The Search for Autonomy: Governments, Central Banks, and the Formation of Monetary Preferences

Hubert Zimmermann
University of Düsseldorf

Abstract:

This article contributes to the literature on the fundamental preferences of governments and central banks in international monetary policy. Based on archival sources, the paper analyses the dynamics of the relations between the German government and its central bank, the Bundesbank, during the 1950s and 1960s. The core argument is that geopolitical factors, such as the imperatives of the transatlantic alliance or European integration, can be used strategically by governments to constrain the autonomy of nominally independent central banks. The argument is applicable across a large set of countries in which governments and independent central banks co-decide fundamental monetary preferences.

German Policy Studies
Volume 4, Nr. 3, 2008, pp. 31-58

a) State Preferences in International Monetary Diplomacy[1]

Introduced only in 1948, the German mark (DM) quickly acquired a reputation of stability and trustworthiness in international currency markets. Due to the strength of its currency, the Federal Republic of Germany (FRG) became a major player in international monetary policy from the mid-1950s onward. Its support was an essential factor in the preservation of the postwar international monetary order (the Bretton Woods system) which was characterized by fixed (but adjustable) exchange rates, the anchor role of the dollar, the dollar-gold exchange guarantee of the U.S., and the institutionalized transatlantic management of international monetary relations (Andrews 2003; Andrews, ed., 2008; Helleiner 1994). In the late 1960s, the system came under increasing strain and the U.S. called upon the major economic powers to support it by political and economic means. Shattered by a quick succession of speculative crises targeted at the DM-dollar exchange rate, German policy-makers saw themselves confronted with the increasing political constraints and economic costs of supporting the monetary system. With time, these costs seriously undermined their allegiance to the established framework of international monetary cooperation. As a result, alternative conceptions of monetary order emerged in Germany.

The period of 1965-78 was characterized by uncertainty and conflicts about these alternatives which presented three different fundamental policy options to German monetary decision makers (Zimmermann 2001). The first option was the retention of (or return to) the transatlantic management of monetary relations. This required the close alignment of German monetary policy to trends in the dollar exchange rate in order to avoid excessive imbalances, the resulting, preferably

[1] The author thanks Wesley Widmaier and the anonymous reviewer of GPS for very insightful comments.

institutionalized, cooperation with American (and British) monetary authorities, and the acceptance of the leading role of the dollar. The second was the option of “benign neglect” to external imbalances, which entailed flexible or floating exchange rates for the DM, liberated capital markets, and the orientation of monetary policy on purely domestic objectives. At the core of this option lay the idea of national autonomy, that is, the conduct of monetary policy with disregard to external considerations. The last option was a regionally managed monetary order in which monetary relations to the most important neighbors and trading partners were closely coordinated among the participating governments whereas the regional monetary zone as a whole appreciated (or depreciated) against the dollar. For German monetary policy, this option was in essence the idea of European monetary integration. Transatlantic cooperation, national autonomy, and European integration: those were the three conceptions of international monetary order which from about 1965 onward became the subject of intense debate in Germany. At the end of the 1970s, the FRG settled for option three, monetary integration in a European framework. Though this basic orientation was still contested and the creation of a working European monetary order was beset by numerous international and domestic conflicts, the result of which was by no means preordained, the European option prevailed at the end. The conceptual base of Germany’s international monetary policy was transformed.

Based on newly available classified material from German archives, this paper develops a framework for identifying the conditions leading to such fundamental policy changes in states and their reaction to external shocks (or monetary unions) in which monetary policy is co-decided by governments and a (more or less) independent central bank. It starts from the premise that the domestic constellation of monetary decision-making is a core factor explaining fundamental monetary orientations[2] of states (as opposed to explanations positing the explanation only on the level of the international monetary system). In addition, it specifies the circumstances under which the preferences of the government are more likely to prevail over those of an independent central bank.

Fundamental changes in the orientations of states regarding their international monetary policies are rare. Usually, they are credited to external shocks, such as wars, major balance of payments crises, or strong pressure by dominant monetary powers. However, the extent and final result of such a reorientation is shaped by the interrelation of domestic and international factors. The international monetary policies of state actors cannot be understood in isolation from internal institutional dynamics, in particular the reaction of the major actors which formulate a country’s external monetary policy, that is, the government and, in most industrialized countries, the central bank. Other domestic actors, of course, also exert influence, above all trade-dependent industries. This was the argument of Jeffry Frieden in a series of important articles (e.g. 1991, 2002). However, the institutional conditions for getting these societal interests represented remained underspecified in this argument (see also Kinderman 2008). Generally, the influence of societal groups in fundamental monetary questions is felt indirectly via the government which has the choice to represent or neglect these often conflicting preferences.[3] The dynamics of relations between the central bank and political authorities are therefore major determinants for the outcome of choices by states in monetary policy. It is in particular the attempt of governments and central banks to maximize autonomy in the pursuit of their respective preferences which conditions the responses of states to

[2] Such as the choice between flexible and fixed exchange rates, monetary integration, large-scale interventions or massive adjustment.

