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Money, Markets and Power: Explaining
Patterns of Pegged Exchange Rate Regimes

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Abstract

This paper investigates the ways monetary power affects the rules and operations of pegged exchange rate regimes. Two puzzles form the basis of this analysis: Why are exchange rate regimes inherently asymmetrical and why do monetary negotiations result in similar bargaining outcomes? Monetary power is the key to solving these puzzles. Drawing on other contributions to this project, the paper argues that monetary power results from differential adjustment obligations of weak and strong countries. At their very core, the rules and operations of pegged exchange rate regimes reflect issues of how to distribute the burden of adjustment. Conceptually, the paper starts with the argument that there is a distinct structural logic of monetary interaction owing to the interdependent nature of exchange rates. Under these conditions, participants in an exchange rate regime need to establish consistency between internal macroeconomic policy and external exchange rate policy. Countries solve the consistency issue on the basis of market power. Strong monetary players have greater bargaining leverage in monetary negotiations because they do not face a reserve constraint. They can use their leverage to protect their own domestic macroeconomic priorities and to compromise merely on questions of external adjustment and financing. The paper evaluates these analytical assumptions by comparing two European exchange rate regimes (the snake and the European Monetary System) and a global regime (the Bretton Woods system).

Keywords

monetary relations, policy leadership, economic adjustment.

Introduction

How does monetary power shape negotiations for monetary cooperation? Does the exercise of monetary power influence the outcomes of negotiations in predictable patterns? In this paper I investigate the ways monetary power affects the rules and operations of pegged exchange rate regimes. I will do so by revisiting, amending and expanding the argument I developed in previous work on European monetary cooperation,¹ while integrating it into the conceptual ideas about monetary power developed elsewhere in this project. Empirically, this paper presents a comparative case study of two European exchange rate regimes—the snake and the European Monetary System—and a global regime, namely the Bretton Woods system.

The observation that international monetary cooperation exhibits striking patterns of similarity and continuity triggered my interest in the effects of monetary power. First of all, monetary regimes are inherently asymmetrical. The rules of monetary cooperation and the actual operation of monetary regimes are characterized by a significant imbalance between stronger and weaker players—no matter whether they are global or regional in scope or which countries participate in it. Second, the asymmetry of monetary regimes follows consistent patterns. Bargaining exchanges typically involve the protection of the leader's domestic macroeconomic preferences and concessions on issues of external adjustment and financing. The continuity of patterns in monetary cooperation forces us to ask a number of important analytical questions: Why are outcomes of monetary cooperation not random or why do they not vary with circumstances? What explains these patterns? Why are the outcomes of exchange rate negotiations consistently asymmetrical? And why do weak and strong monetary players engage in the same type of bargaining exchange each time they negotiate rules for monetary cooperation?

I argue in this paper that monetary power is the key variable to answer these questions. This is not to say that monetary power approaches are necessarily superior to other theories. Rather, they complement each other. For example, my argument treats the state largely as a 'black box'. Such a simplification, of course, ignores the role of domestic politics and with it a large body of important scholarship on monetary issues. However, I am not interested in explaining the formation of preferences for monetary cooperation. While domestic politics approaches often present very successful explanations of monetary interests, they are not helpful for the questions at stake here. They cannot explain the inherent asymmetry of exchange rate regimes nor the consistency with which monetary bargaining results in similar outcomes. Those outcomes do not vary with domestic factors. In this sense, my paper seeks to highlight the strengths of a monetary power approach in answering certain types of questions in monetary relations, while it remains conscious of the limitations of monetary power in explaining all aspects of the monetary realm.²

My argument starts from general assumptions made about monetary power in this project—in particular the contributions by David Andrews and Benjamin Cohen.³ Both of them argue that monetary power results from differential adjustment obligations of weak and strong countries. In this paper I extend and amend their arguments to an analysis of the rules and operations of pegged exchange rate regimes. The crucial issue for my purposes is the translation process from more general assumptions about monetary power into bargaining leverage on exchange rate negotiations. At their very core, the rules and operations of pegged exchange rate regimes reflect issues of how to distribute

1 Matthias Kaelberer, 2001. *Money and Power in Europe: The Political Economy of European Monetary Cooperation*. Albany: State University of New York Press.

2 Andrew Walter's contribution to this collection of working papers supplements my argument by looking at the domestic bases of monetary power. Andrew Walter, 2005. *Leadership Begins at Home: The Domestic Sources of International Monetary Power*. EUI Working Papers RSCAS No. 2005/15.

3 David M. Andrews, 2005. *Monetary Autonomy and Asymmetric Adaptation*. EUI Working Papers RSCAS No. 2005/07. Benjamin J. Cohen, 2005. *The Macroeconomic Foundation of Monetary Power*. EUI Working Papers RSCAS No. 2005/08.

the burden of adjustment. Pegged exchange rate regimes allocate adjustment obligations either *de jure* through explicit rules, or *de facto* because some areas of adjustment remain uncodified.

The paper develops two broader conceptual claims. First, I argue that there is a distinct structural logic of monetary interaction. Exchange rates, by their very nature, are expressions of interdependence. Simply speaking, an exchange rate represents the price of one currency in terms of another currency. Because exchange rates constitute the point of convergence between domestic policy autonomy and the exogenous international environment, monetary regimes must codify the mechanisms by which participants establish equilibrium between their own domestic macroeconomic policy and that of their partner countries. In other words, governments need to establish consistency among their policies.

My second conceptual claim deals with the solution countries devise for this problem. In theory, governments have two options to establish consistency. They can establish consistency either through internal adjustment (change in macroeconomic policy) or external adjustment (exchange rate change). A third instrument that is relevant in this context, but that does not constitute real adjustment, is the potential to delay or soften real adjustment through the financing of the disequilibrium. I argue that countries solve the consistency issue on the basis of market power. Simply speaking, some countries are in a better bargaining position to achieve their goals in exchange rate negotiations than others. The most important advantage that strong monetary players have over their weaker counterparts is the *absence of a reserve constraint*—in other words, their unlimited financing ability. Countries that do not face a reserve constraint can finance a balance of payments disequilibrium as long as they want. Their factual limit on interventions in financial markets reflects a *domestic* policy choice (for example, a desire to limit the inflationary consequences of interventions). Weak monetary players, on the other hand, face an *externally imposed* reserve constraint. They simply cannot continue financing a balance of payments disequilibrium once their access to hard currency reserves runs out.

