

CHAPTER 2

The Monetary Convergence Hypothesis

The first research puzzle at the focus of this book concerns the hypothesis of systematic monetary policy convergence among the advanced industrial democracies in the post-Bretton Woods era. In what is arguably its most favorable theoretical domain, can we observe much evidence of monetary policy convergence and the corresponding loss of domestic monetary autonomy? To answer this question, it is important to lay out—in much greater detail than was possible in the introductory chapter—the monetary convergence proposition. It is also important to define some major concepts that will be used throughout the book.

This chapter begins with a simple presentation of the macroeconomic model known as the Mundell-Fleming framework. For readers well acquainted with the model, this may be an unnecessary presentation, and they are urged to skip ahead. For many other readers, it will help to define some important conceptual issues.

As I mentioned in chapter 1 and will further demonstrate in this chapter, systematic monetary policy convergence is a curious proposition. While it has not yet been convincingly demonstrated, a large number of political scientists (but certainly not all) seemingly accept the basic hypothesis. I suspect that some of this acceptance may simply stem from conceptual confusion. Occasionally in print and more often in conversation, one encounters the tendency to treat the terms *international capital mobility* and *monetary policy convergence* as effective synonyms. Perhaps this development is not surprising since the terms *financial market integration* (a common term for expressing international capital mobility) and *monetary integration* (an alternative phrase for monetary policy convergence) sound similar. But treating these terms as equivalent is not only misleading but technically incorrect.

On this point, the Mundell-Fleming framework helps demonstrate how

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international capital mobility is conceptually distinct from monetary policy convergence, or the loss of domestic monetary autonomy. The former concept concerns private capital markets, while the latter is concerned with how public sector actors use the national monetary policy instrument. Thus, we simply cannot take the well-established fact of international capital mobility among the advanced industrial democracies in the post-Bretton Woods era as *prima facie* evidence for their monetary policy convergence. Not only are international capital mobility and systematic monetary policy convergence different theoretical concepts, the former is not even a sufficient condition for the latter.

After presenting the Mundell-Fleming framework, this chapter will work through the logic of the monetary convergence hypothesis as it has been developed in the political science literature. This exercise helps demonstrate how the hypothesis has advanced in the discipline, despite the lack of strong empirical evidence supporting the theoretical proposition. Of course, that there is not yet much evidence in favor of systematic monetary convergence does not mean that the hypothesis is falsified. But it does reveal how the hypothesis desperately requires some rigorous empirical evaluation.

Finally, having worked through the details of the monetary convergence hypothesis, this chapter will conclude by discussing several problems facing its causal logic. These potential problems illustrate why we cannot continue to accept the notion of systematic monetary convergence among the advanced industrial democracies in the post-Bretton Woods era without bringing some additional evidence to bear on the proposition. Such evidence is presented in chapter 3.

1. The Mundell-Fleming Framework

The model known in the open-economy macroeconomic literature as the Mundell-Fleming framework (Mundell 1960, 1963, 1968; Fleming 1962) is perhaps more commonly known in the political science literature as the “unholy trinity” (Cohen 1993) or “impossible trinity” (Broz and Frieden 2001). At its most basic level, the model describes the existence of a monetary policy trilemma facing national policymakers. This monetary trilemma states that from a menu of three potentially desirable economic conditions—(1) domestic monetary policy autonomy, (2) external currency stability, and (3) international capital mobility—governments can achieve at most only two of the three at any one time.

The first menu item—domestic monetary policy autonomy—simply refers to the ability of national governments to direct their monetary policy instru-

ment toward certain domestic economic objectives. For example, faced with an economic decline and societal demands for more growth and employment, governments might desire to lower interest rates to stimulate economic activity. Alternatively, in an economy with rising prices and societal demands for domestic price stability, governments might like to raise interest rates to reduce inflationary pressures. While there are certainly limits to what governments may be able to achieve domestically with interest rate changes, especially if market actors anticipate such changes in advance, democratic governments nonetheless perceive monetary policy independence as potentially desirable in at least the short to medium term.

The second menu item—external currency stability—is defined as fixing the national currency’s value relative to some external benchmark. Many actors consider exchange rate stability as desirable because currency variability and volatility potentially impede cross-border trade and investment. Indeed, governments often cite expanding international trade and, by extension, national income as the major justification for making fixed exchange rate commitments. For example, a positive relationship between exchange rate stability and international trade was given as the main foundation for monetary coordination leading to monetary union in Western Europe (see, e.g., Commission of the European Communities 1990).¹

At this point, it is also useful to distinguish between a country’s *de jure* and *de facto* exchange rate regimes. The former refers to the formal, or stated, commitments made by the government, often to fix or stabilize the national exchange rate within a certain range. The latter refers to the actual stability of the national currency’s value relative to some external benchmark. Governments that achieve greater external currency stability are said to have a more fixed *de facto* exchange rate regime. Thus, the second menu item—external currency stability—is a synonym for *de facto* fixity, which may be unrelated, in practice, to *de jure* regimes and commitments. This is a very important point, which will be discussed in more detail later in this chapter.