[3] Other actors which occasionally play a role are private banks, parliaments, epistemic communities, etc. See Torres 2004.

external monetary developments.[4] Based on this argument, this article claims broader relevance for situations in which governments and central banks are confronted with international monetary problems, in particular for the future monetary diplomacy of the Eurozone in which the institutional set-up closely follows the German example. However, the relevance of this argument does not stop here. 25 years ago, most central banks were dependent agents of governments. Now, most central banks enjoy a high degree of independence, usually combined with an over-riding mandate to pursue anti-inflationary policies (Bernhard 2002; Cukierman 2005). In this sense, the German case is instructive to illuminate the consequences of this relatively recent institutional constellation.

For the monetary choices of the FRG during the period of system transformation since the early 1960s, the complex relationship of the German government to its central bank, the Bundesbank, is essential. A voluminous literature identifies a latent tension in the relationship between governments and central banks. Whereas governments, due to electoral concerns, accord primary importance to the establishment of economic conditions which are conducive to growth and full employment, central banks usually are concerned mainly with the stability of the currency (Caesar 1995). Thus, there is frequent conflict between governments which prefer expansionary economic policies to a more restrictive stance of the central bank. External constraints on the autonomy of governments and central banks are further factors leading to conflicts since they often have an asymmetrical impact on the actors. The

[4] National autonomy is one factor in Mundells unholy trinity (the other two are capital mobility and formally or informally fixed exchange rates). As he postulated famously, only two of these conditions can exist simultaneously. However, the “national” in this formulation has to be disgreggated if we want to understand the choices of states. An increase in national autonomy might benefit the preferences of one national actor, but constrain those of others.

preferences of both actors in the field of monetary diplomacy coincided for most of the time during the history of the FRG; however, during the monetary crises of the late 1960s and the early 1970s, conflicts emerged. At their core was the struggle for the power to define the fundamental direction of Germany's monetary policy.

German postwar monetary policy was frequently shaped by these tensions. The outcome of conflicts between governments and central banks is usually decided by the extent of the central bank's autonomy in pursuing its objectives. Autonomy is defined here not only in the sense of institutional autonomy. This institutional autonomy or central bank independence is the subject of a well-established literature which has shown that the existence of an independent central bank is conducive to a stable currency.[5] It explains why most central banks are isolated to a certain extent from societal pressures. However, central banks are never completely autonomous. Governments have reserved themselves important leverage on monetary policy to ensure that their primary objective of re-election (or staying in power) is not jeopardized. This can be best achieved if a state's foreign and domestic monetary policy is geared towards solid economic growth, thus guaranteeing high employment and social stability. One core element in this respect is support for domestic industries which have to be shielded from the potentially disastrous impact of monetary disturbances.

As defined by its institutional and legal framework, the Bundesbank was nominally independent in the pursuit of its primary objective: safeguarding the value of the currency. However, the government retained important resources, such as the power of appointment, the authority to determine the external value of the currency, and the possibility to exert public pressure on

[5] Alesina/Summers (1991); Winkler, in: Torres/Verdun/Zimmermann (2004). For additional literature, see Caesar 1995: 124.

the Bundesbank (Lohmann 1998). Yet despite a corresponding body of laws as well as formal and informal rules, the conditions under which governments can decisively constrain the autonomy of institutionally independent central banks are hard to define very precisely (Bini-Smaghi 2008). In effect this depends much on what can be called *real autonomy* (in the sense of the political clout of actors to realize their preferences and to overcome possible opposition from other actors). Soft factors such as reputation and political context count a lot.

I argue that geopolitical[6] arguments often give governments decisive leverage in conflicts with the central bank over monetary decisions. If the monetary order contains a geopolitical element which has a high degree of public salience and support, governments can use this to constrain the autonomy of nominally independent central banks. This usage might be instrumental or sincere. The German government was motivated in its foreign policy during the postwar period by two major geopolitical objectives: preserving the transatlantic alliance and maintaining and furthering European integration. It will be shown that these two fundamental objectives exerted a strong influence on monetary policy and where instrumental in constraining the autonomy of the Bundesbank.
Taking on board geopolitical motives, we can thus discern three basic sets of preferences in Germany's (and other states') international monetary diplomacy: domestic economic growth and social stability, the preservation of the currency's internal and external value, and geopolitical objectives. These sets of preferences can be ranked among the main two actors in monetary diplomacy. The first preference of governments with regard to monetary and exchange rate policy is the pursuit of economic growth and social stability, with geopolitical objectives (excluding matters

[6] Geopolitical refers to general foreign policy concerns of states.

of life and death, such as wars, etc) ranked second. In addition, the German government also shared the anti-inflationary stance of the Bundesbank. Of course, the government tries to pursue all these goals simultaneously and in a mutually supporting way. However, if forced to choose between these preferences it would rank economic growth and stability first, geopolitical goals second, and anti-inflationary policies third.