This paper concentrates on explicit pegged exchange rate regimes. It does not include efforts at *ad hoc* monetary cooperation under flexible exchange rates—for example, the Plaza—or Louvre accords. Similarly, I will not address unilateral decisions by governments to peg exchange rates or any form of currency union. The advantage of concentrating on pegged exchange rate regimes is that it allows us to zero in on explicit rules and procedures with identifiable bargaining processes and patterns of behaviour. The explicit character of exchange rate negotiations makes it feasible to compare the pre-bargaining positions of governments with the outcomes of bargaining processes. We are, therefore, able to trace the bargaining exchanges by the participants in the negotiation process and we are able to assess and compare the actual functioning of different monetary regimes.

The first section of the paper examines the consistency dilemma and the basic structural logic of interdependent monetary relations. The second section spells out the sources of market-based power that countries use in solving the tension between internal and external monetary goals. Here I specify what makes countries stronger and weaker players in the monetary realm. In the third section, I evaluate these analytical assumptions by comparing the snake, EMS and the Bretton Woods System.

Monetary Power, Interdependence, and Adjustment

Monetary power is the inevitable result of the fact that monetary relations are by definition interdependent. Exchange rates express relationships; they are not self-referential. The exchange rate is the price of one currency measured in terms of another. Thus, no single government can single-handedly determine the price of its currency and at the same time pursue its domestic macroeconomic objectives autonomously. The two objectives logically preclude each other. Similarly, the logic of balance of payments is interdependent as well. What is one country's surplus is another one's deficit. The global balance of payments must be zero. Not all players can expect to run a balance of payments surplus.

The interdependent nature of exchange rates leaves governments with a range of options on a spectrum of policy alternatives between two endpoints. At the one extreme, they could focus purely on

domestic autonomy and disregard the exchange rate. At the other extreme, they could fix the exchange rate and give up domestic autonomy by letting the domestic economy adjust automatically to external conditions. The key issue for monetary cooperation is to establish mechanisms that create consistency between these two objectives. A currency union, for example, fixes the exchange rate permanently and prescribes more or less an automatic adjustment to its members.⁴ A truly floating exchange rate system would let currency values adjust freely to autonomous macroeconomic policies.

Pegged exchange rate regimes, on the other hand, represent an attempt at a middle path between the two extremes. They seek to combine some degree of exchange rate stability with some degree of domestic macroeconomic autonomy. Neither one of the policy goals is absolute: Exchange rates are fixed, but adjustable, while domestic autonomy finds its constraint in the need to maintain policies consistent with reasonable exchange rate stability.⁵ Indeed, bargaining over the rules of pegged exchange rate regimes are in essence contests as to who can achieve the optimum balance between domestic autonomy and external stability. Monetary power represents the key factor in determining the solution to the trade-off between domestic autonomy and external environment.

This means that rules and operations of pegged exchange rate systems will be the result of inherently asymmetrical relations. However, in critical distinction from contemporary debates about monetary power and the minimum consensus shared among the participants in this project, I argue that the issue of monetary power and the pervasiveness of asymmetry in monetary relations is deeply rooted in the nature of monetary relations itself and is not causally related to the level of capital mobility. Monetary power shapes the pattern of monetary cooperation not simply because exchange-rate stability and the pursuit of independent monetary policies become incompatible under conditions of *high international capital mobility*, but rather because monetary power determines the trade-off between exchange rate stability and domestic authority, no matter the level of capital mobility.

In recent years, capital mobility has received significant attention among analysts of monetary policy as a major driving force to reduce the policy autonomy of governments. In particular, the Mundell-Flemming framework with its ‘unholy trinity’ has served as a popular means to describe the conundrum governments face when trying to engage in exchange rate cooperation.⁶ Simply said, the ‘unholy trinity’ argues that governments can achieve only two of these three policy goals: exchange rate stability, macroeconomic autonomy and capital mobility. They would have to sacrifice one of them, if they intend to pursue the other two. This concept of the ‘unholy trinity’ has been used frequently as a persuasive framework to explain policy choices and tradeoffs involved in monetary cooperation.⁷ For example, the most successful period in the operation of the Bretton Woods System coincides with relatively low capital mobility. Thus, under Bretton Woods, governments were able to achieve relatively stable exchange rates while maintaining some degree of policy autonomy. Similarly, the progression of

4 Fiscal policy is the one larger area of macroeconomic adjustment left to individual members of a currency union. However, in the case of European Monetary Union, even that policy area is guided by very explicit constraints on the leeway of governments to use fiscal policies as tools of adjustment.

5 John Ruggie’s notion of ‘embedded liberalism’ expresses the interlocking nature of these policy goals for the Bretton Woods System; see: John Gerard Ruggie, 1983. ‘International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order’, in: Stephen D. Krasner, (ed.), *International Regimes*. Ithaca: Cornell University Press, pp. 195-231.

6 The document coining the phrase ‘unholy trinity’ is Benjamin J. Cohen, 1993. ‘The Triad and the Unholy Trinity: Lessons for the Pacific Region’, in: Richard Higott, Richard Leaver, and John Ravenhill, (eds.), *Pacific Economic Relations in the 1990s*. London: Allen & Unwin, pp. 133-158.

7 Among the most important applications are: David M. Andrews, 1994. ‘Capital Mobility and State Autonomy: Towards a Structural Theory of International Monetary Relations’, *International Studies Quarterly*, 38, pp. 193-218; Kathleen R. McNamara, 1988. *The Currency of Ideas: Monetary Politics in the European Union*. Ithaca: Cornell University Press; and Louis Pauly, 1997. *Who Elected the Bankers? Surveillance and Control in the World Economy*. Ithaca: Cornell University Press.

European monetary cooperation toward more rigidly fixed exchange rates from Bretton Woods, over the snake, the EMS to EMU coincides with rising capital mobility and the loss of policy autonomy.