The third menu item—international capital mobility—refers to the ability of investors to move their money and capital assets across international bor-

1. Despite the expected connection between exchange rate stability and increased cross-border commerce, it is important to acknowledge that the evidence on this relationship is, at best, mixed. As one International Monetary Fund review reported: “The large majority of empirical studies on the impact of exchange rate variability on the volume of international trade are unable to establish a systematically significant link between measured exchange rate variability and the volume of international trade, whether on an aggregated or on a bilateral basis” (cited from Edison and Melvin 1990, 21). Similarly, Levy-Yeyati and Sturzenegger (2003) found no link between *de facto* fixed exchange rates and economic growth for developed countries.

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ders without government interference. National governments arguably prize international capital mobility because of the efficiency gains associated with integrated financial markets. Capital abundance is a desirable economic condition, and an open financial market serves to attract capital assets from outside the domestic economy. Furthermore, regulating national capital markets became a difficult task for democratic governments beginning in the late 1960s. As Krugman (1999, 61) argued, governments want “to assure business that money can be freely moved in or out of the country, if only to avoid the bureaucracy, paperwork, and opportunities for corruption inevitably associated with any attempt to limit capital movements.”

There is, of course, a potential downside to international capital mobility. Open financial markets also allow for capital assets to exit the domestic economy when local conditions become less attractive relative to external investment opportunities. Thus, of the three menu items of the “impossible trinity,” international capital mobility may be the least prized by national governments. Cohen (1993, 147) observed, “if polled ‘off the record’ for their private preferences, however, most [governments] would probably admit to prizing exchange-rate stability and policy autonomy even more [than international capital mobility].”

Since governments can choose only two of these three menu items at any one time, the Mundell-Fleming trilemma identifies the possibility of three different international monetary orientations. These three different international monetary orientations, or combinations of monetary policy choices, are concisely illustrated in figure 1. At least in principle, governments could be at any of the three sides of the triangle; but at any given side, they lose the desirable economic condition at the opposite angle. Over the last century, we have certainly seen examples of all three international monetary policy orientations, as illustrated in figure 2. For convenience reasons, scholars have often tended to identify a dominant international monetary orientation with a particular historical period, although such characterizations do not necessarily mean that all governments in the international monetary system necessarily followed the dominant orientation during the period in question.²

Political scientists have also sometimes talked as if international capital mobility is a relatively new feature of the international monetary system, unique to the post-Bretton Woods era. But international capital mobility

2. For example, Cohen (1995, 212) notes that even during the classic gold standard, supposedly the golden age of exchange rate stability under capital mobility, “monetary authorities developed a variety of techniques for evading the rules of the game.” He adds, “Monetary policies in this period were never really either fully passive or simply automatic.”

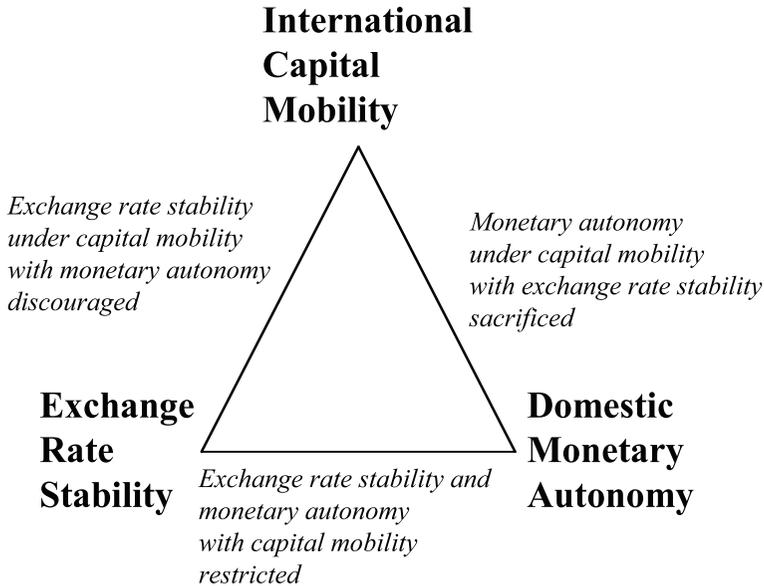


Fig. 1. Three International Monetary Policy Orientations

marked the years before World War I, as well as the interwar era (see Verdier 1998; Nurkse 1944). To protect against external currency variability, the major powers in the international system constructed “fixed” exchange rate regimes, the successful operation of which required the subordination of monetary policy to the external objective of maintaining a stable currency. The classic gold standard, which operated between 1870 until the outbreak of World War I, is generally considered a success in terms of exchange rate stability (see, e.g., Gilpin 1987, 123–27), in large part because governments had not yet developed the interventionist practices—requiring domestic policy autonomy—that would later come to characterize the Keynesian welfare state (Ruggie 1982).

