

## CHAPTER NINE

## Monetary Statecraft in Follower States

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Common sense suggests that successful leaders need willing followers. Coercion can sometimes be effective, but, as every new parent soon learns, outcomes achieved through self-interested acquiescence tend to be more satisfactory and more enduring than those achieved through the application of brute force. Political theorists typically focus on the concept of legitimacy when they evoke the quality that transforms the raw power of a strong actor into something more acceptable to a relatively weaker one. Only when it is operative, we might even say, is the term *leadership* really appropriate. The authority relationship thereby invoked ultimately entails a fundamental respect for the autonomy of the follower.<sup>1</sup>

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1. Research on the meaning of power and authority in international relations is rapidly expanding. For an overview, see Edgar Grande and Louis W. Pauly, eds., *Complex Sovereignty: Reconstituting Political Authority in the Twenty-First Century* (Toronto: University of Toronto Press, 2005). On legitimacy and particular monetary orders, see Benjamin J. Cohen, “Balance-of-Payments Financing: Evolution of a Regime,” in *International Regimes*, ed. Stephen Krasner, 315–36 (Ithaca: Cornell University Press, 1983); Jonathan Kirshner, ed., *Monetary Orders: Ambiguous Economics, Ubiquitous Politics* (Ithaca: Cornell University Press, 2003); David Andrews, C. Randall Henning, and Louis W. Pauly, eds., *Governing the World's Money* (Ithaca: Cornell University Press, 2002). On the concepts of leadership and followership in this arena, see Rawi Abdelal, “The Politics of Monetary Leadership and Followership: Stability in the European Monetary System since the Currency Crisis of 1992,” *Political Studies* 46, no. 2 (1998): 236–59.

In a world characterized by both intensifying economic interdependence and continuing political disunity, the quest to establish rules capable of governing monetary power is as difficult as it is persistent. Leading and following states in many different periods during the past century repeatedly attempted to negotiate such rules. That they needed to do so, for example in 1944 and again after 1971, suggests the enduring temptation of unbridled power on the part of leaders. That they wanted to do so suggests the capacity of followers somehow to limit the power of leaders. As I employ the term in this chapter, *followership* involves an observable capacity for strategic choice. In this policy context, that capacity defines the contours of monetary statecraft. This chapter explores leader-follower dynamics by applying conceptions of monetary power and statecraft developed by David Andrews (chap. 1 in this volume), as well as the discussion of monetary leadership by Andrew Walter (chap. 3 in this volume), to two important and illustrative empirical cases of monetary followership in Canada and Austria.

### National Policies and International Monetary Order

What a follower state basically wants from a monetary leader, it might reasonably be assumed, is a reliable monetary anchor or, more precisely, in recent times an external bulwark against inflation. Despite the integrative effects of economic globalization, however, few follower states have in fact ever demonstrated a complete willingness simply to trust systemic or regional leaders to maintain macroeconomic policies consistent with their own preferences. Certainly since 1945, key follower states in the middle of the pyramid of international monetary power have always insisted on taking out insurance.<sup>2</sup> Because these follower states feared that the leading states might force them to bear more than their fair share of the burden of adjustment to expanded trade and investment flows, collaborative institutions such as the International Monetary Fund (IMF) or the Group of Seven promised them greater symmetry when payments imbalances needed to be equilibrated. But follower states insisted on hedging their bets even further by retaining national control over specific policy instruments, either because they believed that multilateral instruments would be too weak or because they actually hoped that asymmetries might work to their own benefit. Capital controls certainly fell into such a category, especially in the early postwar years. During the past few decades, as most follower states moved decisively to open their economies to freer capital movements, other measures were developed to compensate for the absence of effective controls. Some governments,

2. Benjamin J. Cohen hypothesizes, in *The Geography of Money* (Ithaca: Cornell University Press, 1998), 116–17, seven layers in the world's currency pyramid, extending from the “top currency” (the U.S. dollar) and “patrician currencies” (the Japanese yen and German mark, now the euro) at the apex to the “permeated,” “quasi-,” and “pseudo-currencies” at the base. Roughly speaking, the universe of follower states to which my analysis is addressed comes from the remaining two layers between this base and apex; they range from Switzerland and Canada to Australia, South Korea, Austria, Malaysia, and Chile. Also see Benjamin J. Cohen, *The Future of Money* (Princeton: Princeton University Press, 2004).

for example, opted to combine capital decontrol with exchange-rate floats. Others, particularly inside the European monetary union, chose a combination of regional exchange-rate fixity and new collaborative mechanisms for managing external monetary relationships.

Such decisions construct policy buffers between followers and leaders. The purposes of those buffers are to limit monetary power conceived in relational terms and to constrain the instrumental use of such power. Most clearly, to employ the conceptual terminology employed in earlier chapters, such buffers work mainly to counter the leader's Power to Deflect the transitional costs of balance-of-payments adjustment, including the costs of maintaining a system designed to facilitate such adjustment. A perennial struggle among interdependent but ultimately sovereign states involves the attempted shifting of such costs on to others. Blunting the power of others to do so is equivalent to carving out a zone of autonomy in an interdependent relationship. This makes willing and self-interested followership possible.