Notwithstanding the very elegant analytical framework of the Mundell-Flemming approach and the persuasive historical account of change in some of the exchange rate systems, the three explanatory factors of the ‘unholy trinity’ do not have the same causal weight. At its most basic level, the ‘unholy trinity’ draws attention to the same tension I highlighted earlier—namely the tension between domestic macroeconomic autonomy and exchange rate stability. Thus, stable exchange rates and macroeconomic policy autonomy are the key causal variables in the unholy trinity; capital mobility is merely a framing condition. Capital mobility does not *cause* the disequilibrium; it simply exacerbates the conflicting pressures of internal autonomy and external stability. A government cannot maintain a desired exchange rate forever if its domestic policy diverges consistently—no matter how low capital mobility. Only complete autarky would avoid the tension between external and internal equilibrium.

Thus, capital mobility is not a necessary ingredient for conceptualizing monetary power and its influence on monetary cooperation. In fact, the topic of this paper—pegged exchange rate regimes—could easily be viewed as irrelevant if monetary power is related to the degree of capital mobility. A growing number of experts on international monetary relations have argued that pegged exchange rate systems are not compatible with high levels of capital mobility.⁸ The higher the level of capital mobility, the more governments face a stark choice between a freely floating exchange rate system or more rigidly fixed regimes, for example a currency union or dollarization. Compromise systems, such as pegged exchange rate systems, are squeezed out of the middle of the policy spectrum, because high capital mobility erodes the feasibility of the two main tools available to governments to deal with disequilibria under pegged exchange rate systems without changing domestic policy, namely moderate and measured realignments in between longer periods of exchange rate stability and the use of financing.⁹

I will not further investigate the claim that pegged exchange rate systems are becoming less relevant with capital mobility. While the situation has become arguably more difficult for these types of monetary arrangements, the topic of pegged exchange rate regimes in the context of a research project on monetary power has more than purely historical value. Whereas most forms of pegging these days are unilateral policies, the EMS II and the relationship of the African franc zone to the French franc/euro can be described as rule-based pegged exchange rate systems. Also, it is not out of the question that some form of negotiated pegged exchange rate system could emerge in East Asia or other parts of the world.¹⁰

My argument that monetary power is more fundamentally connected to the basic consistency problem between domestic autonomy and external environment should not be confused with an assertion that capital mobility is irrelevant. Pressures on governments do increase with rising capital mobility. For the explanation of asymmetry in exchange rate regimes and the significance of monetary power, however, capital mobility is not a key causal variable. The numerous exchange rate crises under Bretton Woods illustrate this point. France was able to debate the merits of a franc devaluation for months both in 1959 and 1968/9. Italy had a similar opportunity in the early 1960s and Britain during the mid-1960s. In all of these cases though, eventual devaluation was unavoidable. Since the 1970s leisurely devaluation debates obviously have become impossible. The ‘unholy trinity’ nicely illustrates why the adjustment process has accelerated and possibly become more dramatic. However,

8 See, for example, Barry Eichengreen, 1994. *International Monetary Arrangements for the 21st Century*. Washington, DC: Brookings Institution.

9 The key event triggering the debate over the future viability of pegged exchange rate systems was clearly the EMS crisis of 1992/3. Since then, we have seen a series of crises affecting countries with a variety of different types of pegged exchange rates, including Mexico in 1994 and the Asian financial crisis of 1997. None of these post-1992 examples affected codified systems, though. Rather they were all unilateral policy choices of the affected country.

10 The proposal for an Asian Monetary Fund put forward by the Japanese government during the Asian financial crisis certainly contained elements of a codified pegged exchange rate system.

capital mobility is not the cause of a disequilibrium. Rather, it is best described as an *intervening* variable between the two goals of domestic autonomy and external stability.

Market Power and the Choice of Policy Options

The core issue of monetary cooperation is to find a solution to the trade-off between domestic autonomy and external stability. What rules ensure that domestic macroeconomic divergence does not undermine the pursuit of exchange rate stability? What rules promise consistency among the partners of an exchange rate regime? One logical answer is, of course, agreement on fully binding rules to coordinate domestic macroeconomic policies. The Maastricht Treaty would be a good example of such an agreement. However, a key characteristic of the three pegged exchange rate regimes under investigation here is the fact that such agreement remained elusive. Despite the attempt to bring domestic coordination issues to the bargaining table, negotiating partners were unable to agree. Bretton Woods, the snake and the EMS all existed without a firm rule on coordinating domestic macroeconomic policy among its member states.

What explains this phenomenon? I argue that strong monetary actors are in a better position to safeguard their domestic macroeconomic priorities than their weaker counterparts. In order to conceptualize this monetary power mechanism, it is advantageous to start with Benjamin Cohen's notion of the Power to Delay (see EUI-WP RSCAS 2005/08). Since pegged exchange rate systems are at their core about the trade-off between domestic autonomy and external stability, Cohen's argument that 'monetary power begins with autonomy, the internal dimension' points to the correct source of bargaining leverage in monetary negotiations. Clearly, those players who have the Power to Delay can use it to shape rules in their favour.

It is noteworthy in this context that the financial variables of the Power to Delay are ultimately more critical in shaping the rules of pegged exchange rate regimes than the structural features of the Power to Deflect. Thus, the comparison of the snake, EMS and Bretton Woods provides support to Cohen's conceptual claim that it is the Power to Delay that can be turned into purposive action to achieve favourable monetary outcomes. The difference between Germany's and the United States' position within their respective exchange rate systems underscores this point. By any measure, Germany's Power to Deflect was much weaker than that of the U.S. Yet, it was in position to challenge the United States toward the end of the Bretton Woods regime.¹¹ The explanation for that puzzle lies in the financial variables of the Power to Delay.

Financial variables are the core of creating bargaining leverage in monetary negotiations. Indeed, the key characteristic of a strong monetary actor is the *absence of a reserve constraint*. In other words, strong monetary actors have unlimited ability to finance disequilibria of the payments balance.¹² A word of terminological clarification is appropriate in this context. My use of the term 'strong monetary actor' or 'weak monetary actor' should not be confused with a strong or weak currency *per se*. The source of the ability to finance can be either a strong balance of payments position—as in the case of Germany—or the continued acceptance of the national currency in the rest of world despite balance of payments difficulties—as in the case of the United States. The use of the term 'strong monetary actor' in this paper,

11 Depending on the operationalization of the structural variables of the Power to Deflect (openness and adaptability), Germany could arguably be a weaker player than some of the other larger European countries. Nevertheless, its financial standing clearly was the basis for Germany's leadership position within European monetary relations.

