CHAPTER 6

Illustrating Partisan Divergence in the Policy Mix

Chapter 5 provided large-*N* statistical evidence concerning the determinants of policy divergence among the OECD governments in the post–Bretton Woods era. These quantitative results showed how the partisan character of the government in power played an important role at least with regard to government spending and nominal interest rates, with related consequences for domestic monetary autonomy and exchange rate stability. Leftist governments were significantly associated with more government spending, higher nominal interest rates, larger interest rate differentials, and greater exchange rate variability than were their rightist counterparts.

This chapter will further develop these partisan results by presenting two detailed case examples to illustrate partisan policy mix divergence in the post–Bretton Woods era. Indeed, scholars have a right to be suspicious of statistical evidence that cannot be illustrated and supported by interesting and important case examples. The first such case example will be the French Socialists, who governed their national economy for most of the period from 1981 to 1995. The British Conservatives will be the second case example, having decided the direction of their national economy from 1979 to 1996.

The examples of the French Socialists and British Conservatives are already well-studied cases in comparative and international political economy, but I wish to revisit them here based on the belief that both cases have been somewhat misinterpreted with regard to the hypothesis of macroeconomic policy convergence after 1973. The convergence hypothesis predicted that the OECD governments were moving toward very similar fiscal and monetary policy strategies for governing their national economies with international capital mobility. To the extent that the convergence hypothesis allowed for variation in the extent and timing of national policy convergence, the governments within fixed exchange rate regimes such as the EMS were expected to be the most policy convergent; those outside such regimes were expected to be somewhat less so but nonetheless still on a similar trajectory toward external policy convergence.

Following this conventional wisdom, one might identify the French Socialists, with their formal commitment to the exchange rate mechanism (ERM) of the EMS, as a powerful example of external policy convergence, especially after President Mitterrand's so-called U-turn in 1983. Indeed, as was discussed in chapter 5, scholars have often treated the French Socialists as a crucial case for the partisan economic policy convergence argument, since France was the only G-7 economy governed by a leftist party for a substantial part of the 1980s, a critical time period for the macroeconomic policy convergence hypothesis.

Britain represents a more awkward case for convergence theory, because the Conservative governments generally stayed outside European monetary and exchange rate institutions, a fact thought to suggest policy nonconvergence. Yet the Conservatives also followed neoliberal policy ideas, a fact consistent with certain explanations for monetary policy convergence (see, e.g., McNamara 1998). Thus, Conservative Party governance in Britain could still be consistent with external policy convergence, but the conventional wisdom would read the British Conservatives as a laggard case and, thus, as somewhat less convergent than the French Socialists, who remained within the EMS throughout the two Mitterrand presidencies.

Having argued in the earlier chapters that we cannot judge domestic policy autonomy or external policy convergence in terms of a government's de jure exchange rate regime, I will now make the case that the conventional wisdom has misidentified these two important case examples (see fig. 17). Rather than being more convergent as identified by the macroeconomic convergence hypothesis, the French Socialists are an important example of policy autonomy and nonconvergence in the post–Bretton Woods era, consistent with the argument made in chapter 5 that leftist governments have tended to choose domestic policy independence over exchange rate stability and that they have been able to make this choice even inside such exchange rate regimes as the EMS. Likewise, I will argue that rather than being somewhat less convergent (or a laggard case of policy convergence) due to their nonmembership in European exchange rate regimes, the British Conservatives are, in fact, a much better example of external policy convergence than the French Socialists. With these two cases, I can illustrate partisan policy divergence in terms of government spending, nominal interest rates, and exchange rate variability. The remainder of this chapter will present these two cases, looking at the French Socialists first and at the British Conservatives second.

	French Socialists	British Conservatives
Macroeconomic convergence hypothesis	More convergent since inside the EMS	Less convergent since outside the EMS
Partisan policy mix divergence	Less convergent with policy autonomy inside the EMS	More convergent despite the lack of EMS commitments

Fig. 17. Identifying the French and British Cases

1. The French Socialists, 1981–95

For scholars seeking historical support for the macroeconomic convergence hypothesis, Socialist Party governments in France are often cited as the prime example of the political left adopting rightist policies for managing the national economy. Two facts would seem to bear out this conclusion. The first is President Mitterrand's so-called U-turn in 1983, when he decided to keep France within the exchange rate mechanism of the EMS. The second is Mitterrand's later support for the Economic and Monetary Union (EMU) in Europe. These decisions might suggest that the Socialist Party moved the French economy toward external policy convergence and exchange rate stability in the post–Bretton Woods era.

However, when placed in a broader context, this conclusion seems not only misleading but factually incorrect. The 1983 U-turn did represent an important shift in the Socialists' policy mix, as the leftist party accepted the need for low inflation to become a dominant economic policy objective. But Socialist governments achieved their lower inflation outcomes primarily through monetary, not fiscal, contraction. While government spending might have been reduced relative to planned expenditure levels, French government consumption as a percent of GDP remained higher than the OECD average throughout the Mitterrand presidencies. Thus, the French Socialists did not follow the neoliberal policy mix of less government spending with a lower nominal interest rate that is associated with external policy convergence for exchange rate stability. Instead, the Socialists shifted toward the New Left combination of more government spending with a higher nominal interest rate to better achieve their partisan goals of redistribution and public goods provision. As described earlier, this was not a policy mix associated with external monetary convergence; consequently, the Socialists paid some costs in terms of greater exchange rate variability.

Certainly, Mitterrand kept France within the EMS, but this decision reflected his personal commitment to European institutions, rather than the Socialist Party's collective preference for exchange rate stability over domestic policy autonomy. Indeed, despite the built-in flexibility offered by this exchange rate regime (with currency bands that allowed national currencies to float freely within a 4.5 percent range before any intervention was required), the Socialists realigned the franc within the EMS six times during the Mitterrand era (in October 1981, June 1982, March 1983, July 1985, April 1986, and September 1992).[1] Inasmuch as Mitterrand still felt restricted within the German-dominated EMS, he proposed and supported a new European arrangement designed to restore French monetary independence. Paradoxically, Mitterrand's support for the EMU—which was not shared by many other Socialist Party leaders—was based on the mistaken belief that the new European monetary regime would offer France greater policy flexibility, especially vis-à-vis Germany. The rest of this case study will develop these arguments in greater detail.

The Socialist's Societal Base

Like many leftist parties in the advanced industrial democracies, the French Socialists tended to represent domestically oriented producer groups, those with expected preferences for domestic policy autonomy over exchange rate stability. The Socialists have certainly competed with the Communist Parties in France for support from low-skilled labor and traditional manufacturing. This competition suggests that the Socialists should be particularly attentive to the policy preferences of the "import-competing producers of tradable goods for the domestic market" (Frieden 1991, 445).