In the Canadian and Austrian case histories summarized in this chapter, we see the struggle to limit monetary power, to practice monetary statecraft, up close. We also see very different policy choices being made, arguably with similar degrees of success. Beyond helping us understand how those choices constrain monetary power, a comparison of the underlying reasons for the differences between them suggests the importance of relational context. It also suggests the key role that continues to be played by distinctive domestic political and social arrangements, even in a policy arena commonly depicted as ever more completely dominated by free-wheeling systemic forces. In the end, the empirical evidence presented here points to the importance of conjoining research on the varieties of contemporary capitalism with continuing research on international monetary power and authority. More specifically, it highlights the broader significance of idiosyncratic arrangements for wage bargaining and other measures to redistribute internally the net benefits and costs of ever-deepening national involvement in external markets.<sup>3</sup>

Without attention to those idiosyncrasies, the very different exchange-rate regime choices of Canada and Austria represent an evident puzzle. Both countries have similarly asymmetrical, dependent economic relationships with their larger neighbors and leading trading and investing partners. They also have similarly complicated and historically fraught political relationships with those large neighbors. Prominent international political economists predict that currency politics in small, open economies will incline in the direction of exchange-rate stability.<sup>4</sup> Despite a

3. See, for example, Fritz Scharpf, *Crisis and Choice in European Social Democracy* (Ithaca: Cornell University Press, 1991); Herbert Kitschelt, Peter Lange, Gary Marks, and John D. Stephens, *Continuity and Change in Contemporary Capitalism* (Cambridge, UK: Cambridge University Press, 1999); Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001); Bob Hancké and David Soskice, "Wage-Setting, Fiscal Policy, and Political Exchange in EMU," in *Institutionen, Wirtschaftswachstum, und Beschäftigung in der EWU*, ed. Hans-Böckler Stiftung (Düsseldorf: Hans-Böckler Stiftung, 2003); Linda Weiss, *The Myth of the Powerless State* (Ithaca: Cornell University Press, 1998).

4. As noted by Eric Helleiner, "The Fixation with Floating: The Politics of Canada's Exchange Rate Regime," *Canadian Journal of Political Science* 38, no. 1 (2005): 1–22 (see especially 2); see also Jeffrey A.

rapidly increasing degree of integration with the United States when it comes to trade and investment, however, Canada confounded such expectations by jealously guarding its national currency and maintaining a floating exchange rate for all but thirteen of the years since 1945. It continues, moreover, to reject the logic of monetary union. In contrast, facing high levels of economic reliance on the German market for its exports, and despite the elegant theoretical logic of floating exchange rates in the context of ever more open capital markets, Austria has long followed precisely the opposite path.

Given this curious and persistent difference, surprisingly few comparative studies of these two follower states exist.<sup>5</sup> While helping to fill this lacuna in the empirical literature, this chapter suggests more generally that the efforts of follower states to limit the power of leaders significantly define and structure the relationships between them. If we conceive of the monetary system as a whole essentially as a complex network of such relationships, then future research on international monetary power will require deeper attention to intranational variables and their continuing variety.

### The Canadian Case

Figures 9.1 and 9.2 suggest a straightforward story. With the significant exception of the 1962–70 period, in modern times Canada has relied heavily on the policy tool of flexible exchange-rate adjustment to manage its deepening interaction with its main economic partner. At three moments in living memory, strategic moves occurred not only in the actual exchange rates but in the very nature of the Canadian exchange-rate regime. In 1950, it broke away from its Bretton Woods commitment by floating the Canadian dollar. In 1962, it repegged (fig. 9.1). And in 1970, it returned to floating once more (fig. 9.2), a policy that continues to this day. Throughout the past three decades, the Bank of Canada even began moving away from attempts to manage the currency's value directly. After 1991, it held to an ever-deeper commitment to targeting monetary policy mainly on inflation, in the belief

Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45, no. 4 (1991): 425–51; C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Washington, D.C.: Institute for International Economics, 1994).

5. The trailblazer here is Harald von Riekhoff and Hanspeter Neuhold, eds., *Unequal Partners* (Boulder: Westview, 1993); the volume includes a few paragraphs on Austria's exchange-rate policy by the distinguished economist Georg Winckler, but it has practically nothing on Canada. On the underlying concepts of leadership and followership applied in a broad comparison involving Canada, see Andrew Cooper, Richard Higgott, and Kim Nossal, *Relocating Middle Powers: Australia and Canada in a Changing World* (Vancouver, Canada: University of British Columbia Press, 1993). Although he does not focus on Canada, Peter J. Katzenstein proposes a directly relevant notion concerning successful small states in a globalizing economy: that their economic policies are shaped by broadly shared perceptions of vulnerability, by social learning, and by attendant efforts to construct effective tools for defending their national interests. See Peter J. Katzenstein, *Corporatism and Change: Austria, Switzerland, and the Politics of Industry* (Ithaca: Cornell University Press, 1984); *Small States in World Markets* (Ithaca: Cornell University Press, 1985); "Small States and Small States Revisited," *New Political Economy* 8, no. 1 (2003): 9–30.



**Figure 9.1** Exchange rate (monthly averages): Canadian dollar to U.S. dollar, 1950–1962. (\*) 20 August 1957, modern-day Canadian dollar peak: CA\$1.00 = US\$1.0614.