The Bundesbank and other central banks share all these preferences. However, their ranking is different. First comes price stability as mandated by the Bundesbank law and most central bank statutes.[7] This preference is not only legally mandated but also a rational course of action since giving priority to price stability preserves the central banks' legitimacy and influence (Caesar 1995: 123). Yet, over the long run, without sustained growth and social stability, price stability is doomed to be undermined. Therefore, this is the second preference of the central bank. And finally, central banks usually agree with the general geopolitical orientation of the state and try to fit their monetary policies into this framework. However, this preference ranks third (again excluding extremely serious situations). The preferences of the government and the central bank in international monetary diplomacy thus can be ordered as follows:[8]

[7] According to the Bundesbank law of 1957, §3, the central bank's primary function was "regulating the amount of money in circulation and of credit supplied to the economy, using the monetary powers conferred on it by this Act, with the aim of safeguarding the currency."

[8] This typology also may be of help to explain the preferences of states in monetary diplomacy independent of their actual behavior (which might not reveal their true intentions). On this problem, see Andrews 2004.

	Government	*Central bank*
1st preference	Socio-economic stability and growth	Anti-inflationary policies
2nd preference	Geopolitical objectives	Socio-economic stability and growth
3rd preference	Anti-inflationary policies	Geopolitical objectives

In general, both actors try to pursue all those preferences simultaneously, and “ideal” monetary orders allow them to do so. If this is not possible, actors can be expected to pursue their first preference at the expense of their second and/or third order preferences. In this case, a clash between the government and the central bank is often the case. This contest is usually decided by their real autonomy. I argue that governments can increase their leverage and real autonomy often decisively if they are able to employ credibly geopolitical arguments in addition to their usual economic growth and social stability argument. It is therefore in the interest of governments that monetary orders give them political clout to argue against their central banks and enlarge their room for maneuver. Germany´s monetary diplomacy in the second half of the 20th century is a good example for that. If the argument presented here is correct, it has obvious implication for future governance in the Eurozone. As the international role of the Euro increases, geopolitical effects will become more policy-relevant and might provide Eurozone governments with powerful arguments in debates with the ECB about the future direction of the monetary policy in Europe.

b) The Bretton Woods System(s) and German Monetary Autonomy

During the 1950s and 1960s, the international monetary order of embedded liberalism in effect allowed German monetary actors to reconcile all the preferences cited above. As epitomized by G. John Ruggie (1982), the system of embedded liberalism allowed the state-managed control of capital movements which gave governments the freedom to pursue their domestic objectives. During the 1950s, Germany experienced an economic miracle, strongly pushed by export-led growth and accompanied by the creation of a modern welfare state. A core part of this embedded autonomy was that it also served the geopolitical aims of the participants. For the FRG, this entailed in particular the integration into the transatlantic security structure (Zimmermann 2002). Not only did the transatlantic system offer military protection, but it also spared Europeans exorbitant and potentially inflationary military expenditures and allowed them to concentrate on economic growth and social stability. The external value of the DM was anchored to the dollar, the world's most reputed currency and the currency of Germany's major security provider. Thus, monetary policy became an integral part of Germany's foreign policy.

The interests of the new German central bank were satisfied, too. Despite the economic boom, the Bundesbank, facing no external constraint, was able to pursue its anti-inflationary policy. Its real autonomy had been tested during conflicts with the Adenauer government on the issue of interest rate policies. The bank´s anti-cyclical interest policy had angered Adenauer especially in election years. However, the Bundesbank won the conflicts easily (Wagschal 2000: 145). This outcome showed that the institutional independence of the Bundesbank was strong enough to allow it to pursue its preferences even against a very popular and strong government. The absence of geopolitical factors which might have given the government more leverage was crucial. These emerged, however, during the 1960s.

The dollar-gold link turned out to be the Achilles heel of the transatlantic system. When American balance of payments deficits and the decline of U.S. gold reserves from 1958 onward signaled the dollar's weakness, huge amounts of capital moved into the DM in the expectation of incipient revaluation. This threatened to inflate the domestic money supply and put upward pressure on the external value of the mark. The former made the achievement of the Bundesbank's primary objective of price stability more difficult, whereas a revaluation of the DM would have damaged the government's pursuit of export-led growth. The dilemma for the Bundesbank was summed up in a memorandum by a member of the Bundesbank directorate, Otmar Emminger, who later became Bundesbank president: "..every new foreign exchange surplus [makes] the economy more liquid and [removes] it increasingly from the sphere of influence of the central bank. To consent to such a development signifies implicitly the progressive renunciation by the central bank of its power over the currency."[9] He advocated a revaluation of the DM. The Adenauer government, however, was opposed to revaluation. The majority of the Bank's board was unwilling to confront the government on this question and opted for a lowering of interest rates to stop the foreign exchange inflow. However, this fed an already accelerating economic boom to the extent that the Bank progressively lost control over the money supply (Kennedy 1991: 39). The Bundesbank switched its position in order to preserve its first preference and began to advocate revaluation. At the same time, the Americans also were suggesting a DM revaluation and other supportive measures. Confronted with this choice between sticking adamantly to an under-valued DM, at the risk of damaging its relations with the US and the UK and being exposed to further capital inflows, the government relented. In March 1961, the DM was revalued; however, the step came rather late because of

[9] Bundesbank Archive (BBA), Emminger Papers 2/244, Memorandum: Betrachtungen zur Währungspolitik, 20 Jan 1960 (own translation).

divisions in the government. In addition, the rate change was modest, so that the speculation came to a halt only after a prolonged period of instability (for this episode, see: Emminger 1986: 98-134).