The French Socialists have also sought political support from the growing service sector, especially those working in public and government services (i.e., "producers of nontradable goods and services" [ibid.]). Bell and Criddle (1988,

1. For more details on the French EMS realignments, see Ungerer 1997, 174.

208) concluded: "Advancing more on the votes of the expanding new middle class than on the contracting industrial working class, and internally dominated by the new professionals in teaching and administration, the PS is the Party of the tertiary (largely public) sector, credentialed (not propertied) middle class. . . . Popular (in 1981) with the working class, it lacks deep roots in that class. Capable also of taking 'protest' votes from the parties of the Right, it cannot rely on such support." Cole (1994, 66–67) provided further evidence that these domestically oriented economic sectors tend to support leftist parties in France, identifying the Socialists as an "interclassist" party, which "attracted support from many of the new social groups produced by post-war socio-economic and demographic change: new tertiary sector workers (especially in the public sector), the new and expanded professions (teaching, social work), as well as a high proportion of the cadres, the managerial strata whose ranks had increased dramatically in the post-war period." Cole continued: "In addition to these dynamic expanding groups within French society, the party proved remarkably successful at attracting the support of older, more traditionally left-wing constituencies, such as industrial workers, and low status office and shop-workers (employés), over which the Communist Party had traditionally exercised a strong influence."

As the Socialists obtained their greatest political support from import-competing manufacturing and nontradable services, the party could be expected to face strong interest group pressure for domestic policy autonomy. Indeed, for societal groups wishing to obtain their economic policy preferences, partisan agents have become a necessity in the French political system. Scholars typically treat the French state, especially with regard to economic policy-making, as quite strong relative to French society, making it difficult for interest groups to influence policy directly and forcing them to employ political agents for this purpose. Unions, as potential agents for influencing the French state, tend to be weak. Hayward (1986, 53) noted, "in reality these [French] union have had to confine their inordinate ambitions to acting rather negatively, resisting policies that they disliked rather than promoting policies which they desire." To influence positively the French state on economic matters, societal actors instead rely on "the mediation of political parties" (ibid., 48). Hayward thus concluded: "while the political party [in the Fifth Republic] does not play the monopoly role that it enjoys in the one-party state and parties pursue less divergent policies when in power than would be expected from their ideologies or programmes in opposition, it continues to have an important place among the plurality of political actors in France" (54).

Predictably, Francois Mitterrand, as the Socialist Party's presidential candidate, ran in 1981 on a platform of French policy independence. Howarth (2001, 80) summarized: "The policies of the Socialist Party prior to the 1981 elections and the rhetoric of its leadership created considerable expectation within the Party's rank and file, the new government and the trade unions of the pursuit of social and economic policies which would transform French society. This expectation increased opposition to the ERM [of the EMS], as the most obvious manifestation of the 'international capitalist' constraint which prevented the fulfillment of Socialist goals. Much of Mitterrand's rhetorical commitment to growth-oriented policies, under-emphasis of austerity, and his statements suggesting the possibility of a franc devaluation outside the ERM stemmed from the need to mollify this demand." The previous right-centrist government led by Valery Giscard d'Estaing—representing capital-intensive internationally oriented producer groups (see Bell and Criddle 1988; Hayward 1986) with much stronger preferences for stable exchange rates—was instrumental in constructing the EMS and initially committed France to this multilateral exchange rate regime. Although the Socialists did not directly repudiate French EMS membership, they expressed little genuine interest in exchange rate stability. Goodman (1992, 127) argued: "Most Socialist party leaders agreed on these points [economic expansion with redistribution], but far less accord existed on the question of exchange rate policy. Although Mitterrand's electoral policy promised to defend the franc, it was never clear how this goal would be reconciled with the government's commitment to domestic growth. One leading Socialist economist admitted: 'We were thinking more about growth, protecting employment, and structural reforms. . . . Defending the franc was a secondary consideration.'"

Upon Mitterrand's victory in the 1981 presidential elections, the Socialists obtained their first opportunity to govern the French economy in the post–Bretton Woods era. This fact is important because it suggests that they had little experience with economic governance given the constraints imposed by international capital mobility. Inheriting a situation of rising unemployment and slow domestic growth, Mitterrand began with an Old Left reflation policy, described as "redistributive Keynesianism" (Hall 1986, 194), using relatively loose fiscal and monetary policies. Mitterrand's reflation program had three main components: increase the minimum wage to boost private consumption, increase welfare benefits, and boost economic growth with greater government spending, including worker training and funding for research and development (see Muet and Fonteneau 1990, 75). Goodman (1992, 127) wrote: "In the Socialists' macroeconomic strategy, fiscal policy became the principal motor of economic growth. In fact, little attention was paid to monetary policy, which was expected to accommodate [i.e., remain loose to facilitate] the planned increase in government spending."

But as the policy mix framework predicted, Mitterand's Old Left policy mix (high government spending and low national interest rates) would quickly become unsustainable with international capital mobility, since no policy instrument was directed toward inflation control. Indeed, the French economic situation worsened as inflation rose and the twin deficits (budget and trade) grew. Mobile capital exercised its exit option, and the French franc lost value. The declining economy forced President Mitterrand to consider a shift in the French policy mix. But his party was internally divided on how best to proceed.

On one side stood the CERES group (members of the Centre d'Etudes de Recherche et d'Education Socialistes), led by Jean-Pierre Chevenment, who wanted to pursue full economic expansion regardless of the inflationary consequences, withdraw from the EMS, and institute trade and capital controls to buffer against external pressures. Capital controls, to the extent that they could be maintained, would make the Old Left policy mix a more feasible policy option. The so-called Second Left (*deuxieme gauche*) opposed this plan. Michel Rocard and Jacques Delors, the latter of whom served as the Socialist finance minister at the time, argued for monetary contraction to restore domestic price stability, while remaining open to the world economy. The Second Left argued that continued EMS membership could provide some anti-inflation credibility even if exchange rate stability was not an important Socialist economic priority (Oatley 1997, 111–20).

U-turn or "New Left" Turn?

The Second Left gradually won this policy struggle, as France undertook a series of austerity programs and realignments inside the EMS. In late 1981, the Mitterrand government began to raise nominal interest rates in the French national economy. Higher interest rates reflected a deliberate policy choice on the part of the Socialist-led government, since the French central bank, the Banque de France, was quite subordinate to the Socialist finance ministry in setting monetary policy. As shown in figure 18, French nominal interest rate differentials remained positive (above the prevailing world interest rate) throughout the fourteen years of the two Mitterrand presidencies, reflecting domestic monetary policy autonomy in an international context. Figure 18 also shows that during the cohabitation years (particularly 1987–88 and 1993–94) when Gaullist ministers ran French economic policy under a Mitter-