12 Given the cases examined in this paper, I concentrate on the United States and Germany as the key countries. It ignores the somewhat special role small countries with a strong financial position, such as Switzerland, can play within international monetary relations. Clearly, a Switzerland would be too small to serve as the leader of a pegged exchange rate system. On the other hand, even a cursory examination of the Swiss position within international monetary relations would support the basic assumption made in this paper that the absence of a reserve constraint is central to explain monetary power. Switzerland is certainly a much more powerful monetary actor than would be expected by its mere size.

thus, is based on a minimalist definition—namely the absence of a reserve constraint. It is not meant to describe the balance of payments position. This definition is deliberately broader than the one I used in earlier work to explain patterns of European monetary cooperation.¹³ There I defined a strong currency country by reference to a country's balance of payments position—operationalized in terms of low inflation, the strength of the exchange rate and the actual payments balance. While I will return to this more precise definition later in my analysis, it is necessary for this paper to start with a more general conceptualization.

By definition, a country that does not face a reserve constraint is characterized by its ability to finance a disequilibrium of its balance of payments indefinitely—at least in theory. This provides the government with the opportunity to choose among its options for balance of payments adjustment more freely than a country that may run out of currency reserves. Strictly speaking, balance of payments disequilibria create adjustment pressures for countries on each side, those with and those without a reserve constraint. They can react to balance of payments difficulties through a mixture of internal adjustment, external adjustment or financing the disequilibrium. Typically, a country that faces a balance of payments deficit can devalue its currency, adopt domestic austerity measures or use its currency reserves for interventions to bolster its exchange rate. A surplus country can revalue or let the exchange rate appreciate, allow the domestic economy to reflate or finance the disequilibrium.

The key structural asymmetry between countries with and without a reserve constraint is the fact that those with unlimited financing ability can continue to finance their disequilibrium as long as they want because they can use their own currency for that purpose. The country that faces a reserve constraint, however, can run out of hard currency.¹⁴ The experience of the Bretton Woods system's last decade offers an intriguing variation on this theme—and presents the rationale for my emphasis on the reserve constraint rather than on the actual payments balance. During the 1960s, the United States developed into a weak currency country compared to Germany. However, the United States did not suffer the fate of ordinary weak currency countries since the US dollar remained a widely used intervention currency and reserve asset. *De facto*, the United States did not face a reserve constraint despite its deteriorating balance of payments position.¹⁵ In my analysis of the late stages of the Bretton Woods system, I will address this paradoxical situation as the key factor in the breakdown of the exchange rate system.

The argument developed above makes clear that monetary followers face a problematic bargaining scenario on monetary cooperation. To recall, bargaining over the rules of pegged exchange rate systems in its core really pertains to the trade-off between domestic autonomy and external stability. Countries with a reserve constraint would have an obvious interest to get other countries to take on at least some—if not all—of the burden of domestic macroeconomic adjustment. Indeed, Bretton Woods, the snake and the EMS offer numerous examples of weak currency countries attempting to negotiate rules to that effect.

However, weak monetary players have hardly any leverage to achieve their goal of shifting some of the adjustment burden. Strong monetary actors have little or no incentive to accept an obligation for domestic adjustment.¹⁶ As a matter of fact, their ability to act without a reserve constraint allows them to ignore such demands and to push domestic adjustment on weaker players.

13 Kaelberer, *Money and Power in Europe*, pp. 18-22.

14 Actual currency reserves may not necessarily limit someone's ability to finance. The key is *access* to financing. The IMF as well as the funds associated with the snake and the EMS are examples of multilateral financing facilities that can extend the financing ability of countries beyond actual reserves. However, these funds are subject to international agreement and, in the end, dependent on the willingness of others to borrow. Again, the key difference is that countries without a reserve constraint have a unilateral ability to finance.

15 I do not further investigate the causes that produce the absence of a reserve constraint. Clearly, there are material factors at stake, but an analysis would also have to get less tangible aspects—in particular, the question of trust.

16 At best, strong monetary countries may be compelled to accept compromises here because of a linkage to issues outside the monetary area. Germany, for example, in part felt compelled to go along with some Bretton Woods practices (e.g. two-tier gold market) because of its security dependence on the United States. Similarly, the Germans had reasons

The conceptual discussion of the preceding sections yields three broader predictions about exchange rate cooperation in pegged exchange rate regimes:

- First, a pegged exchange rate system must have a mechanism to resolve the issue of macroeconomic consistency. This could either be an explicitly negotiated solution or it could be formally left open. In practice, the difference matters little, because the solution is based on market power in either case.
- Second, the solution to this consistency issue will be asymmetrical.¹⁷ It will reflect the fact that those countries without a reserve constraint are in position to protect their own domestic macroeconomic adjustment options. The strongest player in a regime becomes the standard-setter for the monetary regime.
- Third, if strong monetary actors are willing to compromise at all, this will be only on questions of financing, external adjustment and side-payments. Thus, exchange rate negotiations will be successful, if weaker actors accept the terms of domestic adjustments and if governments can find mutually acceptable compromises on the margins of the agreement.

Comparing Pegged Exchange Rate Regimes

Domestic Autonomy and Adjustment

This section evaluates the above-mentioned three analytical assumptions and predictions. It will compare both the negotiations leading up to the Bretton Woods regime, the snake, and the EMS, as well as the actual operation of the regimes. At first sight, the Bretton Woods system provides us with the most clear-cut solution to the consistency problem. The fact that the dollar was fixed to gold meant that the U.S. currency explicitly served as the centre currency and the *numeraire* for the system. In other words, the gold-dollar exchange standard was an agreed solution to the consistency problem. The choice of the U.S. dollar was obvious, given the sheer size and dominance of the U.S. economy in the post-World War II period. Other countries pegged their currencies to the dollar, which served as the stable reference point for all participants. Implicitly, other participants took over the obligation to adjust their macroeconomic policies to the standard set by the United States.