After World War I, the European powers attempted to construct another fixed exchange rate regime under the condition of international capital mobility. However, the new gold exchange standard, adopted in 1922, was only partially successful in stabilizing national exchange rates (see Simmons 1996). During the interwar years, European governments faced better-organized domestic constituencies and new political ideologies demanding that available policy instruments be directed toward internal economic objectives (see Eichengreen 1996, chap. 3). Under such political pressure, the gold exchange

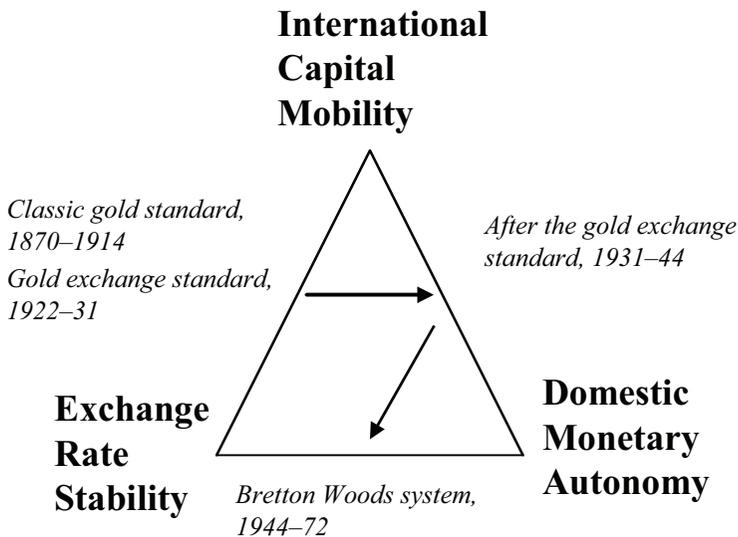


Fig. 2. Examples of Different International Monetary Orientations

standard was abandoned in the early 1930s, as national governments opted for domestic policy autonomy under international capital mobility, sacrificing the external goal of exchange rate stability.

The Bretton Woods system, created in 1944 and ended in the early 1970s, sought to provide national governments with both external currency stability and domestic policy autonomy. Ruggie (1982) labeled this new international monetary orientation “embedded liberalism,” since the Bretton Woods system was economically liberal, seeking to foster international trade with more stable exchange rates. The fixed exchange rate regime in operation during the Bretton Woods era pegged the value of the U.S. dollar to gold and then pegged other national currencies to the U.S. dollar. But this internationally liberal orientation was embedded in a larger framework that permitted and even encouraged governments to intervene in their domestic economies to achieve national (and partisan) objectives concerning economic growth, employment, and inflation.

To obtain exchange rate stability with domestic monetary policy autonomy, governments were forced to restrict international capital flows, as much as it was possible to do so. Indeed, the Bretton Woods agreement acknowledged the right of states to impose capital controls and financial restrictions designed to discourage speculative flows of money (i.e., capital movements not linked to

trade flows). John Maynard Keynes (quoted from Gold 1977, 11) explained: “As a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox. . . . It follows that our right to control the domestic capital market is secured on firmer foundations than ever before, and is formally accepted as a proper part of agreed international agreements.”

But restricting international capital flows was easier said than done. To cite Cohen’s “Iron Law of Economic Controls,” “limits on capital mobility must be multiplied at a rate at least equal to that at which means are found to circumvent them” (Cohen 1993, 147). In fact, the current and capital accounts of many advanced industrial democracies were quite open during the 1960s, before the final end of the Bretton Woods system in the early 1970s (see Quinn and Inclan 1997). With the expanding ability of capital holders to move their assets across national borders, governments simply could not simultaneously maintain both a fixed exchange rate and domestic policy autonomy. One or the other had to be sacrificed; consequently, the Bretton Woods system ended.

As I mentioned earlier, financial integration among the advanced industrial democracies has only expanded further in the post-Bretton Woods era. Consequently, I accept the conclusion advanced by other scholars (see Andrews 1994b; Webb 1995) that international capital mobility can reasonably be treated as a structural feature of the international monetary system, at least in the global North. Even if certain governments, especially rightist ones, encouraged capital liberalization (see Helleiner 1994), the international capital mobility constraint has become extremely difficult to reverse, even for leftist governments, due to advances in information and communications technology, as well as changes in national regulatory environments and market practices (see Bryant 1987; Cerny 1993; Goodman and Pauly 1993). Andrews (1994b, 214) has persuasively concluded: “the difficulties in reversing the trend toward financial integration derive in part from this diversity of sources and in part from their collective interaction. The costs of reversing the technological advances that underlie capital mobility are difficult to contemplate in any straightforward counterfactual sense.”

Thus, at least for the advanced industrial democracies in the post-Bretton Woods era, the Mundell-Fleming trilemma can be reduced to a simpler dilemma. This dilemma concerns the trade-off between external currency stability and domestic monetary policy autonomy. Understanding this monetary policy trade-off in the post-Bretton Woods era brings us to the second research puzzle explored in this book. What factors have led the advanced industrial democracies to choose exchange rate stability, and what factors led them

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instead toward domestic monetary autonomy under the condition of international capital mobility?