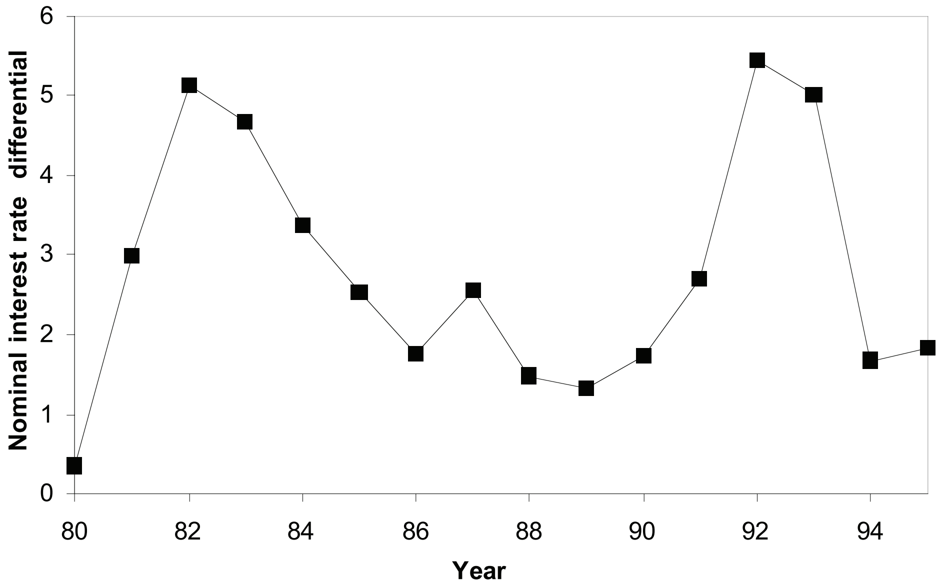

Fig. 18. French Monetary Policy Autonomy, 1980–95. (Monetary policy data from International Monetary Fund, *International Financial Statistics*.)

rand presidency, French interest rate differentials tended to decline, consistent with rightist preferences for external monetary convergence toward the low world interest rate.

The tight money policy instituted by the Socialists beginning in 1981 took some time to reduce inflation. During this period, the lack of external monetary policy convergence in France predictably led to exchange rate instability. France realigned within the EMS first in October 1981, again in June 1982, and a third time in March 1983. In 1983, Delors, as finance minister, instituted an even tighter monetary policy, as measured in terms of money supply growth. Goodman (1992, 135) reported: "An implicit target for the growth of domestic credit was set at 12 percent, a significant drop from the previous year. But Delors reportedly rejected the central bank's proposal and set a 10 percent target, apparently anticipating that the government would have to tighten monetary policy even further in 1983."

Socialist monetary tightness eventually produced the desired effect in stabilizing domestic prices. Loriaux (1991, 220) argued: "The Socialist party outperformed its conservative predecessor in its efforts to impose price stability and to contain the growth of wages. By 1985, the Socialists had brought inflation to under 6 percent, compared with an average in excess of 10 percent under the government of Raymond Barre [Giscard's prime minister]." But despite such low inflation outcomes, the Socialist monetary policy never converged on the low world interest rate, as shown in figure 18. This evidence accords well with the data presented by Bilger (1993, 111, 114) showing that French interest rates and inflation rates never fully converged on those in West Germany during the 1980s.

Such monetary nonconvergence can be explained in large part by the Socialists' expansionary fiscal policy stance over this period. At the same time that the Socialist government directed its monetary policy instrument toward inflation control, it needed another policy instrument to help maintain economic growth, consistent with the logic of the policy mix framework. Given Socialist ideological objectives favoring public goods and income redistribution, their preferred policy instrument for economic growth was fiscal expansion.

Certainly, Mitterrand began his tenure in 1981 with an expansionary fiscal stance. But it is often argued that the two austerity programs, the first coming in June 1982 and the second in March 1983, led to drastic cuts in French government spending. The empirical evidence simply does not bear out such a conclusion. As figure 19 demonstrates, contrary to the conventional wisdom, French government consumption relative to GDP actually grew during the austerity years (1982–83). As compared to the OECD average, French fiscal policy was relatively expansionary throughout the two Mitterrand presidencies (1981–95). Also consistent with the partisan policy mix framework, French government spending tended to contract when the Right controlled fiscal policy instruments during the cohabitation years (1986–88 and 1993–95).

How can it be that the Socialists' fiscal policy—at least as measured in terms of relative government consumption spending—was relatively expansionary even during the austerity years? To answer this question, it is helpful to examine the austerity packages and note that they did not mandate large cuts in government spending. The 1982 austerity package came as part of the franc realignment within the EMS and consisted of three primary components. First, France would seek to hold its budget deficit to 3 percent of the gross national product, a goal that could be attained through tax increases rather than drastic spending cuts (Oatley 1997, 119). Second, France would contract monetarily, slowing money growth from 12 percent in 1982 to 10 percent in 1983. Third, France instituted a series of wages and price controls to reduce inflation.[2] When this package failed to deliver the desired effect, France accepted a second

2. Ross's description of French austerity (2001, 26) bears out the story of limited (if any) cuts in government spending by the Socialists.

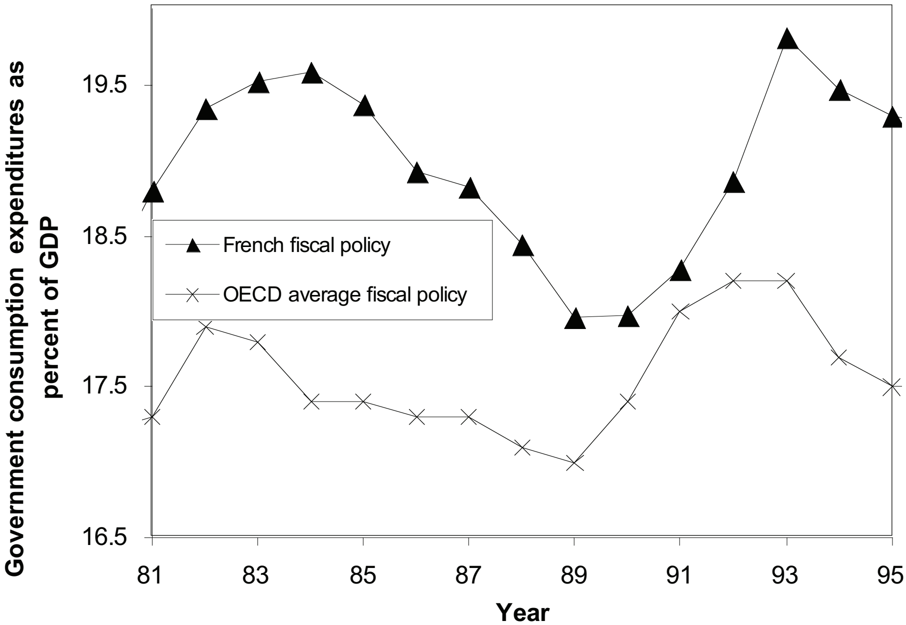

Fig. 19. French Government Spending, 1981–95. (Fiscal policy data from Organization for Economic Cooperation and Development, *Annual National Accounts*.)

austerity program in conjunction with the 1983 franc realignment within the EMS. The second program had four main parts (ibid., 124–25): (1) increased taxes to reduce the budget deficit; (2) limited cuts in government spending, mostly in terms of grants to nationalized sectors; (3) measures to increase the national saving rate; and (4) additional capital controls (e.g., a limit of two thousand francs on foreign exchange transactions for foreign travel).