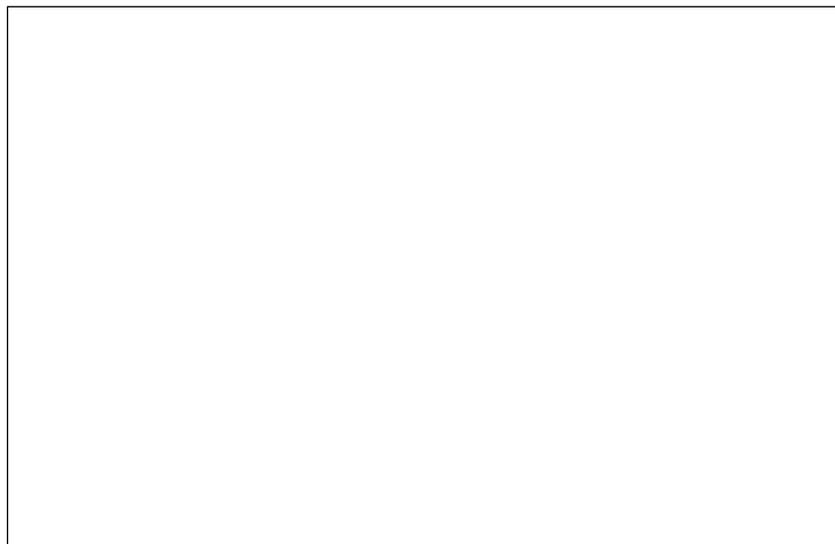
1. September 1950, Canadian dollar floated
2. December 1951, exchange controls lifted
3. May 1962, Canadian dollar fixed

*Source:* Reproduced from James Powell, *A History of the Canadian Dollar* (Ottawa: Bank of Canada, 1999), 43.

that movements in the exchange rate would complement, or at least not entirely undercut, the macroeconomic consequences of movements in interest rates. There was no change in basic policy after 1998, even though the bilateral exchange rate soon bottomed out and returned to the \$0.80 range by the middle of the next decade.

What lies behind the policy choices encapsulated in this brief summary? In the years just after World War II, Canadian ties with Britain attenuated, and the United States rapidly became the only partner crucial to its economic fortunes. Since 1971, an exceptionally deep economic partnership with the United States developed; this was finally acknowledged and even embraced in 1988 in the Canada-US Free Trade Agreement.<sup>6</sup> At present, nearly 90 percent of Canadian exports go to the United States, although in the wake of the integration of transport systems some of this huge proportion, as yet unmeasured by either Canadian or U.S. authorities, simply represents Canadian goods passing through U.S. ports. In terms of power conceived

6. See Louis W. Pauly, "Canada in a New North America," in *The Rebordering of North America: Integration and Exclusion in a New Security Context*, ed. Peter Andreas and Thomas Biersteker, 90–109 (New York: Routledge, 2003); Stephen Clarkson, *Uncle Sam and Us: Globalization, Neoconservatism, and the Canadian State* (Toronto: University of Toronto Press, 2002).



**Figure 9.2** Exchange rate (monthly averages): Canadian dollar to U.S. dollar, 1970–1998. (A) 25 April 1974, Canadian dollar high: CA\$1.00 = US\$1.0443; (B) 4 February 1986, CA\$1.00 = US\$0.6913; (C) 27 August 1998, CA\$1.00 = US\$0.6311.

1. 31 May 1970, Canadian dollar floated
2. December 1971, Smithsonian agreement
3. 15 November 1976, election of Parti Québécois in Quebec
4. 20 May 1980, Quebec referendum
5. October 1980, National Energy Program introduced
6. 26 October 1992, defeat of Charlottetown accord
7. 30 October 1995, Quebec referendum

*Source:* Reproduced from James Powell, *A History of the Canadian Dollar* (Ottawa: Bank of Canada, 1999), 54.

in relational terms, this trade dependence obviously gives the United States enormous leverage.

But we need to back up a bit if we are to understand the monetary aspect of Canada's relationship with the United States. One method is to trace the rationales for the three principal changes in Canada's postwar international monetary policy regime.<sup>7</sup> A key source is the one person who was at, or very near, the center of policy decision from 1940 right through to 1973. Louis Rasminsky managed the Canadian Foreign Exchange Control Board during and immediately after World War II.

7. See A. F. W. Plumptre, *Three Decades of Decision: Canada and the World Monetary System, 1944–75* (Toronto: McClelland and Stewart, 1977); Paul Wonnacott, *The Canadian Dollar, 1948–62* (Toronto: University of Toronto Press, 1965); Douglas Fullerton, *Graham Towers and His Times* (Toronto: McClelland and Stewart, 1986); Eric Helleiner, *Towards North American Monetary Union? The History and Politics of Canada's Exchange Rate Regime* (Montreal: McGill-Queen's University Press, forthcoming).

He played an important role in the drafting of the Bretton Woods Agreement in 1944, served as the first Canadian director on the IMF Executive Board, and held the position of deputy governor and, from 1961, governor of the Bank of Canada until his retirement in 1973. Rasminsky lived a full life and was into his ninety-first year when it ended in 1998. He was physically frail but mentally extremely sharp when I had the opportunities to interview him in 1993 and once again a few months before his death. Those interviews, in conjunction with observations drawn from the secondary literature, provide the basis of the analysis of Canadian exchange-rate policy that follows.