Occasional exchange rate changes provided an option to re-establish consistency if countries were not able or willing to adjust domestically to the U.S. standard. However, there were political limits on the frequent use of exchange rate changes. For one, the architects of Bretton Woods wanted to avoid beggar-thy-neighbour policies and discouraged frequent devaluations. Moreover, potential devaluations were caught up with questions of political prestige and the domestic popularity of governments—in the sense that devaluations seemed to symbolize the failure of a government's economic policies. France was reluctant and the United States unwilling to devalue their currencies.

In contrast, both the snake and the EMS did not rely on an explicit arrangement to solve the consistency problem. Since the major European powers, Britain, France, Germany, and Italy, were all of comparable size and political importance, an explicit agreement to select one of their national currencies as the *numeraire* would have been politically infeasible. Indeed, the formal rules of the snake and the EMS maintained apparent equality within these systems—i.e. no currency was officially privileged like the dollar under Bretton Woods. On the contrary, negotiators of the EMS regime discussed compromise solutions to the trade-off between domestic autonomy and external stability.

(Contd.) _____

outside the core monetary interests to pursue the European Monetary System. Nonetheless, German concessions merely had the character of side payments; they did not yield anything significant at the core of the domestic adjustment issue.

17 Scott Cooper's contribution to this project takes a different analytical slice at this issue. He looks at the internal legal obligations within an exchange rate regime and concludes that they are more symmetrical the more codified they are. My emphasis is on the adjustment embedded in exchange rate regimes.

For example, they established a new artificial book-keeping currency, the European Currency Unit (ECU). This currency represented a basket of all participating currencies and was the official *numeraire* of the system as well as the *de jure* intervention currency.

Moreover, weak currency countries demanded establishing mandatory intervention obligations based on a currency grid around the ECU. In particular, they hoped that this would distribute the adjustment obligations more evenly. The idea was basically that a conventional parity grid would always identify pairs of currencies that reached their respective upper and lower limits. In such a situation, the country without a reserve constraint always has the upper hand, since it can finance its interventions indefinitely. The divergence indicator, on the other hand, had the potential of singling out only one currency that deviated too far from the average. This could have possibly been a strong currency. Predictably, the weaker monetary players did not succeed on this point. The ECU grid merely became a divergence indicator that was supposed to function as an early warning signal that exchange rates were drifting apart.¹⁸ Mandatory interventions, however, remained based on the bilateral parity grid.

The absence of formal rules in the snake and the apparent compromises of the EMS merely disguised the underlying asymmetry. In practice, the snake and the EMS resembled the functioning of the Bretton Woods System in many respects. The European exchange rate systems functioned with a less explicit, but nevertheless a *de facto* similar solution to the consistency problem. As a matter of fact, in the European cases the role of market power is more clearly visible than in the case of Bretton Woods. The deutsche mark emerged as the centre currency of the snake and EMS due to Germany's position as the principal strong currency country in both systems. In some sense, the central role of the deutsche mark was a bit more concealed than the role of the dollar under Bretton Woods largely for three reasons. First, there existed no equivalent to the dollar-gold exchange standard (e.g. the deutsche mark did not have to maintain external stability vis-à-vis another currency or other reference point). Second, the dollar remained the largest *de facto* intervention currency within Europe until the second half of the 1980s when the deutsche mark acquired that status. Third, the divergence indicator around the ECU provided a bit of a veil for the manifest underlying adjustment obligations.

However, these items were merely symbolic and did not reduce the underlying asymmetry in a substantive manner. Neither the snake nor the EMS imposed real domestic adjustment obligations on those actors without a reserve constraint. The attempt to use the ECU—and therefore the average performance within the EMS—as the mutual reference point for adjustment obligations was in reality nothing more than a cosmetic rule. During the negotiations, the Germans insisted that the divergence indicator would not trigger mandatory interventions, but would merely serve as a warning sign that exchange rates were starting to deviate. By necessity, this absence of explicit adjustment rules meant that market forces determined the respective adjustment obligations of countries. Germany effectively set the benchmark for macroeconomic performance in the Snake and the EMS. The breakdown of Bretton Woods in fact provided German policymakers with the opportunity to determine domestic macroeconomic priorities without a significant balance of payments constraint. Freed from the obligation to follow U.S. priorities, the Bundesbank increasingly moved toward a more and more exclusive *domestic* orientation of monetary policy.¹⁹ Indeed, Germany was in some sense even less constrained than the United States: it was not required to maintain a fixed relationship to gold (or the dollar). Other EMS member countries, on the other hand, were obliged to follow German priorities. They needed to maintain their macroeconomic policies consistent with their deutsche mark exchange rate target. The well-known fact of Germany's ability to set the floor for interest rates in Europe is the most visible expression of this situation. Of course, one of the more desirable effects of this

18 On the technical details of the ECU-grid see: Peter Ludlow, 1982. *The Making of the European Monetary System*. London: Butterworths, pp. 159-166.

19 Peter Henning Loedel, 1999. *Deutsche Mark Politics: Germany in the European Monetary System*. Boulder: Lynne Rienner.

asymmetric solution to the consistency problem was that high inflation countries started to use the deutsche mark as a reference point for their own efforts at disinflation during the 1980s.²⁰

The dollar and the U.S. economy initially served similar functions under Bretton Woods—although the system saw more change over time in some essential features than the European Monetary System. During the immediate post-war period, the dollar provided a stable reference point for war-shattered economies around the globe. The United States could pursue its macroeconomic priorities without a balance of payments constraint. Others had to adjust their domestic policies in accordance with their exchange rate targets, while the U.S. could treat the value of the dollar with ‘benign neglect’ and concentrate on its domestic objectives. It is important to acknowledge that this type of asymmetric solution provides an important contribution to successful cooperation: it avoids policy conflict and establishes consistency among the players in the global economy.²¹ Under Bretton Woods this meant that as long as the U.S. did not produce significant negative externalities, adjustment by the other countries to American priorities was advantageous and uncontroversial.