Often interpreted as a U-turn in Socialist economic policy-making, Goodman (1992, 138) and other scholars have identified Mitterrand's acceptance of austerity as "a true watershed in Socialist economic thought." On this point, the partisan policy mix framework would also identify the austerity programs as watershed events inasmuch as they demonstrate how the Socialists accepted inflation control, along with economic growth, as a top macroeconomic priority given international capital mobility. In this sense, the Socialists finally abandoned any effort to hold an Old Left policy mix with more government spending and lower nominal interest rates.

Others (see, e.g., McNamara 1998, chap. 6) have interpreted these events as consistent with external policy convergence, maintaining that the French left adopted the neoliberal policy prescriptions of the political right. But as figure 20 illustrates, there is a problem with this logic when we identify the combination of less government spending with a lower nominal interest rate as the more neoliberal policy mix. If the French Socialists had wanted to move in this direction, they would have needed tighter fiscal conditions permitting a lower nominal interest rate in order to converge on the low world interest rate. But they did not make this choice: the evidence clearly shows that French government spending under the Socialists remained relatively high on an international basis even during the austerity years. Perhaps it was cut relative to planned levels, and French budget deficits certainly fell as tax revenues grew. But contraction occurred primarily on the monetary side, as French nominal interest rates rose well above the prevailing world rate. This fiscal and monetary combination demonstrates how the French Socialists clearly moved toward a different, more autonomous policy mix.

Exchange Rate Variability

As long as the world interest rate remained low on a nominal basis, the New Left policy mix would be generally incompatible with the external policy goal of exchange rate stability given international capital mobility. Arguably, Mitterrand's new policy mix did offer greater currency stability than would have the Old Left alternative, which had no policy instrument directed toward inflation control. But the New Left policy mix, with its large nominal interest rate differential, could not offer the exchange rate stability promised by the more neoliberal policy mix, with its reduced interest rate differential made possible through cuts in government spending. Indeed, the Socialists continued to face currency pressures within the EMS: a fourth franc realignment occurred in July 1985, a fifth in April 1986, and a sixth in September 1992.[3]

3. These realignment events were currency depreciations. As discussed in chapter 3, positive interest rate differentials could be associated with either currency appreciation or currency depreciation, depending on how international investors interpret the interest rate differential. If interpreted as a sign of excess positive returns on capital in the national economy, then positive interest rate differentials would lead to capital inflows and domestic currency appreciation. If interpreted instead as a sign of increasing domestic prices, then a positive interest rate differential would lead to capital outflows and currency depreciation, as it did for the French Socialists. This understanding helps explain why the solution to French exchange rate instability during this period was not simply to raise interest rates even higher, a decision that might have been read as a signal of yet more expected future inflation. Instead, relative exchange rate stability could have been achieved with reduced public spending, since government intervention in the national economy was viewed as one of the major sources of French inflation during this period.

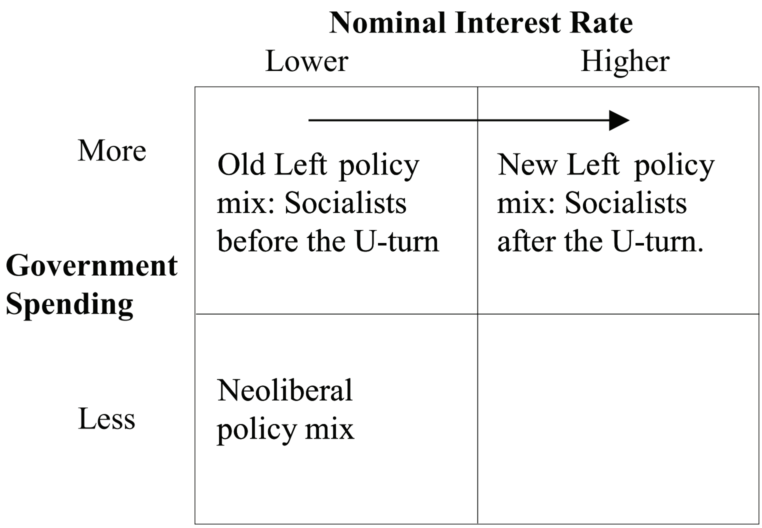

Fig. 20. The Socialists' New Left Policy Mix

Consequently, Mitterrand's decision to remain inside the exchange rate mechanism of the EMS should not be interpreted as a choice for exchange rate stability over domestic policy autonomy. Howarth (2001, 62) reported in his detailed history of French monetary policy: "One important conclusion can be drawn: that Mitterrand's decision could probably have gone either way on the issue. His rather confused attitudes on desirable economic policy both encouraged and discouraged a float. His European attitudes—support for the *acquis communitaire* and the belief in France's leadership role in Europe—encouraged continued ERM membership, although their importance is difficult to determine. He was convinced less by economic arguments." The decision to remain within the relatively flexible EMS instead reflected Mitterrand's personal goal to maintain French commitments to European institutions. On this point, Howarth further reported, "all of Mitterrand's advisors claim that the most important factor encouraging his decision in favour of the ERM was a long-standing commitment to the European Community, especially given that his knowledge of economics was extremely limited" (78). Jean Peyrelevade, an economic advisor to President Mitterrand, stated, "Allowing the franc to float [i.e., exiting the EMS] would have caused our international partners, who were already suspicious, to doubt the new government's attachment to Europe" (cited in Goodman and Pauly 1993, 71).

Further evidence for the Socialist Party's relative disinterest in exchange rate stability came in 1985, when the French government played only a secondary role in the G-5 Plaza Accord, designed to stabilize the world's major currencies at a time of high exchange rate variability (see Funabashi 1988, 173). The French government later played a major role in constructing the 1987 Louvre Accord, a target-zone system for maintaining currency stability among the G-5 currencies after the Plaza Accord (see Howarth 2001, 100). But it is important to remember that the Louvre Accord was negotiated during a period of cohabitation, when the French political right, who prized exchange rate stability over domestic policy autonomy, governed the national economy.

As President Mitterrand increasingly perceived (perhaps erroneously) the EMS to be a policy straitjacket on the French national economy, he became the vocal leader in searching for a new European monetary regime to replace the EMS. His alternative was the EMU, with a European central bank. Mitterrand reasoned that the EMU's regional central bank with French national representation might be more responsive to the domestic policy preferences represented by the French Socialists than was the German Bundesbank, whose conservative policy decisions arguably dominated the operation of the EMS.

