the domestic monetary implications of the EMS affected the German, British, and French governments' preferences over membership and discuss how these preferences match up with the expectations of the previous section.<sup>17</sup> I then evaluate alternative explanations for EMS entry.

Both Germany and Great Britain were governed by left-of-center governments that favored relatively accommodating monetary policies—in

Germany, Helmut Schmidt led a Social Democratic Party–Free Democratic Party coalition, whereas in Britain, James Callaghan headed up a Labour Government.<sup>18</sup> Institutionally, however, the two countries differed sharply in who controlled monetary policy. In Germany, monetary policy was dictated by the Bundesbank, one of the most independent central banks in the world, whereas in Great Britain, the government set monetary policy through the quite dependent Bank of England. The effect of this institutional difference is evident in their resultant domestic monetary conditions, as seen by relatively low inflation in Germany and higher inflation in Britain.<sup>19</sup> By joining the EMS, both governments believed that monetary conditions would have to converge with those of other member states. For Germany, this would mean a looser monetary policy and a higher rate of inflation; conversely, Britain would have to tighten its monetary conditions to achieve lower inflation. As a result, I argue that one reason why the EMS appealed to the German government was because it would provide a respite from the Bundesbank's anti-inflationary stance; in contrast, the British government, which did not face any institutional constraints on their ability to set monetary policy, viewed the EMS as an unnecessary straitjacket on their ability to control the domestic economy. The divergence between these two views reflects differences in the policy-making autonomy exercised by the two central banks.

## Germany

The end of the Bretton Woods system in 1973 signaled a well-appreciated return to floating exchange rates for the Bundesbank. The German central bank looked on a floating exchange rate as the way for the Bundesbank to most effectively control domestic inflation (Loedel, 1999). While the rest of Europe suffered high rates of inflation in the wake of the 1974 oil crisis, the Bundesbank maintained its policy of extreme monetary restraint, even in the face of the economic downturn brought about by higher oil prices (Scharpf, 1987). The Bundesbank's restrictive monetary policy led it into conflict with German labor unions, which felt that the country's rising unemployment stemmed directly from the central bank's nonaccommodating monetary policy (Kaltenthaler, 1998). However, for the Bundesbank, "unemployment was certainly the lesser of two evils, and because of its independent status, it was sufficiently powerful to force an anti-inflationary bias on less willing segments of the West German economy" (Goodman, 1992, p. 71). As Jacobi (1986) argues, "unemployment became an economic policy instrument to control the movement of wages" (p. 217).

The unions' discontent with domestic economic conditions in the second half of the 1970s was reflected in the growing rift between labor and the government, which appeared powerless to counteract the Bundesbank's restrictive monetary policy.<sup>20</sup> Although the government could not afford to allow unemployment to rise for fear of losing labor's political support, in light of the Bundesbank's independence, it was powerless to force the Bundesbank to adopt a more accommodating monetary policy, and its attempts to influence the bank's policy were ignored (Goodman, 1992). It was against a background of tenuous labor-government relations and Bundesbank recalcitrance, therefore, that Schmidt, in consultation with French President Valéry Giscard d'Estaing, proposed the EMS in 1978. Although the focus of the proposal was exchange rate stability, the possibility of bypassing the Bundesbank's monetary policy was a happy coincidence for the government and one that garnered labor's support.

Although labor supported the government's proposal for the EMS, neither industrial capital, financial capital, nor the Bundesbank were in favor.<sup>21</sup> As Kaltenthaler (1998) recounts:

The Bundesbank was the most prominent critic of the plan. It argued that a system of fixed exchange rates threatened to import inflation into Germany from its inflation-prone neighbors. . . . The leadership of the Federation of German Industry (BDI) and the German Chamber of Commerce (DIHT) were also critical of the plan. These organizations shared the fears of the Bundesbank that a set of international monetary institutions, which could constrain the Bundesbank's ability to control the domestic German monetary supply, would bring inflation to Germany. (p. 49)

Schmidt was well aware that one implication of his proposal would be more accommodating monetary conditions. As he remarked in an interview with *Business Week*, "[EMS] might mean for Germany . . . that we have to expand our money supply somewhat more rapidly than we have done until now."<sup>22</sup> In an interview a month later with *Die Zeit*, Schmidt continued to downplay the importance of reducing inflation any further in the German economy, arguing that the current level of inflation was "bearable" and discounting inflationary concerns as a problem for EMS.<sup>23</sup> Schmidt, politically more concerned with labor's preferences than with those of capital or the central bank, pursued EMS in the face of the central bank's and capital's opposition. In fact, as Leaman (2001) argues, far from designing a monetary system to reinforce the Bundesbank's independence, Schmidt was "clearly seeking to bind the German and other central banks to a new set of politically defined rules" (p. 186).