The episode is very instructive as it shows how the government and the Bundesbank, faced by external constraints on their autonomy, tried to satisfy their first preferences, and finally produced a suboptimal compromise. It also illustrates the basic dilemma faced by Germany in the ensuing decade: the attempt to stabilize the external value of the DM undermined the Bundesbank´s anti-inflationary policy. The 1961 revaluation was a first indication that the FRG´s integration in the transatlantic system required compromises which made an ideal combination of all preferences increasingly hard to achieve. The government had to accept some limitations on its first preference. It was also about to experience painful dilemmas in its geopolitical goals. The growing support of the dollar-gold system required very close cooperation with the U.S. (Gavin 2004). This embarrassed France which favored more European independence, and generally hampered closer European integration in many fields. Soon, the government had to choose in its monetary policy between France and the U.S.

The Bundesbank, too, began to lose autonomy. As a result of the dollar and pound problem, central bank cooperation greatly expanded in the following years. In the 1960s, the Bundesbank became a core player in the multilateral management of the system. By participating in this endeavor, the Bundesbank committed itself to active efforts to stabilize the DM exchange rate. In the course of the 1960s, this became increasingly difficult, forcing the Bundesbank to costly interventions and the neutralization of enormous capital inflows. Multilateral cooperation became an external constraint.

The first indications of reduced autonomy, however, did not yet lead to a fundamental questioning of the transatlantic order. To the contrary, the FRG intensified its efforts to preserve the system. In the so-called offset negotiations from 1961 onward, the German government agreed to support the dollar to an unprecedented degree, by buying weapons and treasury bonds from the U.S. The Bundesbank cooperated as long as it did not have to compromise its own freedom of action. However, conflicts about the distribution of the resulting costs soon emerged. In 1965/66, the offset system came under heavy strains. Chancellor Ludwig Erhard had promised the U.S. the fulfillment of all obligations deriving from the offset agreement. However, he needed the help of the Bundesbank. Relations between the bank and the Erhard government were already strained, because the central bank had put on the monetary brakes in 1965/66 to control a boom which was partly sparked by high government expenditure. The following recession unsettled the government's budget. Erhard was already too weak politically to force the Bundesbank to a change its policy and bail out the government, although he strongly used the geopolitical argument of preserving the transatlantic alliance – a credible argument, given U.S. threats to reconsider their security guarantee (Zimmermann 2002). Due to its economic troubles and the disintegration of its political authority, the Erhard government collapsed and bequested the offset problem to its successor.

As a strong coalition of the two major parties, the government of chancellor Kurt-Georg Kiesinger was able to instrumentalize the geopolitical argument to get the Bundesbank to help. This help took the form of the so-called Blessing letter, a pledge by the then Bundesbank president to refrain from converting dollars to gold. This constituted a sizeable loss of autonomy since it forced the bank to stick to the dollars in its reserves at a potentially high risk. Not surprisingly, Blessing later regretted the letter and admitted that he had signed it only because the government argued that otherwise the alliance with the U.S. would be in complete disarray. He called the letter a “damn thing” and said that instead of signing it he should have converted dollars simply into gold until the transatlantic order came down (Brawand 1971: 62). The Blessing letter in effect condemned the Bundesbank to neutralize the dollars streaming into the DM by various means without being able to exchange them for gold directly. The restrictive policies required by this situation often conflicted with the perceived necessities of macro-economic policies in the German domestic economy.

At the same time, the government began to have strong doubts regarding the wisdom of the transatlantic order. The American policy of brinkmanship in the monetary and offset question had led to a lot of resentment. In the wake of the Vietnam War, the U.S. was less tolerant in supporting the fundamental goals of German foreign policy and this reduced Germany´s readiness to support the dollar. In a letter to Chancellor Kiesinger, Economics Minister Karl Schiller even recommended that the German government followed de Gaulle’s example in undermining the dollar-gold link.[10] This would have toppled the transatlantic system immediately. However, it was still regarded by West German politicians as the most legitimate framework for Germany´s international monetary policy. As long as the monetary crisis did not interfere with economic growth and German exports, the geopolitical imperative of preserving the transatlantic alliance was paramount for the government. The central bankers for their part were still cooperating in a global network of experts which they hoped would allow them to control foreign exchange crises and to continue pursuing their domestic objectives (Andrews 2008). The allegiance to this network was strong (Coombs 1976). Thus, while it became increasingly difficult to reconcile the different interests of the actors, most observers were optimistic that in the end the reform of the system would succeed.

[10] PA-AA, IIIA1, vol. 180, Schiller to Kiesinger, 12 Jan 1967.