The Socialists and the EMU

Many have interpreted Mitterrand's support for the EMU as proof that the Socialists had finally accepted external policy convergence and exchange rate stability as their dominant economic objectives. But just the opposite appears to be the case. Ross (2001, 29) neatly summarized: "The bottom line was that the French wanted to seize some control of European monetary policy from the German Bundesbank. Others, the Italians in particular, were interested in helping them. The concern was not simply power. What mattered was to construct a new institutional basis for European monetary policy that would be less constrained towards price stability and more growth-friendly." Elgie and Thompson (1998, 127) offered a similar assessment: "Suffice it to say here that Mitterrand promoted monetary union as early as January 1988 because he believed that it would reduce the economic influence of Germany."

Many Socialist Party leaders correctly recognized that the EMU would not offer France greater domestic policy autonomy than did the EMS, and they opposed the new monetary arrangement. Howarth (2002, 185) reported, "there is no evidence of any pro-EMU activity by [Socialist] financial policy advisors close to President Mitterrand or leading Treasury officials prior to June 1988 and the latter continued to oppose the project over the next three years." Indeed, the EMS had permitted the Socialist governments to exercise substantial domestic policy independence, consistent with the assessment that this arrangement represented only "a partial tying of the French government's hands" (Howarth 2001, 191). However, by treating European monetary integration as a French foreign policy issue and, thus, as within the exclusive domain of the French president, Mitterrand simply ignored the opposition within his own party and moved forward on the EMU.

This conclusion is further supported by Ross's evaluation (2001, 45) that the EMU was "*not* a French Socialist project in any partisan terms" but, rather, "the product of a French Socialist President, working in the realm of high diplomatic politics, with the aid of a French Socialist President of the European Commission." Ross continued: "the French Socialists, as a party, did not really confront the realities of EMU in domestic politics until the mid-1990s, at which point EMU was a *fait accompli.* When the confrontation occurred, it was less about the desirability of EMU and more about developing a 'left' domestic-policy package [i.e., maximizing domestic policy autonomy] within the constraints of EMU . . . [suggesting] that EMU will be a negotiable process as it unfolds." In chapter 7, I will return to the subject of how leftist governments have dealt with the policy constraints imposed by the EMU.

2. The British Conservatives, 1979–96

Conservative Party governance in Britain is an important case to illustrate external policy convergence because it is not an obvious one. Except for a brief period in the early 1990s, Conservative governments have stubbornly stayed outside of European monetary regimes in the post–Bretton Woods era. Thus, for scholars who equate membership in such regimes as a decision for external policy convergence with exchange rate stability and who equate nonmembership as a choice for domestic policy autonomy, the case of the British Conservatives would appear to be an example of the latter choice.

But the Conservatives espoused neoliberal policy ideas and represented the capital-intensive internationally oriented sectors of the British economy. On this point, Philip (1992, 166) concluded, "Clearly industrial and City interests are likely to be most happy with the Conservatives while trade union interests will naturally try to influence Labour's position above all others." Gamble (1994, 246–47) similarly identified the Conservatives as the partisan agent for the internationally oriented sectors of the British economy. He wrote that "by reasserting the traditional international orientation of British economic policy, the [Conservative] government gave priority to the maintenance of the openness of the British economy over the protection of domestic industry." Gamble continued: "This policy favoured those industrial sectors that were already dominated by transnational companies . . . as well as the financial and commercial companies based in the City."

Given this representation, the British Conservatives fit the government partisanship criteria for external policy convergence and stand as a very unlikely case of domestic policy autonomy. Furthermore, Britain's majoritarian electoral system meant that the Conservative governments were not hindered in their choice for policy convergence by political power-sharing arrangements. I will thus here make a three-part case for the British Conservatives as an important example of external policy convergence. The first part will consider the Conservative's neoliberal policy mix. The second part will show how, with their neoliberal policy mix, the Conservatives were able to achieve a relatively stable national currency while remaining outside of the EMS. The third part will briefly examine the period of Labor Party governance beginning in 1997. This examination is important because Labor, rather than the Conservatives, is frequently cast as the British political party that is most interested in external policy convergence. I will show how this interpretation is misleading, making the case for the British Labor Party as a party of domestic policy autonomy.

Toward a Neoliberal Policy Mix

Under the leadership of Margaret Thatcher, the Conservative Party took power in 1979, following five years of Labor Party governance in the United Kingdom. Other than the final years of the Heath government, Thatcher's ascendancy marked the first opportunity for this rightist party to govern its national economy in the post–Bretton Woods era of international capital mobility. Consequently, the Conservatives had to experiment with their policy mix before finding a fiscal and monetary combination that was both feasible given international capital mobility and consistent with their own partisan objectives for exchange rate stability. On the latter issue, it is important to begin with the understanding that the British Conservatives desired exchange rate stability. Thompson (1996, 23) concluded in her study of British monetary policy under the Conservatives, "most fundamentally, Thatcher and Howe [Thatcher's chancellor of the exchequer] were committed to the general aim of exchange rate stability." This important point will be developed in much greater detail shortly.

Facing a situation of high inflation in Britain, the Thatcher government began with a policy mix that was relatively tight on both the fiscal and monetary fronts, effectively directing these two policy instruments toward the same goal of domestic price stability. As I argued in chapter 4, such an Old Right policy mix (with less government spending with a higher national interest rate) quickly becomes unfriendly to international capital, because it tends to stifle economic growth in the national economy. Indeed, with no policy instruments directed at this important economic objective, Britain entered a recession in late 1980. As would be expected, internationally mobile capital exited the British economy, and the pound sterling lost value, especially in 1981 (see Walsh 2000, 497).

This situation forced the Thatcher government to reconsider its Old Right policy mix. Recognizing that one policy instrument (either fiscal or monetary) must be directed toward the objective of economic growth, the Conservatives effectively had two possible options: more government spending with a higher nominal interest rate (the New Left policy mix) or less government spending with a lower interest rate (the neoliberal alternative). As illustrated in figure 21, Thatcher effectively chose the latter, also labeled as the New Right policy mix. Indeed, Seldon and Collins (2000, 66) concluded, "Thatcher herself came to accept the recession of 1980/81 had been aggravated by a too tight monetary policy." But the need for continued inflation control meant that British fiscal policy should remain relatively tight. As an explicit means to coordinate their fiscal and monetary policy choices (consistent with the logic of deliberate policy counterbalancing), the Conservatives introduced the new Medium Term Financial Strategy.

The new Conservative government faced some initial difficulty in implementing their plans for fiscal contraction. British government spending relative to GDP did not fall as quickly as the Conservatives had planned (see Boix 1998, 163). But much of this difficulty was certainly due to the recessionary environment in Britain. Hall (1986, 116) noted, "the high public spending to GDP ratios [in the early Thatcher years] reflect a sluggish denominator as well as a rising numerator." The numerator also rose in the early 1980s, because the Thatcher government "increased expenditure on such traditional Conservative priorities as defense, law and order, and agriculture" (ibid.).