2. The Systematic Monetary Convergence Hypothesis

As I mentioned earlier, many political scientists, especially in the field of international political economy, would argue that we can already answer the question posed at the end of the preceding section. They propose that pressures associated with international capital mobility, or globally integrated financial markets, have made domestic monetary policy autonomy unachievable for the advanced industrial democracies in the post-Bretton Woods era. They thus maintain that, albeit with differing degrees of enthusiasm, OECD governments have been forced to make low inflation their overriding economic policy objective, which has led them toward exchange rate stability and away from domestic monetary autonomy (see fig. 3). Evidence supporting this proposition can arguably be seen in the various multilateral “fixed” exchange rate regimes formed in Western Europe since the early 1970s: first the European Snake (1972–78), followed by the European Monetary System (1979–98), and now the Economic and Monetary Union (since 1999). While not all OECD governments joined these multilateral regimes, many outsiders made similar unilateral commitments to fix their exchange rates.

The preceding paragraph concisely summarizes what might be termed the systematic monetary convergence hypothesis, known also in political science literature as the “capital mobility hypothesis” (Andrews 1994b). As I mentioned in chapter 1, the broad macroeconomic policy convergence hypothesis first entered the political science literature in the early 1990s (see table 1). While various parts of the broad macroeconomic convergence hypothesis have been seriously challenged, especially with regard to fiscal policy, monetary convergence remains a widely accepted proposition in certain circles. Even scholars critical of the “globalization as policy constraint” research program have stated that monetary policy remains the strongest case for the macroeconomic policy convergence thesis (see, e.g., Garrett 1998a, 802; Drezner 2001, 75).

One of the earliest statements in support of systematic monetary policy convergence came from Goodman (1992), who concluded that international capital mobility has “increased the overall pressure for monetary convergence” (217) and that, consequently, the “assumption of autonomy has become increasingly less tenable” (221). The loss of domestic policy autonomy was supposed to be especially acute for smaller OECD countries, as Moses (1994,

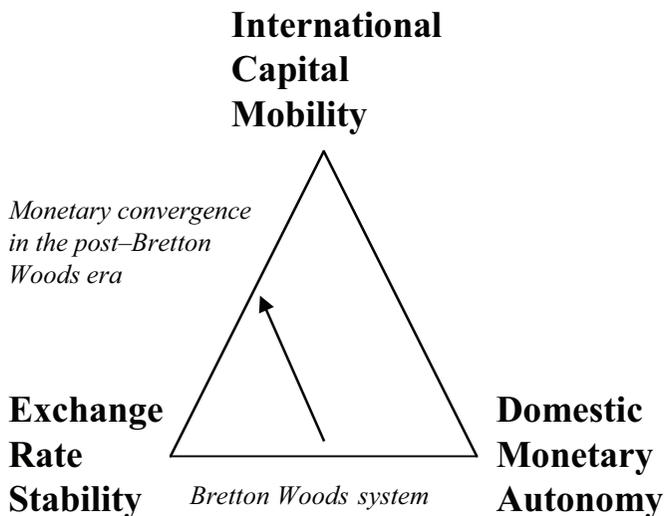


Fig. 3. The International Monetary Orientation Predicted by the Systematic Monetary Policy Convergence Hypothesis

133) argued: “In a world with capital mobility, this has required that monetary policy [be] aimed at defending the exchange rate, and can no longer be used for internal stabilization. In effect, these changes have created a policy dilemma, limiting the number of policy instruments available to small open economies. Those that do remain appear to be insufficient for maintaining both internal and external balances.” Moses continued, “instruments that were traditionally used for managing the internal balance have been diverted away from the internal balance and used to defend the external balance” (135), including the exchange rate.

Webb (1994) broadened this conclusion beyond just the small open economies, writing that “[w]ith few exceptions, national policy making autonomy has eroded dramatically” (395) and that “states—even the largest—have lost a great deal of macroeconomic . . . autonomy because of the growth of capital mobility” (399). Andrews (1994a, 428) reached a similar conclusion: “as a general proposition, the degree of variation in monetary policy among different states has observably narrowed during the past fifteen or so years. One fundamental, underlying reason for this change has been the heightened external constraint imposed upon states by international financial integration.” Similarly, Milner and Keohane (1996, 248) concluded that “internationalization,

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especially in the form of capital mobility, reduces the autonomy and efficacy of governments' macroeconomic policy choices."