Schmidt was also cognizant that the Bundesbank would be bitterly opposed to any international agreement that would restrict its ability to set domestic monetary policy (Henning, 1994). As a result, Schmidt negotiated EMS in strict secrecy, systematically excluding the Bundesbank from all discussions until just before the July meeting of the European Council (Ludlow, 1982). It was Schmidt's hope to present the Bundesbank with an international agreement that would force the Bundesbank to adopt a more accommodating monetary policy. At one level, Schmidt's strategy was successful. Had the Bundesbank entered into the negotiations earlier, it is doubtful that the EMS would have survived the initial rounds. However, this strategy was unable to fully contain Bundesbank opposition. Although Schmidt, as chancellor and with the Bundestag's support, had the authority to commit Germany to international commitments, the Bundesbank argued that if the monetary policy required by the EMS would violate the Bundesbank's constitutional mandate to protect price stability, the Bundesbank could not be forced to comply with the international agreement (Ludlow, 1982; Moravcsik, 1998). In the face of Bundesbank recalcitrance, Schmidt first threatened (not very credibly) to change the Bundesbank law and finally capitulated with a concession that the Bundesbank would not be bound to its EMS obligations if those obligations threatened German price stability.<sup>24</sup>

The prospect of the more accommodating monetary policy that Schmidt hoped German membership would force on the Bundesbank was a key motivation for Schmidt. Unfortunately, the concession the government was forced to make to the central bank negated the government's ability to constrain the Bundesbank through the exchange rate policy. In retrospect, the EMS came much closer to the Bundesbank's preferences than those held by the government, with the deutschmark acting as the strongest currency in the system and forcing other currencies to devalue as a result. As Moravcsik (1998) notes, "Pöhl, later Bundesbank President, later bragged of having 'turned the original [EMS] concept on its head by making the strongest currency the yardstick for the system'" (p. 255). Although the government ultimately failed to tie the hands of the central bank, Schmidt's actions support the argument posited in this article that when faced with an independent central bank, leftist governments may attempt to turn to a fixed exchange rate to achieve a more accommodating monetary policy.

The favorable monetary outcome the German government hoped to achieve through tying German monetary conditions to the EMS stands in marked contrast to the British government's decision to protect more favorable domestic monetary conditions by staying out of the EMS. For two governments with similar preferences and constituencies, the difference in

these two decisions can be traced to the role played by an independent central bank in setting domestic monetary policy. Although the inability of the German government to influence the Bundesbank increased the attractiveness of EMS membership, the British government's control over monetary policy reduced the government's willingness to sacrifice domestic monetary policy.

## Great Britain

Although the proposal for the EMS initially received lukewarm support in London, by the end of 1978, the British government came out solidly opposed to British participation (Jenkins, 1991). Although the Callaghan government never evinced wholehearted support for EMS, the government's position evolved during the second half of 1978, from tepid agreement in favor of "the idea of monetary stability" at the July Meeting of the European Council to open hostility toward the "deflationary effects of the EMS" by the December meeting (George, 1988; Statler, 1979). This change in heart reflected labor's fears that EMS membership would be deflationary, a fear that came to a head at the October Labour Party Conference (George, 1988; Ludlow, 1982).

Vocal segments of labor in Britain came out strongly against British membership in the EMS. Although recognizing the value of exchange rate stability, the Trade Unions Congress (TUC) argued that this stability would not offset the loss of growth that would result from less accommodating monetary conditions.<sup>25</sup> The TUC's position was echoed by Callaghan in his speech to the House of Commons explaining why he chose to keep Britain out of EMS. As Stephens (1996) recounts, "[Callaghan] told the House of Commons . . . that an attempt to tie the pound to the deutschmark would be needlessly deflationary. . . . In Callaghan's view [EMS] 'would place obligations on us that might result in unnecessary deflation and unemployment'" (p. 5).