*The IMF Agreement and the Abandonment  
of Capital Controls*

Rasminsky termed his presence at the 1942 London meeting where Keynes unveiled his draft plan for the postwar monetary system “the highlight of my international monetary career.”<sup>8</sup> Like others at that meeting, he was convinced that deflation, recession, and competitive currency devaluation would be the chief dangers after the war ended. Keynes’s ideas for “a clearing union and code of behavior based on non-discrimination and convertibility” made a deep impression on Rasminsky because they promised an elegant way to avoid recapitulating the dismal monetary experience of the 1930s. That the plan envisaged stable exchange rates was not the main attraction, however. Rather, it seemed to chart a politically feasible and economically sound path back to more freely flowing trade and international capital movements. “Non-discrimination and convertibility were so important to Canada because of the structure of our trade then: we had a surplus of imports from the United States, which we paid for through a surplus of exports to Britain and Europe, and some capital inflows from Britain but mainly from the United States.”<sup>9</sup> Given these priorities, capital controls were never welcomed for their own sake, although they had proved essential during the war years. They came off again as soon as possible, a process completed in 1951.

Although Rasminsky personally favored the idea of exchange-rate stability embodied in the original Articles of Agreement of the IMF, he claimed always to have shared with other Canadian officials an overriding commitment to easing conditions for international capital flows. “We were always committed to freely flowing capital, both before [the IMF agreement] and ever after.”<sup>10</sup> That commitment only deepened when the postwar economic reality turned out to be a boom and not a bust. With U.S. capital flows to Canada rising rapidly at both of the crucial turning points of 1950 and 1970, “we were always willing to sacrifice exchange-rate stability if need be.” Canadian authorities did not relish breaching their Bretton Woods commit-

8. Louis Rasminsky, interview, Ottawa, August 11, 1993.

9. *Ibid.*

10. *Ibid.*

ments in either case, Rasminsky recalled, “But what could we do? When we floated, we floated up, so we could always deny competitive devaluation.”<sup>11</sup>

Although some U.S. counterparts understood the Canadian position in both 1950 and 1970, rising tension existed at the official level, especially in 1970. For Rasminsky, this was nothing new. He had hopes even into 1944 that something like Keynes’s politically neutral Clearing Union might succeed. In theory, such a mechanism could have reconciled the desires for both exchange-rate stability and capital mobility, and Canada could therefore have supported it. But Rasminsky soon concluded that the United States had no stomach for such a multilateral ideal, one which would give voice and, more important, automatic and certain financing to countries when they faced balance-of-payments adjustment problems. In the late 1940s, he complained about the niggardliness of IMF financing, and early on he worried that the IMF was condemned by the United States to be much less relevant than it could have been.

These concerns rested on his close observation of U.S. behavior in the crucial 1944–46 period. A remark he recorded during the 1946 inaugural meeting of governors of the IMF and World Bank in Savannah, Georgia, captured the lesson Rasminsky learned then and carried with him throughout his life: “We have all been treated to a spectacle of American domination and domineeringness through their financial power which has to be seen to be believed. . . . US foreign economic policy seems to be in the hands of the Treasury who are insensitive to other peoples’ reactions and prepared to ram everything they want down everyone’s throat.”<sup>12</sup>

### *The 1950 Float*

In 1950, when Canada found itself awash in U.S. dollar reserves, the necessary consequence of simultaneous export and investment booms, inflation was the rising threat. U.S. Treasury officials were not so much domineering as concerned. Even more worried were IMF staffers, who feared that a Canadian revaluation would set a precedent and undermine the central exchange-rate plank of the Articles of Agreement. Rasminsky saw the problem, but he also now saw serious design flaws in the structure of the IMF itself. His advice to the minister of finance, therefore, took the following line. Especially after the formal end of residual wartime exchange controls, Canada should embrace its full obligations to the IMF (the so-called Article VIII status). At the same time, however, the IMF should be asked to acknowledge the market conditions facing the country and quietly exempt it from any obligation to hold an explicit exchange-rate peg or even to commit itself to reestablishing such a peg by a certain date.<sup>13</sup> This is exactly what happened. Fifty-three years later, Rasminsky was forthright in his rationale for the policy he advocated: “Our commitment to

11. *Ibid.*

12. Bruce Muirhead, *Against the Odds: The Public Life and Times of Louis Rasminsky* (Toronto: University of Toronto Press, 1999), 111.

13. *Ibid.*, 143.

multilateralism mainly had to do with the desire to have a buffer between us and the United States. Negotiating head to head with them was never enjoyable. In a way, our position was like Switzerland's: an island of stability and a great haven for capital flows in a turbulent world. It was often best to keep our heads down."<sup>14</sup>