As the British economy improved, however, the Conservatives' contractionary fiscal stance became more apparent. Nigel Lawson, who replaced Howe as the chancellor of the exchequer in 1983, began budgeting based on a "slower rate of growth for public spending than the sustainable growth rate of the economy as a whole, with the result that public expenditure would steadily decline as a share of GDP" (Lawson 1992, 305–6). Over the long run, the Conservatives were certainly successful in cutting government expenditures relative to GDP.

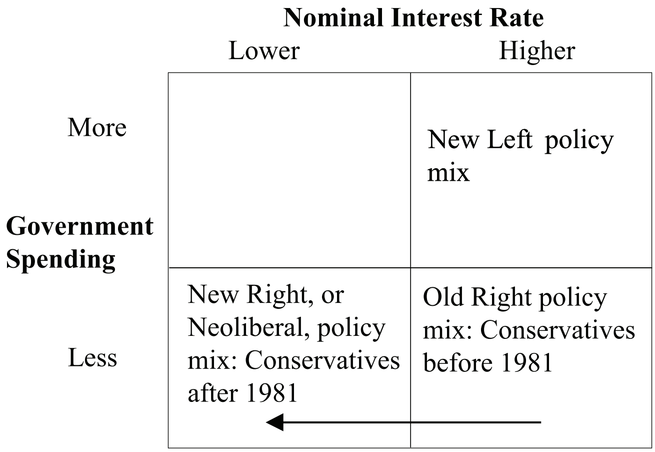

Fig. 21. The Conservatives' Neoliberal Policy Mix

Seldon and Collins (2000, 67) reported: "[total p]ublic spending fell from 44% of GDP in 1979 to just under 40% by 1990, a considerable achievement when it is remembered that expenditure rose significantly in many other European countries over this period."

While describing the Conservatives' fiscal policy stance as generally contractionary is not particularly controversial, many readers may be surprised at the relative looseness of British monetary policy beginning in 1981. Several detailed studies of British monetary policy during this period document how the Conservative government consistently overshot their stated monetary policy targets (see, e.g., Cobham 2002, chaps. 3–4; Temperton 1991), indicating a looser monetary policy measured in terms of money supply. Hall (1986, 118), for example, showed that sterling M3 growth, the Conservatives' preferred monetary supply indicator, consistently went above or to the high end of the target range from 1979 to 1985. Similarly, Talani (2000, 104) presented data from the Bank of England documenting the steady growth of sterling M3 stock during the entire first decade of Conservative Party governance.

In 1985, the Conservatives effectively ended money supply targeting (see Cobham 2002, 53). But even of the period when they did state money supply targets in the early 1980s, Minford (1993, 430) argued that "the implementation of [British] monetary policy has been through interest-rate changes rather than through monetary base control."[4] With regard to national interest rates, low rates were a very important part of Thatcher's privatization program to encourage private investment in formerly state-owned enterprises. Lawson (chancellor of the exchequer for 1983–89) later stated: "low interest rates had an unfailing appeal for Margaret [Thatcher]. Despite her reputation as a diehard opponent of inflation, and her dislike of it was undoubtedly genuine, she was almost always in practice anxious to reduce interest rates" (cited in Thompson 1996, 60).

Exchange Rate Stability outside the ERM

As long as the Conservatives held their neoliberal policy mix, membership in the exchange rate mechanism of the EMS would be a very feasible policy option for the United Kingdom. Thompson (1996, 48) argued: "the Prime Minister and Chancellor had accepted . . . that monetary and fiscal policy could be used for different purposes. In assigning the former to the exchange rate [i.e., a low nominal interest rate to minimize the national interest rate differential] and the latter to controlling domestic expansion [i.e., inflation control], they formulated policy in the way most compatible with ERM membership." Yet they remained outside the institution.

Many officials within the Thatcher government favored joining the ERM, including those at the Treasury (particularly Lawson) and the Bank of England. Thatcher's own views regarding European exchange rate regime membership have often been misunderstood. Thatcher had announced herself as an early supporter of the EMS concept. As the member states of the European Community (EC) drew up plans for the new fixed exchange rate regime in 1978, the then-governing Labor Party announced that Britain would not join the multilateral currency arrangement. The Conservatives in opposition criticized the unwillingness of the prime minister, James Callaghan, to join the EMS, with Thatcher lamenting, "This is a sad day for Europe." She complained that Labor was content to have "Britain classified among the poorer and least influential countries in the EC" (cited in Thompson 1996, 14; see also Gamble and Kelly 2002, 102).

Once in power, however, Thatcher changed her tune, voicing opposition to membership in the exchange rate mechanism of the EMS. But her opposition

4. This illustrates the important point (made in chap. 4) that the money supply is endogenous to the short-term interest rate. Thus, the best indicator of a state's chosen monetary policy orientation is a policy interest rate, rather than a measure of the money supply.

was due not to any lack of interest in exchange rate stability per se (indeed, just the opposite was true) but, rather, to concerns about participation in an exchange rate regime viewed as antidollar[5] and about the perceived loss of British national sovereignty to this and other such European institutions. As Oatley argued, though "Thatcher was in the minority [among Conservatives] opposing membership," she nonetheless "managed to force an outcome" that kept Britain out of the ERM until 1990 (Oatley 1997, 73). Thus, the Conservatives were "operating an economic policy similar in substance to ERM membership [less government spending for a lower nominal interest rate and interest rate differential] but at Thatcher's insistence outside the system and in tandem with a relatively isolationist EC policy" (Thompson 1996, 31).

Some scholars (see Talani 2000, 73) have expressed surprise at the "complete silence of the societal and economic actors" favoring British monetary convergence and exchange rate stability on the subject of ERM membership during the early 1980s. As Thompson documented, "[t]he City [financial services] wanted the security of reduced exchange rate volatility and a counter-inflationary discipline," as did the "[m]ultinational companies operating in Britain [international exporters]," but that "it could not be said that either sector saw [ERM] membership as imperative to their interests" (Thompson 1996, 56). Yet it is not hard to understand why this would be the case, since the Conservative governments, for the most part, held a policy mix consistent with the goal of exchange rate stability. Thus, lobbying their rightist partisan agents for this desired economic objective was simply unnecessary given that the Conservatives were already actively working for and, indeed, achieving external currency stability during this period.[6]

However, British interest rates and interest rate differentials did increase in 1984 and 1985, leading to greater exchange rate variability for the pound sterling (see fig. 22). Predictably, when the Conservatives did not effectively work for external monetary convergence and exchange rate stability, these internationally oriented societal principals began to lobby their partisan agents on behalf of ERM membership as a possible solution to increased external currency volatility. Thompson (1996, 40) documented the lobbying pressure as the sterling's variability grew in 1984–85: "in the City, firms and individuals were becoming increasingly interested in ERM entry. In August 1984, the Lloyd's Bank of Economic Bulletin argued that the fall in sterling in the previ-