This confidence eroded rapidly in 1968/69. The contemptuous Bonn monetary conference of November 1968 which reunited the ten leading Western economic powers was a clear sign for that. The conference had been preceded by speculation against the French franc, the British pound, and, indirectly, the dollar. London, Paris, and Washington exerted concerted pressure on the Germans to revalue the DM. The German government, however, refused to participate in a multilateral re-alignment of parities. For the first time, it pursued a policy of strict national autonomy, based on the conviction that the DM´s strength proved them right and on the perceived necessity for sustained growth and exports (Emminger 1986: 143-4). In effect, it pushed the first preference without regard to its geopolitical consequences. The Bundesbank, however, had negotiated prior to the conference a concerted realignment of parities. It tried to argue this solution with the government, to no avail. Blessing when he was asked later how the government had reacted to that summarized its answer: Well, now that guy shoots us in the back (Brawand 1971: 51). The government stuck to its stance and the multilateral negotiations broke down amidst bitter recriminations.

The international echo to the conference, however, showed that the government’s strategy of sticking exclusively to its domestic preferences damaged its overall foreign policy. Pointedly, the Foreign Ministry, supported by the press, warned of diplomatic isolation.[11] The Bonn conference clearly exposed the problem that the pursuit of a monetary diplomacy oriented on purely domestic objectives undermined the government’s geopolitical goals. The conference thus demonstrated the increasing costs of the transatlantic system. In addition, it also revealed a dilemma with regard to Germany’s European policy. In January 1969, the Federal chancellery analyzed it in these terms:

[11] PA-AA, IA2, vol. 1553, Memorandum of Dept. III: Bonn monetary conference, 25 Nov. 1968.

"Germany is confronted with two options - according to its stability policy a priority over European politics (i.e. the preservation and further development of the Community). A consequential stability policy which is shielded from external influences will inevitably set in motion tendencies for a dissolution of the EEC; - or rather according to its European policy a certain priority over stability policy and accept higher inflation than hitherto, be it through a renunciation of certain external economic preferences or within a common growth and economic policy."[12] The same view was expressed in the foreign ministry.[13] This analysis suggested the coming conflict between government and central bank since it meant that the government would have to constrain the Bundesbank's pursuit of anti-inflationary policies and limit the autonomy it had under the transatlantic system by adding the constraints of European cooperation.

In 1969, this conflict gradually moved to the forefront of internal debates. New speculation put the DM repeatedly under increasing pressure, setting in motion a prolonged public argument about the parity of the mark. The Bundesbank saw no other option to neutralize the excess liquidity than revaluation. However, the government refused – mainly out of concern for the interests of the export industry (Zimmermann 2008). As a result, Franco-German relations dipped to a postwar low, since the franc was again in the center of speculation. Infuriated by their costly yet inefficient efforts to stem the speculative flows and by the havoc created by the monetary crisis in the EC's common agricultural policy (CAP), the French repeatedly protested at the highest level against the nationalist monetary policy of the Germans (AAPD 1969, I: Doc. 147). Once again, monetary policy exposed the

[12] Federal Archives (BA) Koblenz, B 136/3332, Dept.III/1 (Meyer) to Chancellor Kiesinger, 8 Jan. 1969.
[13] PA-AA, I A 2, 1553, Memorandum by State Secretary Lahr, 7 Jan 1969.

incompatibility of the different policy preferences of the government at that time. Finally, in October 1969, after elections and a change of government, the FRG revalued the DM. The consequence the Bundesbank drew from these events was almost inevitable: more and more members of its governing board advocated flexible exchange rates. Removing the intervention obligations would enable the Bundesbank to pursue price stability with much less concern about external constraints. However, it was clear that this would be resisted by the government since the power to set exchange rates was one of its major instruments in constraining the autonomy of the Bundesbank and influencing the direction of monetary trends (Kaltenthaler 2003). This instrument had not been a particular bone of contention between the government and the Bundesbank as long as their preferences coincided. However, once this situation changed, a neutralization of this instrument would greatly enhance Bundebank autonomy, as the bankers realized much earlier than the government.

c) European Monetary Integration and National Autonomy

The Hague summit of the European Community in December 1969 produced a ringing reaffirmation of European integration. Among its most surprising elements was the proposal for a European Economic and Monetary Union (EMU). It had been introduced by the German Chancellor Willy Brandt, reflecting the growing dissatisfaction of the German government with the working of the transatlantic system. The French had enthusiastically embraced the idea since it offered them the possibility of institutionalized cooperation with the Germans in the case of troubles for the franc. However, it was this aspect - adding a new strong commitment to their obligations to intervene under the Basel system - which led the Germans to proceed very cautiously in the ensuing negotiations, held under the chairmanship of Luxembourg’s prime minister Pierre Werner.