On the other hand, of course, such asymmetrical solutions to the consistency issue have a downside. They can serve as a source of friction and contention among member states and they can work effectively only as long as the leadership of the centre country is acceptable and as long as the leader does not abuse its position. With the deterioration of the American balance of payments position and increasing inflationary problems during the 1960s, the U.S. economy started to export negative externalities to other participants in the Bretton Woods system. Germany, in particular, complained about ‘imported inflation’—due to large capital flows of dollars into Germany. As a result, German authorities became critical of the asymmetry embedded in Bretton Woods and were less and less willing to adjust German domestic policies to American priorities. In the end, the Bretton Woods system collapsed because the domestic policies of two key players had become incompatible with each other—and neither one of them was willing to subjugate domestic autonomy for the sake of external stability, and both of them could sustain that policy stance because neither one of them faced a reserve constraint.

The breakdown of the Bretton Woods system underscores an important distinction I raised earlier. I defined monetary leaders broadly speaking as those that do not face a reserve constraint, whereas a narrower definition would emphasize the actual balance of payments position of a country. In essence, the breakdown of Bretton Woods illustrates the potential conflict between these two elements. Toward the later years of Bretton Woods, there were at least two major countries that did not face a reserve constraint. The United States had developed into a country with a weak balance of payments position, but the dollar remained a universally accepted and valuable currency. Others were still willing to accept the American currency, and the government could continue to finance its balance of payments disequilibrium with only minor constraints. In fact, the U.S. monetary power position was strong enough to afford prolonged dollar depreciations throughout the 1970s and the late 1980s/early 1990s without experiencing a reserve constraint.

Germany, on the other hand, became a strong monetary player due to its balance of payments position. It did not face a reserve constraint, because it featured the strong currency compared to the dollar. However, the absence of a reserve constraint was based on Germany’s ability to absorb dollars. This, of course, entailed the danger of higher inflation. Thus, in theory Germany did not face an *external* reserve constraint; however, in practice there existed a *voluntary domestic* constraint: Germany would use its ability to finance its balance of payments disequilibrium only up to the point where it did not threaten to reflate the domestic economy. In other words, Germany used financing for balance of payments

20 The argument has become famous under the label of the ‘advantages of tying your own hands’; see: Francesco Giavazzi and Marco Pagano, 1988. ‘The Advantage of Tying One’s Own Hands: EMS Discipline and Central Bank Credibility’, *European Economic Review*, 32, pp. 1055-82. There is also a long list of literature that emphasizes the process of adopting the German model among the formerly high inflation countries; most importantly on that issue see: McNamara, *The Currency of Ideas*.

21 For this argument see: Benjamin J. Cohen, 1977. *Organizing the World’s Money: The Political Economy of International Monetary Relations*. New York: Basic Books.

disequilibria only as long as they remained fairly small and the Bundesbank could sterilize interventions. This prevented any real adjustment of the German domestic economy through higher inflation.

The EMS created similar leadership and legitimacy problems as Bretton Woods. The asymmetry between Germany and the rest of the EMS remained a constant issue of contention. Most significantly, after successful disinflation in France and other previously high inflation countries, the political economic rationale for asymmetry disappeared during the late 1980s. As argued earlier, markets had selected Germany as the centre country of the EMS due to its policy record of low inflation and its strong balance of payments position. However, there was nothing ‘natural’ about Germany’s centre position beyond its superior macroeconomic record. Once others had caught up with Germany’s low inflation record, the legitimacy of continued asymmetry disappeared. As a result, the EMS would have faced the prospect of growing frictions about the justification of asymmetry. In other words, the very success of the EMS in facilitating lower inflation became one of its liabilities. Not surprisingly, this situation helped to make European Monetary Union politically feasible.

Examination of the bargaining process itself also confirms our assumptions. The need to produce consistency creates a significant distributional problem: Who adjusts their domestic macroeconomic policies to whom? The negotiations over the rules for the Bretton Woods regime, for example, featured significant differences between Great Britain and the United States over the appropriate rules for domestic adjustment. These differences in distributional implications found their most vivid expression in the plans for the post-war monetary order proposed by the heads of the British and the American delegation at the Bretton Woods conference, John Maynard Keynes and Harry White.

A contemporary observer, Richard Gardner, points to the key bargaining dilemma at Bretton Woods behind the core differences between the Keynes—and White—Plans:

The great advantage of the gold standard had been that it assured the making of these adjustments without any formal restriction of national sovereignty. An international organization did not enjoy this advantage: if it was to ensure the making of internal adjustments, it would have to place direct limitations on sovereign power. Its constitution would have to ensure deflation in the case of debtor nations and inflation in the case of the creditors.²²

The key political problem here is, of course, that debtor nations would want to avoid the costs associated with disinflation and creditor countries would like to avoid inflation. The British bargaining position at Bretton Woods reflected precisely this dilemma. As a likely debtor country after World War II, Britain tried to ensure that it would have the flexibility to pursue expansionary economic policies to fight unemployment and deflation. Consequently, the Keynes Plan sought to impose domestic adjustment obligations on strong currency (or creditor) countries by curtailing their credit balances.²³ In effect, the British envisioned a system wherein the excess reserves of creditor countries would be taxed.²⁴ This would have created a slightly higher degree of symmetry between surplus and deficit countries, as there would have been a mandatory constraint on the production of a surplus. In addition, there was supposed to be a generous provision of liquidity, in part to be achieved through the creation of the International Clearing Union (ICU)—an institution that would have in effect curtailed the domestic autonomy of strong currency countries.

Not surprisingly, the United States simply rejected any meaningful restrictions on the options of surplus countries during the Bretton Woods negotiations.²⁵ Mandatory restrictions on its surplus would have unduly limited its sovereignty. A multilateral provision of liquidity could have produced

22 Richard N. Gardner, 1956. *Sterling-Dollar Diplomacy*. Oxford: Clarendon Press, p. 90.

23 Gardner, *Sterling-Dollar Diplomacy*, pp. 92-95.

24 G. John Ikenberry, 1993. ‘The Political Origins of Bretton Woods’, in: Michael D. Bordo and Barry Eichengreen, (eds.), *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*. Chicago: The University of Chicago Press, pp. 155-182.