In contrast to labor's opposition to EMS in the fear that EMS would force Britain to adopt a monetary policy that was less accommodating than the policy which the government would implement, capital was in favor of EMS for precisely that reason. Capital, as represented by the Association of British Chambers of Commerce (ABCC) and by the City of London's leading bankers, hoped that joining the EMS would force an external discipline on the government that would result in a lower level of domestic inflation. As the ABCC argued in its testimony to the House of Commons Expenditure Committee: "It is the discipline imposed by the EMS which is the chief immediate gain from entry" (Association of British Chambers of Commerce,

1978a: 117). In a pamphlet in favor of the EMS, the ABCC further argued that "EMS offers some immediate chance of imposing a much needed discipline on British governments to resist short term political palliatives at the expense of long term economic stability" (Association of British Chambers of Commerce, 1978b, as cited in Statler, 1979).<sup>26</sup> The ABCC's position closely mirrored that held in the city. Similarly to the ABCC's testimony, representatives of the city's leading banks testified to the Expenditure Committee that a key benefit of EMS for Britain would be its anti-inflationary bias, as "a fixed exchange rate imposes an external discipline against inflation" (Johnson, 1978, p. 88).<sup>27</sup> In addition, the Bank of England provided an institutional underpinning to the refrain that the EMS would have a deflationary effect on British monetary policy and would serve to tie the government's hands (Healey, 1990).

The Bank of England's and capital's arguments in favor of the monetary discipline that EMS would provide fell on deaf ears. Rather than participating in EMS and committing to a less accommodating monetary policy, the Labour government acceded to labor's demands that it maintain a more accommodating monetary stance than would have been possible within EMS.

The British case underpins the argument forwarded in this article in two ways. First, Britain's decision not to participate in EMS suggests that arguments that focus primarily on the commitment aspect of monetary institutions and that ignore the distributive effects of monetary policy are insufficient. Despite the lack of a domestic commitment mechanism, Callaghan chose not to participate in EMS. Second, both the British and German cases demonstrate that the distributive aspect of monetary policy matters to governments. In Germany, the Schmidt government preferred EMS in the hope that it would create a more accommodating monetary policy than that chosen by the Bundesbank. In Britain, the Callaghan government preferred to forego EMS and its concomitant solution to the time inconsistency problem rather than commit itself to a nonaccommodating policy.

## France

The French case stands in marked contrast to Britain and Germany. Unlike Schmidt and Callaghan, French President Valéry Giscard d'Estaing preferred a nonaccommodating monetary policy.<sup>28</sup> As such, Giscard's preferences did not greatly differ from those of the Bundesbank. Therefore, although a fixed exchange rate would not lead to less preferred monetary conditions, in the absence of an independent central bank, the model in this article predicts that the government ought to have been able to achieve its



preferred policies domestically. As a result, although the EMS may have appealed to Giscard on other grounds, its domestic monetary implications should not have been an important factor. However, contrary to the expectations of this model, it was precisely because of its effect on French monetary conditions that Giscard supported the EMS. Although Giscard was unconstrained by the *Banque de France*, political opposition to a nonaccommodating policy prevented him from adopting his ideal policy through domestic means.

In 1976, following the high inflation that ensued in the wake of the first oil crisis, Giscard appointed Raymond Barre, a well-known conservative economist, as prime minister with a mandate to impose economic austerity. On entering office, Barre developed a comprehensive economic reform package to control inflation and stimulate economic growth in which a nonaccommodating monetary policy was the linchpin. However, Giscard and Barre quickly found their ability to implement their policies curtailed by domestic opposition; although Giscard and Barre “were prepared to ‘take’ unemployment” (Cohen, Galbraith, & Zysman, 1982, p. 52), other domestic actors were not. As Ludlow (1982) notes, “the domestic political base on which the president relied [was] simply not strong enough for him to sustain the programs and ambitions that he developed or nursed . . . there was simply not enough agreement about the desirability of the end to tolerate the means that the president and his ministers devised . . .” (p. 33). As a result, although the government did adopt more restrictive monetary targets, the money supply consistently overshot these targets, violating the nonaccommodating monetary policy and resulting in continued high inflation.