The German government demanded, in particular, the Europeanization of economic policy and the construction of European monetary institutions. J.B. Schoellhorn, state secretary in the Federal ministry of Economics and German negotiator in the Werner committee, noted that any eventual EMU needed a “rule that external commitments which entail a reduction of the member states´ autonomy in economic policy should be taken only if the necessary harmonization or integration of economic policies is ensured”.[14] Preferably, this should be supervised by a completely independent European central bank, modeled on the Bundesbank. On this point, the German government and the Bundesbank agreed. Since Chancellor Willy Brandt accorded only a relatively low priority to the monetary union project, the Bundesbank and like-minded officials in the Economics ministry successfully captured the German position. France, however, was against any independent monetary institute and advocated automatic intervention by all central banks in the case of monetary imbalances (AAPD 1970, III, doc. 603). The debates in the Werner Committee soon resulted in a stalemate between these two positions and the ambitious Werner plan for an EMU by 1980 was buried in the turmoil of the early 1970s. What the Germans did agree to was the intra-European attempt to narrow the bands of European currencies fluctuating against the dollar. This so-called Snake arrangement preserved the freedom of the Bundesbank from external constraints since it contained no automatic intervention requirement. It also offered the prospect of a certain detachment from the dollar, and a departure from the principles of the Blessing letter (Heisenberg 1999: 30). The European central bankers, however, had hardly reached the agreement on the Snake when new currency crises erupted and intra-European parities descended into unprecedented chaos.

[14] PA-AA, IIIA1, vol. 590, Memorandum by Schöllhorn: EMU, 23 Apr 1970.

During the monetary crisis of May 1971, the FRG was confronted with an enormous influx of foreign currency, forcing it to close the foreign exchange markets. The Bundesbank had tried in vain to counter the dollar glut with its traditional instruments. In its Monthly Report of May 1971 it noted that the "reduction in the discount rate on March 31, 1971 was motivated solely by external considerations; it was no longer in conformity with domestic conditions" (p.7). Continued defense of the dollar made the simultaneous pursuit of the two most important preferences impossible. The bank's governing council was split over whether the FRG should give up its interventions altogether and float the DM, or try to hold on to the Bretton Woods system with capital controls and a temporary float (Grey 2007: 308-10). Vicepresident Emminger and others advocated a permanent float since it would return to the central bank the possibility to concentrate on domestic stability and on the fight against inflation (Heisenberg 1999: 31). However, the government (and Bundesbank president Karl Klasen) warned against such a course, for political reasons. The AA summed up the arguments and noted that flexible exchange rates would in fact return to the Bundesbank autonomy over its domestic economic policy. However, it would severely damage the EEC, mainly as regards the planned EMU and the CAP. "A unilateral German monetary action without prior consultation would throw the EC into a crisis and give rise to doubts about Germany's adherence to the treaties". [15] In the end, the government tried to square the circle by temporarily floating the DM and attempting to get the other Europeans on board for a joint float against the dollar. However, France and Italy refused to do so out of fear that their economies would loose competitiveness vis-a-vis the U.S. (Emminger 1986: 181). Thus, Germany went ahead, effectively putting an end to any prospect

[15] PA-AA, IIIA1, vol. 585, Memorandum by von Bismarck-Osten, 6 May 1971.

of achieving EMU in a foreseeable period. After the German decision to float, the French were furious and suspected the Germans of intentionally torpedoing the CAP as well as slavishly following Washington.[16] The dilemma for the German government persisted.

In August 1971, President Nixon, without consulting Germany, decided to close the gold window and imposed a 10% surtax on all imports to the U.S. The Europeans were confronted with the unpleasant choice to either revalue and damage their export industries, or to pursue a restrictive domestic economic policy to neutralize the dollar glut. This clearly posed a threat to the government's first preference, economic growth. The floating dollar created, in addition, wild fluctuations among European currencies, causing incessant conflict among the Europeans and damaging the fabric of European integration (AAPD 1971, II: Doc. 282). Furthermore, the Americans had unilaterally canceled with their action the transatlantic bargain in the monetary sphere (Cohen 1974). The geopolitical motive in U.S.-German monetary relations all but disappeared. This paved the way for the final breakthrough of the European option. For the German government, the Bretton Woods compromise of embedded liberalism had seen its day. In July 1972, Finance Minister Helmut Schmidt informed Secretary of Treasury George Schultz that the FRG would not sacrifice any more its essential interests for the sake of the dollar exchange rate (AAPD 1972, II, Doc. 205). A unilateral monetary policy or the European solution were the options left.

The progressive liberalisation of exchange rates as a result of these divisions and its untarnished reputation gave the Bundesbank a degree of autonomy in regulating the domestic money supply that it had not posessed since the early 1960s. Speculative currency movements were taken care of by fluctuating rates. The

[16] PA-AA, IIIA1, vol. 585, Ambassador Ruete, Paris, to AA, 13 May 1971.