25 Barry Eichengreen, 1993. ‘European Monetary Unification’, *Journal of Economic Literature*, 31 (September), pp. 1321-1357.

unwelcome repercussions for U.S. domestic macroeconomic policy. As a result, the Bretton Woods System ultimately had to accept the principle of domestic flexibility. It did not stipulate explicit rules for internal adjustment.²⁶ In retrospect, of course, the American rejection of taxes on surpluses and the ICU appear ironic. During the 1960s, constraints on surplus countries would have helped the U.S. in its conflict with Germany; and the reversal of the United States to accept and even promote Special Drawing Rights (SDRs) represented a step toward the acceptance of multilateral liquidity creation under conditions of growing American balance of payments problems.

The same pattern characterized the negotiations over the snake and the European Monetary System. Neither one of these systems established any explicit rules for domestic policy adjustment. Germany simply rejected French demands for binding adjustment obligations on the part of strong currency countries—for example, the proposal for mandatory interventions based on the ECU grid and the creation of a European Monetary Fund (EMF). These proposals entailed some form of mandatory domestic macroeconomic adjustment for surplus countries; however, the weak currency countries in the EU did not have sufficient bargaining power to achieve their implementation.

Exchange Rate Changes

Our comparison of pegged exchange rate systems reveals that monetary leaders have been consistently in a position to reject demands that would constrain the pursuit of their domestic macroeconomic priorities. The Bretton Woods system, the snake and the EMS did not adopt any explicit rules for domestic adjustment. There simply did not exist a zone of compromise between those countries that faced a reserve constraint and those that did not. However, as argued in the first section, exchange rate systems must feature some mechanism to produce consistency among the participants. If it is impossible to agree on domestic adjustment, external adjustment logically becomes an area where participants need to find agreement. Indeed, this area of bargaining is more conducive to potential compromise between stronger and weaker monetary players.

The key concession made by the United States to the British during the Bretton Woods negotiations concerned the permission of greater national discretion over exchange rate changes.²⁷ Initially, both the British and the Americans favoured more rigid rules for exchange rate stability. For Britain, adjustment was supposed to come from binding domestic deflationary measures of the strong monetary actors and generous international provisions of liquidity. The United States, on the other hand, preferred exchange rate stability to avoid a return of inter-war currency chaos and to keep inflation low within the system.

However, these preferred adjustment options were diametrically opposed and would have created deadlock. After the British had given up demands for binding adjustment obligations on creditor countries, for lenient money supply and for the creation of the ICU, exchange rate changes became the least costly area to allow for adjustment between leaders and followers. Initially, the requirements for an exchange rate change were extremely rigid with significant limitations on the size of adjustments. Similarly, the IMF was supposed to play a strong constraining role in any eventual parity adjustment. According to the compromise reached between the British and American delegations later at Bretton Woods, however, decisions to alter exchange rates were basically up to the member states, with the IMF providing only a multilateral packaging of the process. Given the alternatives, to allow for

26 For a description of the Bretton Woods bargaining exchanges see Michael D. Bordo, 1993. 'The Bretton Woods International Monetary System: A Historical Overview', in: Michael D. Bordo and Barry Eichengreen, (eds.), *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*. Chicago: The University of Chicago Press, pp. 3-98.

27 On this point see: Bordo, 'The Bretton Woods International Monetary System'; Benjamin Cohen, 1983. 'Balance-of-Payments Financing: Evolution of a Regime', in: Stephen D. Krasner, (ed.), *International Regimes*. Ithaca: Cornell University Press, pp. 315-336; Barry Eichengreen, 1996. *Globalizing Capital: A History of the International Monetary System*. Princeton: Princeton University Press.

national autonomy over exchange rate changes was a relatively easy compromise for the Americans. It did not impinge on their domestic macroeconomic priorities.

Similarly, compromises on exchange rate changes were crucial for the creation of the snake and EMS. Everything else being equal, the Germans would have preferred more thorough rules for stable exchange rates to force domestic adjustment on higher inflation countries in the snake and EMS. However, compromises on the rules of external adjustment in the interest of creating a zone of compromise between stronger and weaker monetary players were more feasible than agreed rules on domestic adjustment. Most importantly, Italy received extended fluctuation margins around the lira in the EMS agreement—a concession that was crucial for Italian participation. Similarly, Germany accepted occasional revaluations of the deutsche mark during the 1980s—instead of devaluations of the French franc—in order to allow the French government to save face with their domestic public.

There is also an interesting parallel between German and American behaviour on the *procedural* norms of exchange rate changes as well. Both countries accommodated the needs of their weaker partners. Officially, Bretton Woods required a finding of a ‘fundamental disequilibrium’ by the IMF to justify exchange rate changes. *De facto*, however, governments were allowed to devalue unilaterally, depending on their macroeconomic priorities. The EMS rules established a norm of multilateral negotiations over exchange rate adjustments. Nevertheless, in practice EMS members initially changed exchange rates unilaterally. This custom, however, switched again once French authorities felt the need to negotiate ‘face-saving’ deals with other EMS members. To avoid embarrassment, France insisted on collective devaluations of other weaker currencies in the EMS. This allowed for a shift toward the initially agreed norms—multilateral procedures for realignments—after 1981. During the September 1992 crisis of the EMS, the pattern reverted back to unilateral exchange rate decisions. Again, German policymakers could stay fairly aloof of the issue. They could afford to allow their partners to choose the procedures for exchange rate changes any way it suited them, since neither unilateral nor multilateral procedures had any real impact on the major German priorities.²⁸

Financing

Thus, external adjustment was the decisive area for achieving conditions of consistency among the participants of Bretton Woods, the snake and the EMS. However, there is a third area of bargaining that deserves attention. The rules for financing balance of payments disequilibria do not directly concern the question of adjustment. Financing does not lead to adjustment; it is merely a temporary tool to address a short-term payments problem. However, adequate financing facilities allow weaker monetary players some breathing room and can ease the process of adjustment. Thus, they can be an important area of compromise as well.

Financing is another area in which compromises between weak and strong monetary actors are possible. Concessions are not particularly costly for creditor countries. They also have sufficient leverage to prevent potential negative spill-over for their domestic macroeconomic objectives. Since they do not face a reserve constraint, they can stop interventions at their own volition. Moreover, they can sterilize the accumulation of reserves, as long as interventions remain within limited boundaries. The typical financing issues for which countries need to find rules are the following: Under what conditions can governments ask for balance of payments assistance? How much financing can governments ask for? What types of financing facilities are available? Who decides about financing assistance? What are the repayment conditions? Strong monetary actors have shown some willingness to make concessions on the amounts, lending periods and repayment conditions of financing facilities.