The weakness of the government’s base can be seen most strongly prior to the 1978 parliamentary elections, in which it was widely believed that the socialists and communists would secure enough seats to form a government of the left. As one government official noted, “the left seemed likely to win the elections. . . therefore, we had to be careful to maintain an economic situation in the country which would not provoke social unrest. We would have been right in economic terms, but would have lost the elections.”<sup>29</sup>

Against expectations, and because of the implosion of the pre-electoral accord between the socialists and the communists, the left failed to win a majority in the 1978 election, and Barre remained prime minister in a center-right coalition government composed of Giscard’s economically conservative *Union pour la Démocratie Française* and the socially conservative Gaullist *Rassemblement pour la République* (RPR). At first glance, then, it would appear that Giscard’s and Barre’s ability to achieve their preferred nonaccommodating monetary policy had increased. However, although



labor was no longer a looming threat to Giscard and Barre, their Gaullist coalition partners were. As Lauber (1983) notes, "the attitude of the RPR . . . evolved from support for Barre's policy in the first year to open criticism before the 1978 elections, and finally to increasingly bitter, even vicious attacks" (p. 111). In the face of this strident opposition from their coalition partners, Giscard and Barre were unable to adopt a sufficiently restrictive monetary policy to meet their nonaccommodating preferences.

In light of continuing domestic opposition, Giscard and Barre viewed the external discipline that EMS membership would impose on the economy as an integral component of their reform efforts. Had they been able to adopt a nonaccommodating monetary policy domestically, the external discipline of a fixed exchange rate would not have been needed. However, because of the strong presidential powers that allowed Giscard to commit France to the EMS without parliamentary approval, a fixed exchange rate allowed Giscard to escape his domestic constraints and use the EMS to achieve his preferred domestic monetary policies. Thus, the French case provides support for the broader argument in which this article is nested—governments may turn to the international arena to overcome domestic constraints.<sup>30</sup> Like Schmidt, Giscard faced domestic constraints on his ability to achieve his preferred monetary policy. For Schmidt, the Bundesbank prevented the adoption of a more accommodating policy, whereas Giscard was constrained by domestic political opposition from achieving a nonaccommodating policy.

The primary goal of this article is to highlight how the distributive effects of an independent central bank's monetary policy may increase a labor-based government's incentives to adopt a fixed exchange rate, as shown in the German and British cases. However, the French case demonstrates that governments may face additional domestic constraints on their ability to achieve their preferred policies. A more comprehensive explanation of how domestic monetary considerations affect exchange rate choice must look beyond the central bank for constraints on government action. As such, the French case suggests an avenue for refining and extending the model developed in this article.

## Alternative Explanations

The argument developed in this article emphasizes the importance of considering the distributive aspects of domestic monetary institutions. Below, I briefly review partisan, credibility, ideational, institutional, and trade-based explanations for fixed exchange rate regimes and argue that

these explanations are insufficient to explain the preferences over EMS entry held in Germany, Britain, and France.

Based on a partisan explanation of exchange rate choice, Bearce (2003) argues that "rightist parties tend to represent internationally oriented business groups with preferences for monetary convergence, while leftist parties do the same for domestically oriented groups preferring monetary autonomy" (p. 375). Drawing on this framework, we would expect Giscard, as the leader of a rightist government, to favor EMS entry, whereas Schmidt and Callaghan, as leaders of leftist governments, should oppose EMS membership. Although France and Britain match Bearce's predictions, Schmidt's advocacy of the EMS as a mechanism to remove domestic autonomy and thus tie the hands of the Bundesbank does not. The argument developed in this article shares Bearce's partisan emphasis but differs in its predictions based on the role played by an independent central bank in shaping the preferences of a leftist government.