government lost its exchange rate instrument. Reflecting on this development, Emminger, now president, commented gleefully: “Reclaiming the control over our own money supply was – and is – the primary function of a flexible exchange rate policy” (Emminger 1976: 533). Therefore, the central bank was very alert to any attempts by the government to replace the constraints of Bretton Woods with new commitments, particularly in the field of European integration. When Chancellor Schmidt and the French president, Valery Giscard d`Estaing moved towards closer European integration, they met with stiff resistance by the Bundesbank, in particular to any measure that would have amounted to an institutionalisation of geopolitical constraints (Kennedy 1991: 80). Schmidt’s initiative was motivated by his frustration with American monetary policy, the wish to further European integration and by concerns about German exports which depended mainly on the markets of its EC partners. Schmidt also made no secret of his preference for higher inflation instead of revaluation (Emminger 1986: 231). A regionally fixed currency system would have reclaimed for the government the exchange rate instrument, underpinned by the weighty legitimising factor of European integration. In response to Schmidt’s initiatives, Emminger declared that the Bundesbank would only agree to those measures that safeguarded its autonomy (Heisenberg 1999: 63). Repeatedly, Bundesbank reports painted the danger of the European Community degenerating into a “community of inflation” (Deutsche Bundesbank, Annual Report 1975: 53). This stance reflected the experience of the 1960s which had brought an increasing use of the geopolitical argument against the Bundesbank. The Bundesbank fought against new attempts at demand management co-ordinated at the G7 summit in 1978, fearing the come-back of Bretton Woods through the backdoor (Loedel 1999: 58). Thus, in the late 1970s, relations between the government and the Bundesbank were at their worst (Heisenberg 1999:

49). As Loedel (1999: 13) put it: “The crux of the disagreement between the Bundesbank and the government lies within the debate over whether some monetary autonomy should be sacrificed for political objectives like EU, to say nothing of exchange rate stability.”

The tug-of-war between Chancellor Schmidt and the Bundesbank on European monetary integration resulted in a compromise which took the form of the European Monetary System (EMS). The members of the EMS agreed to maintain their exchange rates within narrow bands and to intervene if their currencies were about to leave these bands. The system was meant to be symmetrical and, in effect, the Bundesbank went to some length in support of EMS currencies under assault. It did so, however, only if its two first rank priorities were fulfilled. Usually, therefore, the other EMS members were forced to adjust. This situation came to a head during the EMS crisis of 1992/3 when the Bundesbank dealt with the impact of German reunification without regard to the external balance and set in motion a series of devaluations in the EMS. This episode was the heyday of Bundesbank power and it seemed that it had successfully dealt with the threat of Europeanization. However, in the same year, at the Maastricht conference, chancellor Kohl was able to use this geopolitical agument again. This time, its use would result in the end of the Bundesbank as an autonomous actor in international monetary diplomacy.

d) Conclusion

This article attempts to explain basic choices of states in their international monetary policy. It identified three scenarios of monetary order which states can choose: a global system centred on a core currency; a regional currency area, and a system of fluctuating exchange rates. Only in the latter, the domestic monetary policy of central banks is relatively autonomous. This autonomy often tends to constrain the first preference of governments, economic growth. In the case of such conflicts, geopolitical arguments often decisively strengthen the hand of governments. Their impact in the three versions of monetary orders identified at the onset of this article can be summarised as follows. In the system of embedded liberalism, geopolitics played a significant role due to the institutionalised transatlantic management of capital movements. In the system of flexible exchange rates, geopolitical arguments were quite insignificant and hardly useful for the government if it wanted to reign in on the autonomy of the central bank. In a system of regionally fixed exchange rates, such as the EMS and later EMU, the geopolitics of sustaining the regional monetary zone is again a powerful potential constraint on the central bank. The result is consistent with Loedel's empirically generated observation that the government has "less political leverage over the Bundesbank in the international monetary arena than in the European monetary arena" (1999: 26-7).

These results suggest a number of lessons, in particular for the international policy of the Eurozone which is closely modelled on the Bundesbank. It also provides a counter-balance to public-choice models influenced by neo-classical economics which expect a global convergence in the institutional setting of government-central bank relations towards unchecked central bank independence. Governments will continue to establish geopolitical frameworks for international monetary diplomacy and central banks will try to prevent that – often without success. The ECB, for example, due to the fact that EMU is not underpinned by a political union, will have to continue dealing with the geopolitical argument.

References

Archival Material:
Bundesarchiv, Chancellor's Office files (BA)
Bundesbankarchiv, Nachlass Emminger (BBA)
Political Archive of Auswärtiges Amt (PA-AA), Files of Economic Departments

Literature:

AAPD (various years), Akten zur Auswärtigen Politik der Bundesrepublik Deutschland, München.
Alberto Alesina/Lawrence Summers (1993), Central Bank Independence and Macroeconomic Performance. Some Comparative Evidence, Journal of Money, Credit, and Banking, vol. 25, pp. 151-62.
Andrews David (2003), The Basel system of international monetary relations, 1960-1968, Prepared for delivery at the 2003 Annual Meeting of the American Political Science Association, August 28 - 31, 2003.
Andrews David M. (2004), Cooperation, Coercion, and Asymmetric Adaption, Paper prepared for the 2nd Pan-European Conference on EU Politics, 24.-26. June, Bologna, Italy.
Andreas David M. (2008), Kennedy's Gold Pledge and the Return of Central Bank Collaboration: The Origins of the Kennedy System, 1959-1962, in: ders., ed., Orderly Change: International Monetary Relations Since Bretton Woods, Ithaca, NY: Cornell University Press, 2008.
Andrews, David M. (ed.), 2008, Orderly Change: International Monetary Relations since Bretton Woods, Ithaca, NY: Cornell University Press, 2008
Brawand Leo (1971), Wohin steuert die deutsche Wirtschaft?, München.
Bernhard William T. (2002), Banking on Reform: Political Parties and Central Bank Independence in the Industrial Democracies, Ann Arbor: University of Michigan Press.