As Eric Helleiner points out, the decision to float in 1950 was certainly backed by the weight of opinion in the Canadian private sector.<sup>15</sup> It would be an exaggeration, however, to say that the actual decision to break IMF obligations and float the currency originated there. Nor was there much evidence of any particularly salient partisan influence or serious lobbying by provincial governments. Instead, the central governmental policy makers who actually made the final choice of assigning priority to monetary independence and capital mobility over exchange-rate stability enjoyed a significant amount of policy autonomy within the Canadian political system. We might argue that this choice made by the small group of Canadian policy makers was ideational or even ideological in origin.<sup>16</sup> It seems more accurate, however, simply to call it logical, both in light of market conditions and policy makers' understanding of the decentralized structure of the Canadian state and the regionally differentiated nature of the national economy. The only feasible alternative to floating the currency in 1950 would have been a combination of running a very loose monetary policy (risking accelerated inflation during an unexpected period of economic expansion) and reimposing capital controls. Price stability was even then seen to be in the national interest and so too was the development of manufacturing in Quebec and Ontario and of commodity-based businesses in the Maritimes and the West. Private U.S. capital inflows were the key to achieving these latter goals. If this meant that bankers in Montreal and Toronto had to continue living with some hot money, this seemed a small price to pay.<sup>17</sup> Was excessive currency speculation ever really a serious problem? Rasminsky was clear: "No. We didn't build very many long-term assets with short-term money."<sup>18</sup>

### *The 1962 Peg*

In light of such reasoning, the decision to repeg in 1962 is anomalous. Unique circumstances explain it, but in retrospect the main conclusion Canadian policy makers subsequently drew was that it was a mistake.

Erratic domestic economic policy in 1961 set the stage. A trade deficit was exacerbated by an overly tight monetary policy that simultaneously depressed exports and attracted an avalanche of capital inflows. In the face of rising unemployment, a populist Conservative government tried to talk the Canadian dollar down, the United States and the IMF began complaining about competitive currency depre-

14. Rasminsky, interview, Ottawa, August 11, 1993.

15. Helleiner, "Fixation with Floating," 5.

16. Ibid.; Kathleen McNamara, *The Currency of Ideas: Monetary Politics in the European Union* (Ithaca: Cornell University Press, 1998).

17. I have seen no record of loud objections emanating from that quarter.

18. Rasminsky, interview, August 11, 1993.

ciation, and a politically tone-deaf central bank governor refused to loosen the monetary reins. That governor, James Coyne, resigned under pressure on July 14, 1961, and Rasminsky took his place ten days later.<sup>19</sup> His first order of business was to hammer out an historic understanding with the government concerning the future unique and depoliticized responsibilities of the Bank of Canada; his second task was to use the Bank's renewed mandate to help restore confidence in a Canadian economy beset by rising unemployment.

For a brief period of time, it seemed that one prudent way to do so would be to accede to U.S. and IMF calls to repeg the exchange rate. There was also some pressure from the business community to take this route. Rasminsky emphasized the need "to eliminate uncertainty" when in May 1962 he announced the decision to fix the rate.<sup>20</sup> In later years, he insisted that the government, with advice from the Bank, would never have taken that decision if it had not believed that domestic circumstances themselves had warranted it. In the event, the new policy did not work. The rate immediately came under pressure as a deteriorating trade position convinced the markets that the Canadian dollar was overvalued. In order to defend the currency, the government found itself forced into the classic posture of imposing fiscal stringency, acquiescing as the Bank raised interest rates, and shoring up emergency reserves by borrowing from the IMF as well as the U.S. and UK central banks—all in the face of rising unemployment. Once committed, however, Rasminsky himself could see no other way out, except to urge the government to take even more direct measures to reduce the current account deficit. This necessarily implied reducing domestic production costs. He therefore urged that "cabinet should consult with business and labor."<sup>21</sup> But such consultations could not quickly reduce those costs, and the government relied instead on import surcharges. This antagonized the United States but also changed market psychology. The exchange crisis eventually subsided; later in the decade, the focus of policy attention shifted away from unemployment and back toward inflation.

### *The 1970 Float*

By 1970, Canada faced again a situation very similar to the one in 1950. Confidence in the Canadian currency had long since returned, and capital rolling in from the United States made alternatives to refloating the Canadian dollar unpalatable. Defending the then-existing Canadian-U.S. exchange rate would have required massive official purchases of U.S. dollars and sales of Canadian dollars. This could easily have exacerbated inflationary pressures in Canada and set off a spiral of currency speculation.<sup>22</sup> In the event, Canadians were determined to float. Even under

19. James Powell, *A History of the Canadian Dollar* (Ottawa, Ontario: Bank of Canada, 1999), 44.

20. Plumtre, *Three Decades of Decision*, 168; Muirhead, *Against the Odds*, 196.

21. Muirhead, *Against the Odds*, 200.

22. Powell, *A History of the Canadian Dollar*, 49. As Powell further notes, "The authorities also considered asking the United States to reconsider Canada's exemption from the U.S. Interest Equalization Tax. Application of the tax to Canadian residents would have raised the cost of foreign borrowing and,

the most aggressive pressure from U.S. Treasury officials, especially from Secretary John Connally, Canada refused to support the U.S. attempt to shore up the Bretton Woods system in the negotiations following President Richard Nixon's decision to suspend the official convertibility of the U.S. dollar on August 15, 1971. Rasminsky recalled the key negotiating session vividly:

Connally was very rude. We had to float, and I told him privately that we were not his problem. We were not draining US gold reserves, since we were holding much of our foreign reserve in the form of non-marketable T-bills. He began yelling about Canada always having its hand out for one thing or another but never being willing to help, and I raised my voice in anger. He stormed out of the room. In a public session later, Connally asked [IMF Managing Director Pierre-Paul] Schweitzer if Canada was contravening the Articles. He said yes. But we immediately intervened to ask Schweitzer if he thought that under the circumstances it would be possible for Canada to fix a durable par value. He said no. This probably helped put him in hot water with Connally.<sup>23</sup>