Emphasizing the external discipline implied by EMS participation, Giavazzi and Pagano (1988) posit that for countries that cannot credibly commit to a nonaccommodating policy, EMS provides anti-inflationary credibility. As a result, we should expect France and Britain, who both faced high rates of inflation, to favor EMS entry, whereas Germany, which had a credibly anti-inflationary policy, should not join EMS. Although this argument does well to highlight Giscard's desire for EMS entry, it goes against Schmidt's rationale for EMS entry and ignores Callaghan's opposition to EMS entry. By focusing on aggregate welfare improvements rather than on the distributive effect of monetary policy, this explanation cannot explain why gaining anti-inflationary credibility is important to some governments and not to others.

Although the argument developed in this article emphasizes a class-based approach to identifying when an anti-inflationary policy may be important to the government, McNamara (1998) presents an ideational explanation. For McNamara, the neoliberal policy consensus that characterized European economic policy making in the 1980s increased the likelihood of anti-inflationary policies, and hence, EMS. As a result, countries that adopted a neoliberal outlook prior to 1978 were more likely to join EMS. McNamara suggests that a neoliberal policy consensus existed in Germany throughout the 1970s, emerged in France in 1976 with Barre's appointment as prime minister, and did not emerge in Britain until Margaret Thatcher's election in 1979. Therefore, we would expect EMS participation by France and Germany, but not by Britain. At first glance, this explanation comports well with reality. However, as the earlier discussion of the French

and German cases demonstrated, there remained strong domestic disagreement over monetary policy. In Germany, Schmidt turned to the EMS to escape a neoliberal monetary policy, whereas in France, Giscard viewed EMS as a way of implementing a neoliberal policy that had been blocked domestically. Although the neoliberal consensus of the 1980s may explain EMS stability in the second half of the 1980s, it does less well as an explanation of initial EMS participation.

The preceding explanations focus on the substantive choice of domestic monetary policy. In contrast, Bernhard and Leblang (1999) emphasize the value to the government of pre-electoral monetary policy manipulation and argue that "in systems where the cost of electoral defeat is high and electoral timing is exogenous, politicians will be less willing to forego their discretion over monetary policy with a fixed exchange rate" (p. 72). For France and Britain, which are both majoritarian systems with low opposition inclusiveness, electoral defeat is costly; in contrast, the German system is characterized by high opposition inclusiveness and proportional representation, lowering the cost of electoral defeat.<sup>31</sup> As a result, we would expect EMS participation to be more likely in Germany than in Britain or France. Although this argument fits well with the British and German cases, it does not explain the French case. Although domestic political institutions may describe one factor affecting the government's decision, such an explanation is incomplete without analyzing how closely domestically determined monetary policy reflects politicians' preferences. As such, it cannot address why, in a system where electoral defeat is costly, France joined EMS and Britain did not.

Finally, although the previous explanations focus on the monetary aspects of a fixed exchange rate, Frieden (2002) emphasizes how EMS membership may facilitate intra-European trade and investment and demonstrates that adherence to exchange rate stability increases with a country's level of intra-European trade.<sup>32</sup> Extending this argument to EMS entry, we would expect that countries that trade more with other European Economic Community members would be more likely to join EMS. From this view, German participation in EMS is expected because of Germany's strong trade ties within Europe. Similarly, British disinclination toward EMS membership may in part reflect Britain's relatively weak European trade ties, with British intra-European manufactured exports accounting for only 6.5% of GDP in 1978. In contrast, the French case appears less compelling. Although French trade ties with Europe appeared to be at least as weak as British ties (French intra-European manufacturing exports accounted for 5.75% of GDP), France joined EMS, whereas Britain did not.

This would suggest that although trade ties may affect EMS membership, the monetary aspects of exchange rate regime choice remain important.

## Conclusion

In this article, I have argued that governments are concerned about the distributive aspects of monetary policy. As a result, central bank independence may have the unintended effect of increasing the likelihood of a fixed exchange rate. In the face of an independent central bank, a left of center government may adopt a fixed exchange rate in an attempt to garner a more accommodating domestic monetary policy. More generally, when an exchange rate peg results in a monetary policy more favorable to the government than that which could be achieved domestically, governments are more likely to adopt a fixed exchange rate. Conversely, when a fixed exchange rate forces governments to accept less favorable monetary conditions than could be achieved at home, the attractiveness of a fixed rate declines.