Using stronger language, Cerny (1995, 612) argued that "globalization has undercut the policy capacity of the national state in all but a few areas." These remaining areas certainly do not include monetary policy, as "currency exchange rates and interest rates are increasingly set in globalizing market-places, and governments attempt to manipulate them at their peril" (*ibid.*, 609). Perhaps the strongest statement about the loss of domestic monetary autonomy came from Ohmae (1995, 12), who wrote: "as the workings of genuinely global capital markets dwarf their ability to control exchange rates or protect their currency, nation states have become inescapably vulnerable to the discipline imposed by economic choices made elsewhere by people and institutions over which they have no practical control." As such, he continued, "the nation state is increasingly a nostalgic fiction."³

As readers should now understand after working through the Mundell-Fleming framework, international capital mobility does not necessarily mean the loss of domestic monetary autonomy, although it is a necessary condition. Oatley (1997, 15–16) correctly noted in his review of the monetary convergence literature: "even if we treat a high level of capital mobility as exogenously given, we are still left with the need to explain which of the remaining two [menu items, exchange rate stability or domestic monetary policy autonomy] will be chosen." To explain this choice, IPE scholars often argued that the costs associated with exchange rate instability and volatility were simply too high for OECD governments and their capitalist supporters to bear. Andrews (1994a, 428) wrote about the Western European experience in this regard, noting a strong regional "predisposition towards exchange rate stability." Webb (1991, 318) advanced an even broader argument, writing that "governments are not willing to tolerate the drastic exchange rate fluctuations that accompany monetary policy choices which reflect only domestic concerns." He continued, "The high costs of exchange rate volatility mean that, despite economic theory, international capital mobility does *not* increase the real-world effectiveness of monetary policy" (319).⁴

3. I include so many quotations by prominent scholars in an effort to demonstrate that monetary policy convergence with the loss of domestic policy autonomy is not a "straw man" hypothesis. To the contrary, these quotes (and many others that I do not reproduce here) show how this hypothesis was forcefully advanced by IPE scholars in the 1990s. Indeed, this literature continues to be cited by IPE scholars as evidence of macroeconomic policy convergence.

4. It is important to acknowledge that many of the scholars cited here were not trying to explain exchange rate stability *per se*; instead, they were more interested in OECD inflation convergence. In this regard, exchange rate stability and low inflation are different policy outcomes, a

Indeed, the first wave of literature on the policy constraints imposed by globalization went beyond the loss of monetary autonomy, often including the loss of fiscal autonomy (see, e.g., Scharpf 1991; Kurzer 1993). With neither fiscal nor monetary policy instruments at their immediate disposal, it was often argued that leftist and rightist political parties, once in power, would have to govern the national economy in a very similar manner. We should thus expect to observe partisan economic policy convergence in the post-Bretton Woods era. Garrett and Lange (1991, 543) summarized, “in anything but the short run, the fiscal and monetary policies of governments of the left and the right should converge.” More specifically, convergence was expected to occur on the economic policies and outcomes favored by the political right—notably, reduced government spending, lower inflation, and more stable exchange rates. Kurzer (1993, 3) further argued, while “social democratic parties are again or still in power, . . . they simply follow the cues and programs of right-wing or conservative parties and have no alternatives to proposals to shrink the public sector, privatize social services, and deregulate labor markets.”

By the mid-1990s, the hypothesis that economic globalization including international capital mobility was forcing OECD governments of the political left and right to constrain government spending and limiting their fiscal policy choices came under strong attack in the second wave of political science literature on the subject (see table 1). If anything, average OECD government spending relative to the gross domestic product has expanded since the early 1970s,⁵ consistent with the growth in international capital mobility. Scholars now debate whether this rise in relative government spending stems more from greater economic openness including international capital mobility (see Garrett 1995, 1998b) or from deindustrialization unrelated to it (see Iversen and Cusack 2000). Although there are arguably no definitive conclusions, the second-wave debate successfully demonstrated how little evidence exists to support the conclusion that international capital mobility has forced systematic cuts in OECD government expenditures across a wide range of spending cate-

point that I will develop in later chapters. Unfortunately, the two outcomes have become very closely linked in the minds of many IPE scholars, and this link is perhaps reinforced by arguments from economics that exchange rates should stabilize as national inflation rates converge (according to the model of purchasing power parity) and that fixing the exchange rate may be a solution to the problem of domestic inflation. Indeed, on many IPE syllabi, the literature on OECD capital mobility and inflation convergence is situated right next to the literature on fixed exchange rate regimes. The close proximity of these two arguments (international capital mobility and fixed exchange rates) has certainly encouraged acceptance of the monetary policy convergence hypothesis, even if many of the original scholars did not intend to make precisely this argument. I thank Michael Webb for making this point clear to me.

5. For evidence on this point, see Garrett 1998a, 813; 1998b, 77.

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gories (see Burgoon 2001), even if certain advanced industrial democracies have made deliberate choices for fiscal contraction.

But this second wave of literature barely considered the original hypothesis of monetary policy convergence and the related issue of exchange rate stability.⁶ On this point, Drezner (2001, 65) observed a “paucity” of empirical studies concerning the policy convergence hypothesis in a number of important issue areas. As further evidence on this point, it is notable that the growing literature on the varieties of capitalism (see, e.g., Kitschelt et al. 1999; Hall and Soskice 2001) tends to focus almost exclusively on national differences with regard to welfare spending, taxation, and regulatory policy without addressing in depth the topic of divergent national monetary policy choices. The unwillingness or inability to test the monetary convergence hypothesis may stem in part from the fact that while it is relatively easy to obtain reliable data on government spending and other fiscal policy indicators, it has been much harder to identify good operational measures for the loss of domestic monetary policy autonomy and corresponding stability of national exchange rates. Thus, the hypothesis of systematic monetary policy convergence has remained largely untested.