#### *Continuity in Canadian Analysis and Policy*

After the Smithsonian Agreement was announced in December 1971, Canadian unwillingness to participate in the repegging exercise was publicly and bluntly attacked by Paul Volcker of the U.S. Treasury and by Arthur Burns, then chairman of the Federal Reserve. Canada, according to Burns in 1972, "had not been prepared to be helpful to the USA in its time of need."<sup>24</sup> Underlying the adamant position of Canada, however, was the reawakening of a strong preference for monetary autonomy. The line of thinking was well articulated as early as 1932 by Clifford Clark, arguably the most important deputy minister of finance in Canadian history and the person who, along with central bank governor Graham Towers, originally recruited Rasminsky to government service:

Under a policy of fixed exchanges, an upset in the country's balance of payments due to a crop shortage, or a change in foreign demand for one or more of the country's important products may have to be corrected by the painful process of restricting credit and reducing prices and personal incomes. This process appears the more ruthless when it is realized that many disequilibria in international balances of payments are temporary in nature. The question may be raised whether the policy of exchange stability in some cases does not involve the payment of too high a price for the advantage gained. . . . The arguments against a tie-up with New York and with London constitute the case for retaining our national autonomy in monetary affairs for the present at least. In particular, neither alternative offers any real assurance of price stability or the restoration of our prices to a level at which the burden of fixed debt upon the shoulders of industri-

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hence, would have dampened capital inflows. This too was rejected, however, because of concerns that it would negatively affect borrowing in the United States by provincial governments."

23. Rasminsky, interview, Ottawa, August 11, 1993. See also Muirhead, *Against the Odds*, 293.

24. Muirhead, *Against the Odds*, 294.

alist and taxpayer will be appreciably mitigated. . . . If we retain our independence, we may choose our own objectives and plot our own course towards them.<sup>25</sup>

What we might call the Clark-Rasminsky shared narrative on Canadian external monetary and financial policies really extended from the 1930s straight through to the 1990s and beyond. In this narrative, there has been no basic change in the country's exchange-rate regime since 1971. If anything, the country made an even stronger commitment to floating in the aftermath of the negotiation in 1988 of a free trade agreement with the United States, when the Bank of Canada let it be known that it would not intervene in foreign-exchange markets to manage the rate. Such a commitment was harshly tested during the late 1990s when the exchange rate plummeted to historic lows against the dollar. To the surprise of many in the business community who continued to push the cause of fixed rates, even to the point of monetary union, that commitment held. The strong recovery in the exchange rate since then has tested it again from the opposite side. But the Clark-Rasminsky consensus survives.

In sum, policy autonomy remains the key Canadian priority. Sometimes, this means maintaining the ability to counter official insistence on obedience to the changing policy preferences of the United States. More often, it means letting the exchange rate buffer the impact of monetary and fiscal policy changes in the United States. In the wake of the miserable experience of the 1930s and the shock to Canadian polity and economy posed by World War II and the rapid erosion of the British empire, there was a brief moment when the country's monetary policy makers were willing to consider new international arrangements that might have fundamentally compromised that autonomy. The need for national-level policy insulators might have been met by a radically new kind of international organization. But by 1946, it was crystal clear that no such organization could be created. Canadian policy makers were therefore left to confront the unmediated power of the United States. The historically tried and tested response has been to let the exchange rate be the main instrument for limiting that power, especially because there was no serious constituency for a permanent regime of capital controls.

In the meantime, Canada wanted to be as helpful as possible in the establishment of the Bretton Woods institutions and in their subsequent operation.<sup>26</sup> The government would take its day-to-day operations seriously, and it would send respected

25. W. C. Clark, "Monetary Reconstruction," 1932, National Archives of Canada, RG25 D1 v. 770 File 333, 145-46, 195; cited in Helleiner, "Fixation with Floating," 5.

26. Rasminsky had spent most of the 1930s working in the economic and financial department of the League of Nations. In the twilight of his life, he concluded that although Keynes's more ambitious plans for a currency union remained noteworthy, the creation of the IMF actually did represent something new and it was wrong to underestimate its role in postwar history. "What emerged was better than the League, and probably as much as the United States could ever stomach politically. The decisions made in Savannah in 1946 were bad ones, but Congress and the politicized environment in Washington likely made them unavoidable. In the end, the Fund can claim substantial credit for the prosperity of the golden age of 1945-1970." Interview, Ottawa, August 11, 1993.

senior officials to sit on their boards. Even when it failed to meet the spirit of its obligations to the IMF, it would go to great lengths (before the generalized shift to floating in March 1973) to ensure that the IMF formally acceded to its “temporary” derogations. But it would always defend its own way of dealing with the practical exigencies of U.S. monetary and financial power. Viewed from a less generous perspective, this sometimes meant defending Canada’s own interest in bearing less of the load of system maintenance. Canadian senior monetary officials were, in short, pragmatic nationalists. Time and again, not wanting either to impede the capital inflows required to underwrite national prosperity or supinely to acquiesce in asymmetrical external constraints on their own monetary policy, they relied on the exchange rate as the principal buffer against U.S. monetary hegemony.