Recent experience in Europe's Eurozone has highlighted this reality. As the divergence between the more accommodating monetary preferences of domestic politicians and the anti-inflationary preferences of the European Central Bank (ECB) becomes more pronounced in the face of the Eurozone's continued economic weakness, countries' unhappiness with Economic and Monetary Union (EMU) has grown. Since its inception as monetary guardian for the Eurozone, the ECB and its nonaccommodating monetary policy have been castigated as the architects of the European economic slowdown. Increasing frustration with ECB policy has led some politicians to ramp up their criticism, moving beyond demands for lower interest rates to calls for a return to domestic currencies (Barber, 2005). Most notably, in June 2005, Italian Welfare Minister, Roberto Maroni, declared that Italy would be better off with the lira rather than the euro, whereas in Germany, rumors abounded that the government was considering the conditions under which Germany might exit the EMU ("The Euro," 2005). Although a German or Italian exit from the EMU is unlikely to occur in the near future, these two episodes highlight the importance governments place on achieving favorable domestic monetary conditions.

This article highlights two important findings. First, although central bank independence and fixed exchange rates may both overcome the government's time inconsistency problem in the realm of monetary policy, overcoming this time inconsistency problem may be of less importance than the distributive implications of the resulting monetary policy. Second,

because governments care about the distributive consequences of monetary policy, in cases in which the government's control over monetary policy is constrained, governments may attempt to escape the ties that bind them.

## Notes

1. This stems from the Mundell-Fleming constraint, which states that countries can have up to two of the following three: capital mobility, domestic control over monetary policy, or a fixed exchange rate. Attempts to control monetary policy and the exchange rate in a world of international capital mobility run a high risk of a balance of payments crisis.

2. For central bank independence as a policy recommendation for the government's time inconsistency problem, see Cukierman (1992), Lohmann (1992), and Rogoff (1985).

3. For a review of the opportunistic uses of monetary policy, see Alesina, Roubini, and Cohen (1997).

4. For central bank independence as a "free lunch," see Grilli, Masciandaro, and Tabellini (1991).

5. See Giavazzi and Pagano (1988) for an explanation for why governments will turn to a fixed exchange rate to lock in anti-inflationary monetary conditions.

6. This assumption has a long tradition. See Alesina et al. (1997) for a review.

7. See Hibbs (1977), Cukierman (1992), and Alesina et al. (1997) for a discussion of the Phillips curve and its effects on the preferences of labor and capital.

8.  $\pi = \pi_a - \pi_e$ , in which  $\pi_a$  = actual inflation and  $\pi_e$  = expected inflation, with  $\pi_e = 0$ ,  $\pi = \pi_a$ . This conceptualization of inflation reflects the critique, first voiced by Friedman (1968), that expected levels of inflation are factored into economic actors' decisions, and therefore, the only inflationary effects in the economy stem from unanticipated inflation.

9. As the members of the fixed exchange rate system more closely resemble an optimal currency area, the conditions necessary to maintain a fixed exchange rate ( $\pi_w$ ) should approximate the prevailing conditions in the anchor country or countries.

10. This can be demonstrated more formally by setting  $\pi_D$  equal to  $\pi_G$  and substituting Equation 5 into Equation 4 and maximizing with respect to  $\alpha$ ;  $\alpha = 1$ .

11. For a critique of the assumption that central banks always hold nonaccommodating monetary preferences, see Adolph (2004).

12. These comparative statics are monotonic; however, as  $\alpha$ : [0, 1], corner solutions apply.  $\pi_D \neq \pi_w$ .

13. The stronger the Phillip's curve tradeoff in the economy, the larger this effect. This result, although not subject to testing in this article, would suggest that the intensity of any findings in this article may be subject to the structure of the labor market.

14. At a technical level, what this comparative static captures is that as international conditions become more accommodating, a less stringent exchange rate regime is needed to force the central bank to adopt a more accommodating monetary policy. More theoretically and importantly, it highlights the narrow range of the government's monetary preferences. Although a government may prefer a more accommodating monetary policy than that preferred by the central bank, the government's accommodation preferences will not exceed the level dictated by  $\gamma$ —as international conditions exceed  $\gamma$ , the central bank's nonaccommodating policies will more closely resemble the government's preferences than will international conditions.