This development (or lack thereof) does not mean that all political scientists currently accept the monetary convergence hypothesis. Clearly, some never believed the argument from the outset; for example, Oatley (1999) and Clark and Hallerberg (2000) presented early evidence in support of monetary policy divergence. Other scholars rejected international capital mobility as the real cause for the loss of monetary policy autonomy, but they did so without explicitly rejecting the phenomenon of monetary policy convergence in Western Europe and elsewhere. Thus, we have reached the third wave of literature on the subject, which offers new explanations for monetary cooperation and integration, concepts that are clearly related to the original idea of monetary policy convergence and the corresponding loss of domestic monetary autonomy (see table 1). For example, McNamara (1998, 2) proposed that a new policy consensus on neoliberal economic ideas can explain why “political actors from socialist to conservative [have] supported an exchange rate regime that in effect gives away economic policy tools and limits their ability to use macroeconomic policy to distinguish themselves [to groups in society].”

6. Garrett’s work (1995; 1998b) considered the effect of internationalization on national interest rates, but monetary policy was not his primary focus, and he seems to have read his results as being generally consistent with the monetary convergence hypothesis. Finding that an interest rate premium has been imposed on leftist governments who engage in greater fiscal policy expansion, Garrett (1995, 683) speculated that “[i]n time . . . no government would be able to bear this burden.”

At this point in time, it is perhaps tempting to believe that the discipline has moved so far away from the original monetary convergence hypothesis that it is no longer necessary to investigate it empirically. But it seems that the proposition may be on the verge of making a comeback, based on new arguments originating in the field of international economics. For example, Calvo and Reinhart (2002) have described a “fear of floating” phenomenon that leads governments without any formal commitments to fix their exchange rate (i.e., *de jure* floaters) to behave as *de facto* fixers. Likewise, Frankel, Schmukler, and Servén (2002) have argued that only the very largest countries can obtain the benefits associated with monetary policy independence. Their empirical work, while strongly criticized by Shambaugh (2004), suggests that monetary policy autonomy is effectively disappearing in most regions of the globe, not just in Western Europe.

Thus, it seems inadequate to say that nobody currently believes in monetary policy convergence so the hypothesis does not require any testing. Many scholars continue to accept the proposition. Furthermore, they do so despite a number of theoretical and empirical problems that I will briefly outline in the next section of this chapter.

3. Problems with the Monetary Convergence Hypothesis

The first problem facing the monetary convergence hypothesis concerns the nature of “fixed” exchange rates in the post-Bretton Woods era. As evidence of external monetary policy convergence, political scientists often point to the fact that many governments in Western Europe have participated in a series of multilateral monetary and exchange rate regimes since the early 1970s: first the European Snake, then the European Monetary System (EMS), and now the Economic and Monetary Union (EMU). Furthermore, other OECD governments, not directly participating in these regimes, made similar unilateral commitments to “fix” the value of their national currency.

Putting aside for a moment this evidence’s limited cross-sectional domain (restricted to only Western Europe), membership in these multilateral currency regimes can be treated as persuasive evidence of external monetary convergence and the corresponding loss of domestic monetary autonomy if—and only if—it can be demonstrated that these monetary commitments have operated as *de facto* fixed exchange rate regimes, thus significantly constraining the policy choices of member governments with international capital mobility. On this point, the evidence is not particularly strong. Beginning with the European Snake, most observers (see, e.g., Gros and Thygesen 1992; Ungerer 1997; McNamara 1998, chap. 5) have written off this first regional monetary institu-

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tion as weak and almost completely ineffective in promoting regional exchange rate stability.

Other scholars, including McNamara (1998, chaps. 6–7), have written in more positive terms about the European Snake’s successor, the exchange rate mechanism of the European Monetary System. But even if it was associated with less exchange rate variability than the European Snake, the EMS hardly qualifies as a truly fixed exchange rate regime. Its exchange rate mechanism permitted the exchange rates of member states to fluctuate within fairly wide bands as compared to the more fixed Bretton Woods system.⁷ Furthermore, when national governments could not maintain their currency values within those bands, the band limits could be realigned, permitting additional domestic monetary autonomy. For such reasons, even optimistic assessments of the EMS characterized the arrangement as “more akin to a crawling peg” than to a fixed exchange rate regime (Froot and Rogoff 1991, 270). Consistent with this view, Ungerer (1997, 174) documented eighteen major realignment events within the EMS from 1979 to 1995, involving more than fifty separate national currency adjustments. Certainly, these realignments became less frequent in the 1990s. But this fact arguably stems less from the achievement of external monetary convergence and more from the decision to widen the EMS bands to 30 percent after the 1992 European exchange rate crisis, thus turning the exchange rate mechanism into something like a “managed float,” where formal realignments to maintain the appearance of a “fix” were hardly necessary.