Ironically, the logic and consistent wisdom of this choice was starkly revealed when Canadian monetary policy makers made the unusual mistake of repegging in 1962. Fearing the consequences of quickly reversing course, they set out to uphold the peg—and immediately confronted the core political contradiction of the Canadian political economy. If external costs could not be adjusted rapidly as payments pressures mounted, internal production costs—and their major wage component—would have to adjust. But this simply could not easily be done in a liberal, continent-spanning economy marked by distinct regional differences and disaggregated unions fully capable of resisting downward wage pressures. The fact that the initial error was soon masked by the effects of an eventual inflationary boom in the United States in the 1960s should not confuse the basic issue. In 1970, Canadian policy makers once again squarely confronted their internal political constraints and reverted to their traditional external practices.

Canadian exchange-rate policy was therefore capable of being deployed unilaterally and swiftly in a deadly serious game always played on two dimensions. Internally, if business and labor could not be cajoled into negotiated concessions to keep national production competitive, then a change in the value of the currency could accomplish the same end less obtrusively, even if internal regional effects might be unbalanced. Externally, the same kind of change could shift some of the costs of adjustment on to others, or, more benignly, limit the shifting of such costs to Canada. Despite external political pressures, including most prominently those voiced in the early 1970s, Canadian policy makers steadfastly refused to rely on any other policy mechanism. Blaming financial markets for changes in living standards always proved a workable political strategy, and it certainly was more effective than relying on negotiating wage agreements in a complex and diffuse labor market. Call it the influence of a particular brand of liberal-market ideology, but this approach certainly did complement revealed policy preferences. It helped manage the irresolvable tension between equally enthusiastic demands from opposing domestic constituencies for continental economic integration, on the one hand, and for the retention of national political independence, on the other.

Despite tremendous changes in the real economy of Canada in recent decades, including those resulting from freer trade with the United States, the explicit adoption of inflation targeting in 1991, and dramatic fiscal restructuring in the mid-1990s, this

logic continues to hold.<sup>27</sup> External shocks continue to entail abrupt changes in foreign demand for Canadian goods and services, whose composition and production vary markedly across the country's regions. In the face of such shocks, we could certainly imagine an alternative adjustment mechanism focused mainly on the continental movement of labor or on relative changes in sectoral wages. But even in a post-North American Free Trade Agreement (NAFTA) era, the movement of labor and other factors of production across the Canadian-U.S. border is still considerably more difficult and less common than their movement within the country. It also remains the case that relative wages across Canadian regions are sticky in nominal terms.<sup>28</sup>

The question of whether smoother and deeper continental adjustment will be possible in the future is an open one, which overlaps with quiet expert debate on the extent to which a separate currency now comes with mounting transaction and opportunity costs. Booming cross-border trade and investment during the past decade suggest that such costs are low, but the jury is out until more empirical work is done. In the meantime, the Clark-Rasminsky policy consensus continues to hold: as long as Canadian monetary policy is disciplined, a flexible exchange rate facilitates macroeconomic stabilization with minimal political costs, both domestic and external. In other words, it limits U.S. monetary power while carving out an acceptable degree of political autonomy for the Canadian state and the decentralized national society it still seeks to steer.<sup>29</sup>

### The Austrian Case

Austrians understand what it means to confront power. When the democratic Republic of Austria was reconstituted on April 27, 1945, Germany had yet to surrender and the country was occupied by the Soviet army. Allied troops were approaching from the west, and their governments had yet to recognize the new state. Ironically, although the country had been shattered by external forces even more thoroughly than in 1918, the traumatic experience of the previous seven years effectively incubated a new sense of national identity. In a hostile environment, a new nation and a new state initiated a complicated process of mutual construction.

Especially after the State Treaty of 1955 finally ended the Allied occupation, monetary policy became an important instrument in that task. Whereas only 47 percent

27. Stephen Harris, once a senior official in the Bank of Canada, reinforces my point here by emphasizing that inflation targeting became especially attractive to Canada after the difficult era of rising prices and high interest rates in the late 1980s. In its aftermath, dominant thinking in the Bank held that if Canadian inflation performance could better that of the United States, interest rates could be made-in-Canada. Hard experience in the 1990s and beyond undercut this reasoning. Personal correspondence, March 31, 2004.

28. John Helliwell, *How Much Do National Borders Matter?* (Washington, D.C.: Brookings Institution Press, 1998).

29. For an exceptionally clear statement of this position and of the associated agenda for future research, see Lawrence Schembri, "Exchange Rate Policy in Canada: Lessons from the Past, Implications for the Future," paper presented at the University of Victoria Conference, October 17–18, 2003.

of its people considered themselves to be members of an Austrian nation in the mid-1960s, within a quarter century some 80 percent embraced just such an identity.<sup>30</sup> The performance of the Austrian economy, and of the schilling, surely played no small part in this transformation. A small group of monetary policy experts understood from the beginning the deeply political nature of their own assignment. Like their Canadian counterparts, they may fairly be labeled pragmatic nationalists, but their pragmatism led them in distinctly different directions.