15. Throughout this article, I use EMS to refer to the exchange rate mechanism of the European Monetary System. Although Britain did join the European Monetary System, it did not participate in the exchange rate mechanism until 1990.

16. In reality, EMS, with its frequent exchange rate realignments, was not the fixed exchange rate regime that its framers expected it to be. In this article, I present a picture of the EMS based on initial expectations rather than on how the system evolved in practice.

17. Case selection was determined by two criteria. First, cases were limited to countries where the EMS would constitute a change in exchange rate regime. As a result, Belgium, the Netherlands, Luxembourg, and Denmark, who participated in the "Snake"—the European fixed exchange rate system that preceded EMS—were excluded. For non-Snake members (France, Ireland, Italy, and Great Britain), EMS qualified as a significant alteration of their exchange rate regime, from floating to fixed exchange rate regimes. In the case of Germany, although it was also a Snake member, as the Snake anchor currency, it had maintained exchange rate flexibility throughout the Snake. As I shall discuss below, Schmidt's conception of the EMS would require Germany to sacrifice some of its flexibility and therefore constitute a significant change in the exchange rate regime. Second, countries that received a side payment for joining were excluded. As a result, I exclude Ireland and Italy from the analysis based on the role played by European Economic Community funding to help smooth the transition (Ludlow, 1982).

18. For a discussion of the Schmidt government's ties to the labor movement, see Markovits (1986), Scharpf (1987), and Goodman (1992).

19. German inflation in 1978 was 2.7%, whereas inflation in Britain was 8.3% (Organisation for Economic Cooperation and Development, 2005).

20. Contrary to the belief that inflation is an overriding concern for all Germans, Johnson (1998) argues, "polls indicated that the German population, defying the [Bundesbank's] mythology, continues to worry more about unemployment than inflation" (p. 100). Similarly, Peretz (1981) concludes that although inflation has little effect on party popularity in Germany, unemployment does influence voters' perceptions of parties. For an account of government–union tension, see Thelen (1991) and Goodman (1992).

21. For a discussion of societal preferences with regard to EMS, see Kaltenthaler (1998). For Bundesbank opposition to EMS, see Goodman (1992), Heisenberg (1999), Jenkins (1991), Kaufmann (1985), Kaltenthaler (1998), Kennedy (1991), and Marsh (1992). For the opposition of the Frankfurt financial establishment, see Ludlow (1982).

22. Business Week (June 26, 1978) as cited in Heisenberg (1999, p. 56).

23. *Die Zeit* (July 21, 1978), author translation. Also cited in Kaufmann (1985, pp. 80–81).

24. For more detailed accounts of the Schmidt–Bundesbank standoff and of their communication, both written and verbal, see Ludlow (1982) and Moravcsik (1998).

25. Ludlow (1982), citing testimony given at the House of Commons Expenditure Committee, November 20, 1978.

26. Association of British Chambers of Commerce, *The Case for EMS* (London: Association of British Chambers of Commerce, 1978b), as cited in Statler, 1979.

27. The City Bankers were represented by Sir Jeremy Morse, chairman of Lloyds Bank; Mr. Robin Leigh-Pemberton, chairman of the National Westminster; and Mr. Anthony Tuke, chairman of Barclays Bank.

28. This section draws on Lauber (1983), Goodman (1992), Moravcsik (1998), and McNamara (1998).

29. This interview was cited in Goodman (1992, p. 123).

30. This argument fits well within the tradition of two-level games. For a discussion of the logic of two-level games, see Putnam (1988).

31. According to Bernhard and Leblang (1999), all three countries have endogenous electoral timing.

32. In particular, Frieden argues that manufactured exports to the deutschmark bloc (Germany, Belgium, the Netherlands, and Luxembourg) should be most important but that results from both intra-European Economic Community and deutschmark bloc analyses are consistent. Data used in this section were provided by Jeffrey Frieden from the analyses run in Frieden (2002).

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**Angela O'Mahony** is an assistant professor in the Department of Political Science at the University of British Columbia, Vancouver, Canada.