5. During the 1980s, the United States was Britain's largest export market, just ahead of the German market.

6. On this point, see Bearce 2003, 397–98.

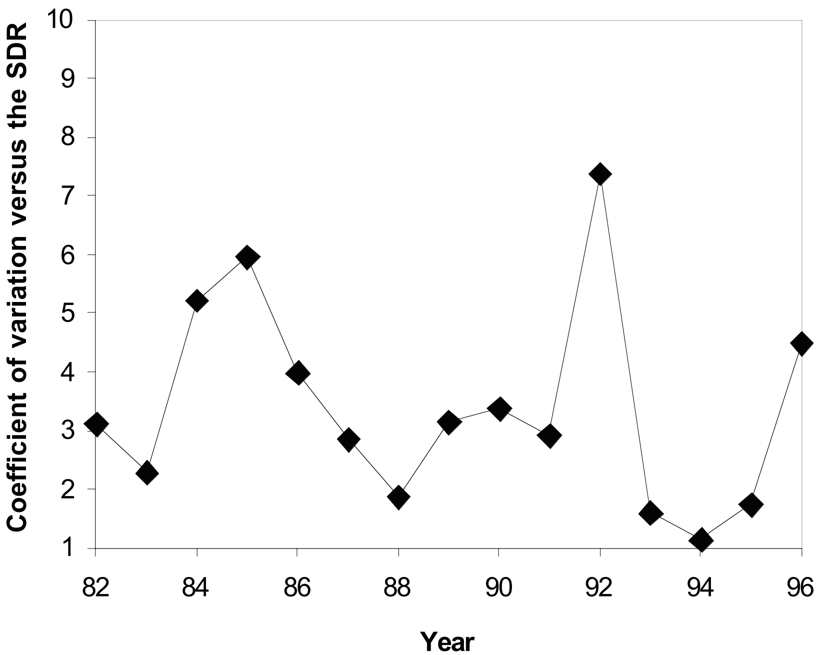

Fig. 22. British Exchange Rate Variability, 1982–96. (Exchange rate data from International Monetary Fund, *International Financial Statistics*.)

ous month could have been avoided inside the ERM. Three months later a group of City bankers and economists published a report highlighting the benefits of membership." Thompson continued: "During 1985 a succession of business groups, economic organizations and financial commentators came out in favor of ERM entry. . . . The sterling crisis had brought the issue of currency volatility to a head. Previously, firms valued exchange rate stability, but were confident that it could be better achieved outside rather than inside the ERM" (51).

To diffuse this lobbying pressure, the Conservatives began to shadow the German currency beginning in 1986, unofficially pegging the value of the pound sterling to the deutsche mark without announcing publicly any specific targets. This shadowing was understood as a "quasi form of membership" that "committed the government to exchange rate stability against the ERM anchor currency" and "used both monetary policy and reserve intervention to achieve that end" (Thompson 1996, 92). Within the British government, Lawson tended to view shadowing as a dry run for eventual ERM entry, while Thatcher viewed it as an alternative to entry. The 1987 Louvre Accord further reinforced Britain's shadowing policy, as the Thatcher government agreed to a de facto G-5 target zone, which included the deutsche mark. As Boix (1998, 197) correctly noted, this shadowing policy would not have been effective without "substantial cuts in interest rates," which were made possible by reduced public spending under Conservative Party governance.

Despite helping to stabilize the British currency from 1986 to 1988 (as shown in fig. 22), the shadowing policy engendered strong criticism from EMS governments that Britain was free riding on European monetary institutions. Such criticism manifested itself as external political pressure on the Conservative government to join the ERM formally. When the sterling's variability increased again in 1989 and 1990, the Conservative government also came under internal pressure from their internationally oriented societal principals with preferences for exchange rate stability.

This combination of external and internal political pressure effectively forced the Conservatives to work even harder on behalf of exchange rate stability. In 1990, Thatcher's government offered the hard ecu as an alternative to the French-led plan for the EMU. The Conservatives' hard European Currency Unit (ecu) strategy had proposed to fix the value of an ecu to each of the EC national currencies and to create a European monetary fund to issue hard ecus, which would then circulate parallel to the national currencies. But coming from the Thatcher government, which had elected to remain outside of (and even to free ride on) existing European monetary institutions, the hard ecu proposal received a very cold reception from other EC member states.

Thatcher then relented on her opposition to ERM membership. Talani (2000, 133) attributes this change to political pressure from the "factions of British capital, the productive [exporters] and the financial one [international investors]." Similarly, despite all the Conservative rhetoric about ERM membership as an anti-inflationary lock, Cobham's (2002, 74) survey of British monetary policy noted that Britain's entry into the institution was more likely due to the Conservative's interest in and societal pressure for an "increase in exchange rate stability." Thus, in October 1990, Britain finally joined the exchange rate mechanism of the EMS.

Unfortunately for the Conservatives and their societal principals, Thatcher chose to join the institution at a time when the British pound sterling was overvalued. The following month, in November 1990, John Major replaced Thatcher as the Conservative Party prime minister. Major and his chancellor of the exchequer, Norman Lamont, rigidly maintained Thatcher's tight fiscal policy, perhaps tightening more for inflation control than ERM membership actually required. Even facing a recession, Major and Lamont proposed budgetary cuts, leaving a looser monetary policy as the only possible economic growth option. However, as Germany raised interest rates in the wake of reunification and as the interest rate differential between the two countries expanded, the sterling faced considerable depreciation pressures. The Bank of England's active intervention into international currency markets delayed a crisis temporarily until September 1992, when circumstances forced Britain (and Italy) to exit the ERM.

Given the Conservatives' interest in exchange rate stability, their exit from the ERM represented a humiliating political defeat. Indeed, Gamble and Kelly (2002, 103) identify this episode as an effective death blow to the pro-European wing of the Conservative Party. The same authors also speculate that had the Conservatives not experienced such an embarrassing failure within the ERM, the Conservative leadership would likely have recommended British entry into the EMU. To this day, there remain EMU enthusiasts within the Conservative Party (see Pilkington 2001, 187–93). These include Kenneth Clarke, who narrowly lost a party leadership struggle to Iain Duncan Smith in 2001.

Indeed, in the early 1990s, the new Conservative prime minister John Major expressed his enthusiasm for the EMU convergence criteria (see Elgie and Thompson 1998, 75). Other than Britain's ERM nonmembership, the Conservatives managed to satisfy the neoliberal EMU convergence criteria without serious difficulty (see Pilkington 2001, 189). In fact, despite ERM nonmembership, Major's Conservative government achieved a remarkable record of exchange rate stability after 1992. Figure 22 reveals a very stable British currency especially from 1993 to 1995, before the Conservatives finally lost power in early 1997.

Given these facts, it is important to address whether or not Conservative governance in Britain fits the "fear of floating" phenomenon (see Calvo and Reinhart 2002). As discussed in chapter 2, this argument from economics describes why de jure floaters, such as Britain, might behave as de facto fixers: external factors make the costs of domestic policy autonomy simply unbearable. But the case analysis here shows why the Conservatives' move toward external policy convergence and exchange rate stability represented a deliberate policy choice. To the extent that the Conservatives were constrained in this policy choice, the operative constraints were less external and more internal, coming from internationally oriented groups within British society.