Bini Smaghi Lorenzo (2008), Central Bank Independence in the EU: From Theory to Practice, European Law Journal, Vol. 14, No. 4, July 2008, pp. 446–460.

Caesar Rolf (1995), Central Banks and Governments: Issues, Traditions, Lessons, in: Financial History Review 2: 119-43.

Cohen Benjamin J. (1974), The Revolution in Atlantic Economic Relations: A Bargain Comes Unstuck, in W.F. Hanrieder (ed.), The United States and Western Europe: Political, Economic and Strategic Perspectives (Cambridge, MA: Winthrop Publishers, l974), 106-33.

Coombs Charles (1976), The Arena of International Finance, New York: Praeger.

Cukierman Alec (2006), Central Bank Independence and Monetary Policy-Making – Past, Present, and Future, Economia Chileana, vol. 9, no. 1, 5-23.

Deutsche Bundesbank (various years), Monthly Reports, Frankfurt.

Emminger Otmar (1976), Deutsche Geld- und Währungspolitik im Spannungsfeld zwischen innerem und äußerem Gleichgewicht, 1948-75, in: Deutsche Bundesbank, ed., Währung und Wirtschaft in Deutschland, 1876-1975, Frankfurt, 485-552.

Frieden Jeffry A. (1991), Invested interests: The politics of national economic policies in a world of global finance, International Organization 45, No. 4 (Autumn) pp. 425–51.

Frieden Jeffry A (2002), ‘Real Sources of European Currency Policy: Sectoral Interests and European Monetary Integration,’ International Organization, Vol. 56, No. 4, (Autumn), pp. 831–60.

Gavin Francis (2004), Gold, Dollars, and Power: the Politics of International Monetary Relations, 1958-1971, Chapel Hill: University of North Carolina Press.

Grey William G. (2007), Floating the System: Germany, the United States, and the Breakdown of Bretton Woods, 1969-1973, Diplomatic History 31, 2 (April), pp. 295-323.

Helleiner Eric (1994), States and the Reemergence of Global Finance, Ithaca/London.: Cornell UP.
Heisenberg Dorothee (1999), The Mark of the Bundesbank: Germany’s Role in European Monetary Cooperation, Boulder: Westview.
Kaltenthaler Karl (2003), Managing the Euro: European Central Bank Exchange Rate Policy Preferences, European Union Politics, September, vol. 4, no. 3, pp. 329-349.
Kennedy Ellen (1991), The Bundesbank: Germany’s Central Bank in the International Monetary System, London.
Kinderman Daniel (2008), The Political Economy of Sectoral Exchange Rate Preferences and Lobbying: Germany from 1960-2005, and Beyond, in: Review of International Political Economy, vol. 15, no. 5, pp. 851-80.
Loedel Peter H. (1999), DM Politics. Germany in the European Monetary System, London.
Lohmann Susanne (1998), Federalism and Central Bank Independence: The Politics of German Monetary Policy, 1957-92,World Politics, vol. 50, nr. 3, April, pp. 401-446.
Marsh David (1992), Die Bundesbank: Geschäfte mit der Macht, München.
Ruggie G.John (1982), International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order, in: International Organization 36: 379-415.
Torres Francisco (2006), On the Efficiency-Legitimacy Trade-Off in EMU, in: Torres Francisco/Verdun Amy/Zimmermann Hubert, eds., EMU Rules: the Political and Economic Consequences of European Monetary Integration, NOMOS: Baden-Baden, 42-76.

*Winkler Bernhard (*2006), Stability and Growth: the Role of Monetary Policy and Other Policy Actors in EMU in: Torres Francisco/Verdun Amy/Zimmermann Hubert, eds. (2004), EMU Rules: The Political and Economic Consequences of European Monetary Integration, NOMOS: Baden-Baden, 240-64.

Zimmermann Hubert (2001), The Fall of Bretton Woods and the First Attempt to Construct a European Monetary Order, in: Bo Strath/Lars Magnusson, eds., From the Werner Plan to EMU, Bruxelles: Peter Lang, 49-72.

Zimmermann Hubert (2002), Money and Security: Troops and Monetary Policy in Germany´s Relations to the UK and the US, 1950-71, Cambridge: Cambridge UP.

Zimmermann Hubert (2008), West German Monetary Policy and the Transition to Flexible Exchange Rates, 1969-73, in: David Andrews, Hg., Orderly Change: International Monetary Relations Since Bretton Woods, Ithaca: Cornell University Press, 155-76.