Perhaps the strongest evidence in favor of European monetary convergence emerged in the middle to late 1990s, as many governments in the region prepared for the Economic and Monetary Union, adopting convergence criteria of the 1992 Maastricht Agreement. By the end of 1997, preexisting national monetary and fiscal policy divergences had been reduced, paving the way for the new European regional currency and a common European monetary policy set by the new European Central Bank. But even with this more recent evidence in favor of regional monetary convergence, political scientists must exercise caution.

In retrospect, the late 1990s now appear as an unusual era of high economic

7. The Bretton Woods system had bands around a par value allowing a 2 percent fluctuation (plus or minus 1 percent). By contrast, the EMS band width for most member states was 4.5 percent (plus or minus 2.25 percent) until 1993. For member states needing greater flexibility (e.g., Italy), the band width was 12 percent. The three EMS latecomers (Britain, Spain, and Portugal) also used the wider bands, first negotiated by Italy. After 1993, the bands were further widened to 30 percent (plus or minus 15 percent). As Obstfeld and Rogoff (1995, 73) concluded, this was “a system barely distinguishable from floating.”

growth and low inflation for most of the advanced industrial democracies. If the 1970s can be called a period of stagflation, when governments were simultaneously plagued by stagnant economies and high inflation, the late 1990s might be conversely treated as a period of noninflationary growth. With steady economic growth, tax revenues boomed, allowing governments to reduce their budget deficits and retire public debt (see Gobbin and Van Aarle 2001), often without any substantial cuts in government spending. The lack of corresponding price pressures also meant that the Maastricht inflation target became relatively easy to achieve, permitting nominal interest rates to fall in Europe, as in much of the rest of the global North. In fact, many advanced industrial democracies outside of Western Europe, including the United States, would have effectively satisfied the EMU fiscal and monetary convergence criteria, although there was neither political pressure to do so nor any opportunity to join the new institution. Von Hagen and Strauch (2001, 342) concluded, “There is . . . no need for a ‘Maastricht effect’ to explain these consolidations.”

Von Hagen and Strauch’s conclusion, echoed by others,⁸ does not mean that some monetary policy convergence has not occurred. But it does suggest that recent policy convergence in Western Europe rests on a somewhat fragile foundation. As the 1990s boom ended and the region again experienced economic contraction with corresponding societal demands for domestic policy autonomy, several governments with EMU commitments found themselves pushing the fiscal limits set by the 1997 Stability and Growth Pact. Other EMU member states have expressed their dissatisfaction with the regional monetary policy set by the European Central Bank.⁹ Finally, three EU member states (Britain, Sweden, and Denmark) have quite successfully run their national economies outside of the EMU arrangement, thus demonstrating the potential attractiveness and viability of domestic policy autonomy for European governments in the twenty-first century. Consequently, because several EU governments remain outside the institution and because many of those inside are behaving in a manner inconsistent with the rules for regional policy convergence, it is not reasonable to conclude that the EMU represents the final proof of Western European policy convergence. I will return to this point in chapter 7.

If—despite all the evidence to the contrary—political scientists still wish to insist that such European monetary regimes as the Snake and the EMS are con-

8. See also an unpublished paper by Ringe (2003) showing that success in meeting the various Maastricht convergence criteria can largely be explained by a business cycle model.

9. See, for example, *Economist* 2001b.

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sistent with de facto exchange rate fixity, then they run up against a new problem regarding the monetary convergence hypothesis. This second problem concerns its now ambiguous theoretical domain. If we treat membership in a European multilateral currency regime as a strong indicator of monetary policy convergence, what can we say about the OECD governments in North America and the Pacific, who have not created and participated in formal monetary regimes like those found in Western Europe? Can we reasonably conclude that Western Europe has converged with regard to monetary policy but that the other OECD governments in North America and the Pacific have not? If we accept such a conclusion, what does this regional dichotomy say about the various possible explanations for monetary policy convergence?

In fact, it is very hard to square this empirical conclusion—that Western Europe is monetary policy convergent while the other OECD governments are not—with the major theoretical explanations advanced in the third wave of literature (see table 1 in chap. 1) to explain monetary cooperation and integration in Western Europe. McNamara (1998) put forth an explanation based on neoliberal policy ideas, while Frieden (2002) updated his earlier argument focusing on the political pressure applied by international exporters and investors, who favor exchange rate stability. If these are indeed the major factors directly explaining monetary cooperation and exchange rate stability, then we must acknowledge the power of neoliberal economic ideas in the non-European OECD countries, especially the United States and Japan.¹⁰ Likewise, it becomes necessary to recognize the political pressure that can be applied by internationally oriented big business in every capitalist economy. These possible explanations for monetary policy convergence lead us toward the conclusion that it must be a broad OECD experience.¹¹ Yet the standard political science measure for monetary policy convergence—membership in a multilateral currency regime, with nonmembership marking domestic policy autonomy—leads us to a different conclusion: that policy convergence has been a uniquely European phenomenon. Simply stated, it is hard to reconcile our currently limited empirical evidence for monetary policy convergence with the theoretical explanations that have recently been advanced to explain it.