This understanding explains why British external policy convergence is not consistent with the larger argument of systematic monetary policy convergence. The Conservatives chose to move in this direction even as other OECD governments made different policy choices with international capital mobility. Thus, the British Conservatives fit nicely with the theme of monetary policy divergence in the post–Bretton Woods era.

Putting Labor Party Governance in Context

At this point, it becomes useful to shift gears and briefly consider the British Labor Party, which took power in 1997 under the leadership of Tony Blair. I have just argued that the British Conservatives—if not in words, then certainly in deeds—were a party choosing external policy convergence and exchange rate stability. What is the policy choice of the British Labor Party, and what are the preferences of its key societal supporters?

With regard to the latter, the British Labor Party continues to receive much of its political support from the traditional working classes. While some have argued that there has been a class-partisan dealignment in Britain, Denver (1998, 200, 211) provided strong evidence to the contrary, concerning voting patterns in both the 1992 and 1997 elections. Similarly, Fielding (1999, 120) presented data on Labor Party membership, concluding that "the new members were socially not very different from those who joined before Blair." If anything, Fielding added, the Labor Party's "new recruits were slightly more likely to be working class and male." With the decline of heavy industry and the import-competing manufacturing sector, the British Labor Party has also looked for political support from the growing service sector, which remains largely nontradable due to Britain's island economy. This means that even as the new Labor government finds its political base to be in services and not in import-competing manufacturing, the leftist Labor Party would still be expected to work for domestic policy autonomy.

But given Blair's apparent enthusiasm for the EMU, at least relative to other British political leaders, conventional wisdom has tended to treat the Labor Party as the British political party most interested in external policy convergence. I argue that this conventional wisdom is somewhat misguided, as Blair's support for the EMU stems not from any Labor Party preference for exchange rate stability over domestic policy autonomy but, rather, from Blair's intense personal desire to increase British influence on the European continent. One observer recently wrote: "Mr Blair, in contrast, has always seen the politics of the euro as a question of influence rather than sovereignty. His ambition is to 'lead' in Europe, and his supporters have always argued that such an ambition can never be fully realized if Britain continues to stand aside from the euro."[7]

7. See *Economist* 2003b.

Other observers have taken an even more skeptical view of the Labor Party's apparent support for the EMU on the Continent, treating Blair's vocal support for the EMU as merely a "political device to counter the [increasingly anti-EMU] direction taken by the Conservatives" (Pilkington 2001, 183). Indeed, British entry into the EMU is opposed by much of the rest of the Labor Party government, including officials at the Treasury and the Foreign Office and many Labor members of Parliament.[8] Despite such opposition, Blair has thus far successfully managed to downplay the EMU and other European policy divisions among Labor Party leaders. Pilkington (ibid., 192) wrote, "New Labour as led by Tony Blair, and with a whole host of spin doctors to manipulate opinion, has been a lot better at masking dissent within the party than the Conservatives and European issues do not figure very prominently in Labour's strategy."

Consistent with this latter point is the fact that the new Labor Party government, not the outgoing Conservatives, officially rejected British participation in the EMU (see Gamble and Kelly 2002, 104). While the Conservatives negotiated the opt-out for Britain at Maastricht in 1992, the Labor government effectively exercised the EMU opt-out in 1997. Furthermore, the new Labor government set up a series of the tests that the British economy would need to meet before any referendum on EMU membership could even be presented to British voters. In June 2003, after several years of speculation, Gordon Brown, the Labor Party's chancellor of the exchequer, finally announced that the British economy had failed four of the five tests. Thus, an EMU referendum (and British entry into the project) appears very unlikely to occur under Labor Party governance.

The reluctance of Gordon Brown and other Labor Party leaders to enter the EMU appears to stem, in large part, from the expected loss of fiscal policy autonomy following from the Stability and Growth Pact, which makes EMU governments running a budget deficit in excess of 3 percent of GDP potentially subject to fines of up to 0.5 percent of GDP. Deficits remain fairly low in Britain after years of spending cuts under Conservative governance, but Labor supporters in the domestically oriented sectors of the British economy have strong expectations for more public goods and services to be supplied by the state.[9] Thus, it is not surprising that the Labor Party has increased government spending by about 4 percent a year, with a particular focus on health, education, and transportation.[10]

8. See *Economist* 2003a.
9. On this point, see *Economist* 2002b.
10. See *Economist* 2001c.

The Labor Party's fiscal policy autonomy has been quietly accompanied by an increasingly autonomous monetary policy stance. Just after taking power in 1997, Blair granted greater independence to the Bank of England, which has helped to keep nominal interest rates low in the domestic economy and to minimize the extent of monetary counterbalancing necessary for fiscal expansion, consistent with the results presented in chapter 5. But under Labor Party governance, British monetary policy has been used almost exclusively for domestic price stability. Indeed, in his survey of British monetary policy through 2000, Cobham's statistical analysis (2002, 117) showed that British interest rates under the Blair government have varied only in response to domestic factors—mostly that of inflation. This finding contrasts sharply with monetary policy under Conservative governance, when the movement of British interest rates also reflected international factors as Thatcher and Major sought to reduce their interest rate differential with the United States and Germany (see ibid., 67, 105). In short, the international character of British monetary policy has effectively disappeared with the more autonomous policy choices made by Labor Party governments.

The two case studies discussed in this chapter illustrate a number of important theoretical arguments. First, they demonstrate how OECD governments have coordinated spending decisions with interest rate policy. In the case of the French Socialists, one can observe deliberate monetary counterbalancing in an effort to offset the inflationary pressures associated with greater government spending. For the British Conservatives, counterbalancing went in the opposite direction: less government spending facilitated a lower nominal interest rate and reduced the interest rate differential.

Second, these cases show how a government's policy mix affects national exchange rate stability. The New Left policy mix, with larger nominal interest rate differentials, made exchange rate stability difficult for the French Socialists to achieve, even with all the supposed advantages made possible by continued membership in the exchange rate mechanism of the EMS. Conversely, the neoliberal policy mix generally held by the British Conservatives facilitated exchange rate stability, even though Britain remained outside of this institution. These prominent examples help illustrate how a government's policy mix choice offers a better explanation for national exchange rate stability than does its (non)membership in regional monetary or exchange rate regimes.

Finally, these two cases illustrate partisan divergence in terms of fiscal and monetary policy instruments and, as a result, the policy outcome of exchange rate stability. International capital mobility in the post–Bretton Woods era may have reinforced partisan convergence in terms of other economic outcomes, such as growth and actual inflation. But partisan governments representing different societal interest groups can meet these macroeconomic outcomes using a different combination of fiscal and monetary policies, provided that they are properly coordinated. Such policy mix divergence engenders further partisan differences in terms of domestic monetary policy autonomy and exchange rate variability.