28 For the historical evolution of EMS rules see: Daniel Gros and Niels Thygesen, 1992. *European Monetary Integration*. London: Longman.

The key point here is that these compromises on financing facilities do not hurt the domestic policy priorities of strong monetary actors. First of all, if assistance needs to be repaid, there are ‘natural’ limits on any kind of ‘prudent’ borrowing. If strong currency countries fear the spill-over of financial interventions into their own domestic markets, central banks can minimize the impact through sterilization. While concrete rules are negotiable and have varied under Bretton Woods and the EMS over time, creditor countries hold structurally a good position to determine the conditions of financing assistance and to stop assistance at their own volition. The duration of borrowing periods or the conditions for repayments also have little relevance for their domestic economy. Ultimately, these items are relatively painless to agree on, if strong monetary actors are sufficiently motivated to overcome bargaining impasses.

These structural asymmetries lead to predictable bargaining behaviour. Debtor countries in general favour easier access, more generous amounts and more lenient terms. At the same time, they have little leverage to achieve their goals, since strong currency countries are more or less directly the source of these financing facilities. The main motivation for strong monetary actors to agree on compromises has been political. During the Bretton Woods period and the operation of the EMS, interest in monetary stability and related political goals prompted the U.S. and Germany to make concessions on financing, well aware that these concessions would not encroach on their structural power.

In the course of the EMS negotiations, Germany accepted a number of compromises on financing to alleviate some of the concerns of weak currency countries—first during the initial negotiations and later during the 1987 Basle-Nyborg reforms.²⁹ The Germans allowed an extension of borrowing periods from 30 to 60 days in the initial negotiations and to 75 days in the Basle-Nyborg accord. Similarly, Germany agreed to extend financing facilities compared to the snake in the initial negotiations and granted more flexible access to these facilities by allowing for the use of the very-short-term facilities for intra-marginal interventions in the Basle-Nyborg reforms.

The United States compromised on questions of financing during the Bretton Woods negotiations in similar fashion. While American negotiators resisted much more far-reaching British demands for generous financing facilities, the U.S. ultimately accepted larger quotas than it had initially offered.³⁰ The United States also agreed to the creation of Special Drawing Rights (SDRs) during the mid-1960s, after initially rejecting their introduction for fear that they would erode the international status of the dollar.³¹ Clearly, the emerging balance of payments difficulties of the United States and the ensuing drain on US gold reserves during the 1960s facilitated that compromise.

Another related feature concerns financial flows for structural adjustment assistance. Since debtor countries shoulder most of the adjustment obligations under internationally negotiated exchange rate regimes, they have tried to negotiate for concessions on direct financial transfers. Facing economic collapse after World War II and the end of the Lend-Lease Accord, the British bargained for economic aid. Initially rejected by the United States, the effort nevertheless resulted in the Anglo-American Financial Agreement.³² The Marshall Plan, as well as the creation of the World Bank, fit a similar pattern, in the sense that direct financial transfers in addition to balance of payments financing assistance were necessary to stabilize the international monetary system. European monetary negotiations have seen similar bargaining exchanges. Italy and Ireland negotiated loans during the EMS negotiations, and the so-called ‘structural funds’ provided long-term assistance to achieve greater convergence between EU members.

29 For descriptions of negotiations to set up the financing regime of the EMS see: Ludlow, *The Making of the European Monetary System*. For a description of the Basle-Nyborg reforms see: Gros and Thygesen, *European Monetary Integration*.

30 Gardner, *Sterling-Dollar Diplomacy*, pp. 112-114.

31 Eichengreen, *Globalizing Capital*.

32 Gardner, *Sterling-Dollar Diplomacy*, pp. 188-207; Harold James, 1996. *International Monetary Cooperation Since Bretton Woods*. Oxford: Oxford University Press, pp. 67-68.

Conclusion

The rules of monetary relations dictate that countries participating in exchange rate cooperation must establish consistency. This paper demonstrates that these ‘rules of the game’ apply under quite disparate circumstances. Neither the overwhelming material ‘size’ of the United States, nor the embeddedness of European monetary cooperation in the European Union changed this underlying logic of the bargaining interaction. The monetary bargaining outcomes for Bretton Woods, the snake and the EMS were remarkably similar. Those players who did not face a reserve constraint were able to protect their own domestic priorities, while they made concessions only at the margins of the agreement (i.e. the specific rules for exchange rate changes and financing). Although European Monetary Union was not subject to this comparison, it is interesting to note that this pattern of bargaining exchanges holds there as well. Similarly, the analysis shows that controversies over the macroeconomic standard set by the leader or insufficient concessions on the margins of the agreement are crucial causes for the breakdown of monetary regimes.

Clearly, the fact that exchange rate regimes solve the consistency issue asymmetrically by allowing the centre country to set the domestic macroeconomic standard does not vary across different settings and time periods. Similarly, the fact that negotiations to achieve compromises between weak and strong monetary powers has invariably concentrated on the rules governing exchange rate changes and financing has not varied over time. Domestic politics approaches—for example, partisan interests or sectoral interests—cannot explain the fact that core institutional features of exchange rate regimes do not change along with variations in the partisan composition of governments or shifts in power among different sectoral interests. The similarity of outcomes between European monetary bargaining and the Bretton Woods system also suggests that institutional processes, such as issue-linkage and spill-over, do not explain the bargaining outcomes. Both the EMS and the snake showed structural similarities to Bretton Woods, and possible spill-over or linkage dynamics within the EU did not constrain the brute force of monetary power.

While monetary power does not necessarily tell us all we want to know about monetary relations, it does provide a framework in which to interpret the bigger picture of exchange rate cooperation. Monetary power approaches supply the conceptual tools to comprehend the continuous patterns of rule formation on monetary cooperation. *Incentives* for monetary cooperation may vary over time with different circumstances; the *logic* of how governments negotiate rules for monetary cooperation does not. Monetary power remains the key to understanding this facet of monetary politics.

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