A third potential problem facing the monetary convergence hypothesis concerns these very theoretical explanations: the influence of neoliberal policy ideas among statist actors and the growing political power exerted by societal actors, such as international exporters and investors, who prefer monetary

10. The United States is regularly identified as a neoliberal political economy (see, e.g., Iversen and Wren 1998). On the influence of neoliberal policy ideas in Japan, see Takenaka 1991.

11. This is true despite the fact that both McNamara and Frieden test their arguments only on European cases.

integration and exchange rate stability. While McNamara (1998) and Frieden (2002) made very reasonable arguments about the potential influence of these factors, their empirical work does not discuss or include important countervailing policy ideas and societal political pressures.

Even if triumphing over Keynesian ideas in the 1980s, neoliberal policy ideas, drawn from monetarist economic theory and supposedly pushing governments toward external policy convergence, had to contend with major new policy ideas in the 1990s. The most notable new contender went by the name of endogenous growth—or new growth—theory.¹² This economic policy idea, which was especially influential within left-wing political circles (see Boix 1997, 1998), made novel arguments to justify state intervention in the national economy, provided that government spending was directed toward public investment projects including infrastructure, worker training, and research and development. Thus, just as certain ideas were pushing governments toward external policy convergence, other ideas were leading governments back toward fiscal expansion and associated domestic policy autonomy.

Likewise, even if international exporters and investors pressured governments for monetary integration and exchange rate stability, OECD governments also faced countervailing pressures for domestic policy autonomy from the nontradable service sector. Iversen, Wren, and Cusack (Iversen and Wren 1998; Iversen and Cusack 2000) have demonstrated the political influence of this domestically oriented economic sector in setting national economic priorities. Even if it does not have the same exit option afforded international investors, the service sector's large and growing economic size gives it a powerful voice in pushing democratic governments toward domestic policy autonomy and away from exchange rate stability.¹³ In short, much the same logic concerning interest group pressures that has been used to explain external policy convergence could also be employed to explain domestic policy divergence. Indeed, I will do precisely this in chapter 5.

The fourth and final problem that the logic underlying the monetary convergence hypothesis must confront was mentioned in chapter 1. The second wave of scholarship on the effects of economic globalization and international capital mobility soundly rejected the proposition of fiscal policy convergence in the post-Bretton Woods era (see, e.g., Garrett 1995; Garrett 1998b; Kitschelt

12. On endogenous—or new growth—theory, see Aschauer 1990; Barro 1990; Romer 1990; Barro and Sala-I-Martin 1995; Alesina and Perotti 1996. For a concise summary, see Gilpin 2001, chap. 5.

13. On the size of the nontradable service sector, see the 1994 article by De Gregorio, Giovannini, and Wolf. Their evidence shows that services are not becoming more tradable. Hence, this sector would continue to hold preferences for domestic policy autonomy.

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et al. 1999; Burgoon 2001; Hall and Soskice 2001). Although the details of fiscal policy divergence remain a source of scholarly disagreement, there is very little evidence that international capital mobility has forced OECD governments to cut taxes and spending, reduce deficits, and retire public debt, even if certain advanced industrial democracies have made such policy decisions. Thus, how can we sustain a story of monetary policy convergence next to all the evidence showing fiscal policy divergence among the advanced industrial democracies in the post-Bretton Woods era?

Perhaps if we can completely divorce monetary policy and interest rate decisions from those involving government spending and budget deficits, it will be possible to find convergence with regard to one policy instrument (monetary) and at the same time demonstrate divergence in the use of the other main policy instrument (fiscal). The notion of monetary policy convergence next to existing evidence of fiscal policy divergence might also be sustainable when employing a very simplified model of the national political economy—a model in which governments have only one policy goal, which can be satisfied using a single policy instrument. However, it is very difficult to build a reasonable model of national economic policy-making without acknowledging that governments have multiple policy goals but relatively few policy instruments through which to achieve their goals. Once we accept the idea that governments have multiple policy goals that cannot be satisfied simultaneously using a single policy instrument, we must confront the fact that governments may need to coordinate their limited number of policy instruments to target different economic objectives at the same time. Thus, fiscal policy differences at the national level could produce the situation of monetary policy divergence, defined to exist when governments move interest rates in different directions toward different economic objectives, depending on whether they contract or expand their fiscal policy instruments.

In conclusion, there are some very good reasons to question the hypothesis of OECD monetary policy convergence in the post-Bretton Woods era. Thus, we simply cannot continue to accept the monetary convergence proposition without more rigorous empirical testing. The task ahead in chapter 3 is to bring some additional evidence to bear on the proposition. If the hypothesis passes its tests, we can place the monetary policy convergence story on a much more solid empirical foundation. If we cannot find evidence of systematic monetary convergence, then we need to explore the origins of OECD monetary policy divergence after 1973.