### *Reconstructing Monetary Autonomy*

For those Austrian monetary policy makers who remember the postwar atmosphere (or who remember what their forebears told them about it), two vivid impressions stand out. The first is the pall cast over all discussions concerning money by the hyperinflation of the early 1920s and by the way it ended, with the state in receivership and the national financial accounts directly administered by a Dutch national assigned by the League of Nations.<sup>31</sup> The League commissioner left in 1926, but by then the new Austrian National Bank was firmly established. The law creating it on November 24, 1922, committed the Bank to one overriding objective: safeguarding the stability of the currency. Even though the subsequent fixed rate between the new schilling and gold had to be devalued by 28 percent at the start of the Great Depression, support for a hard currency survived until German troops arrived on March 12, 1938.

The fact that the Germans proceeded to loot the National Bank's reserves might have been forgotten if World War II had turned out differently. But the memory of that trauma proved useful to the builders of the Second Republic. During the predictable postwar inflation, the Austrian National Bank was resurrected, the schilling was reintroduced and devalued, and the Currency Protection Act of November 1947 was passed in rapid succession, initiating a process of monetary stabilization.<sup>32</sup> Underpinning the restoration of monetary sovereignty was the first of five wage-and-price agreements between organized Austrian industry and the national trade union association, the foundation of the modern "social partnership" and the core of a coordinated market economy.

Bitter memories of debilitating industrial and class conflict during the interwar years framed that progressive-sounding but distinctively illiberal idea.<sup>33</sup> Price infla-

30. Max Riedlsperger, "Austria: A Question of National Identity," *Journal of Politics and Society in Germany, Austria, and Switzerland* 4, no. 1 (1991): 48–71; Peter Katzenstein, "The Last Old Nation: Austrian National Consciousness since 1945," *Comparative Politics* 9, no. 2 (1977): 147–71.

31. Louis W. Pauly, *Who Elected the Bankers? Surveillance and Control in the World Economy* (Ithaca: Cornell University Press, 1997), 54–55.

32. See "Österreichische Geldgeschichte," Austrian National Bank website, <http://www.oenb.at/>, accessed June 27, 2004.

33. Katzenstein, *Corporatism and Change*, 28–29 traces its roots to nineteenth-century nationality conflicts in the multiethnic Austro-Hungarian empire and the syndicalism of Austro-Marxism. Add to that the social teachings of Christian democracy in the late nineteenth century and the establishment of a Labor Advisory Council within the Ministry of Commerce as early as 1898.

tion was also in the background, and not just in people's memories; it was not until 1952 that tightening monetary policies finally reined in prices. Exchange controls and a dual exchange rate remained until the next year, when a one-time devaluation of the schilling was matched with the declaration of a fixed link to the U.S. dollar. Although Austria joined the IMF on August 27, 1948, it took another ten years until it was able to end its dual exchange rate and accept the full obligations of IMF membership. In 1958, it moved with other European states to a regime of currency convertibility. By then, the social recommitment to the monetary orthodoxy of the late 1920s had been tested and found durable. Despite the rebirth of passionate debates over the famous Austrian black-red political divide, the base of support for price stability remained broad and deep. It found expression in a 1955 act affirming the continuity (since 1922) of the National Bank and recommitting it to currency stability. Among other things, the capacity of the Bank for independent action was widened through a grant of powers to regulate the minimum reserves held by banks and to conduct open market operations without prior approval from the government.

#### *Interdependence and Austrian Social Partnership*

If by the 1950s Austrians did not yet fully trust themselves to maintain a sense of national solidarity for internal reasons, external conditions—the familiar problems faced by small states in an increasingly open international economy—provided reinforcement. Social partnership came to mean that organized business groups, the national farmers association, and the trade union federation (Österreichischen Gewerkschaftsbundes, ÖGB) were authorized to make national bargains that were insulated from ideological competition. Domestic politics, in turn, was guided by principles of federalism, proportional representation, and the continual redivision of the spoils of power along red and black lines (the Proporzsystem).<sup>34</sup>

The fact that internal stabilizing measures had failed catastrophically before 1938 undoubtedly contributed to a continuing sense of national vulnerability. But so too did the long shadow of the Soviet Union. The postwar occupation of the country by the victorious allies lasted for ten years; ending it without the formal partition of the country depended on Austria pledging permanent neutrality on the model of Switzerland. This was not declared in the Austrian State Treaty of May 15, 1955, but it was directly noted one month earlier in a bilateral memorandum signed with Moscow. The subsequent constitutional law of October 26, 1955, stated that “for the purpose of the permanent maintenance of her external independence and for the purpose of the inviolability of her territory, Austria of her own free will declares herewith her permanent neutrality, which she is resolved to maintain and defend with all the means at her disposal.”<sup>35</sup>

34. The rise of the Freedom Party and accession to the European Union later complicated these political understandings. See Albert Rothbacher, “EU Accession and Political Change in Austria,” *Revue d'Integration Europeene* 19, no. 1 (1995): 71–90.

35. Marko Milivokevi, “Neighbours in Neutrality: Aspects of a Close but Delicate Relationship,” *Journal of Politics and Society in Germany, Austria, and Switzerland* 3, no. 1 (1990): 69–83, quotation on

Although political neutrality was an existential necessity for postwar Austria, the practical priority was to recover and rebuild the economy as rapidly as possible. But how to do so? History and geography pointed only one way—to economic interdependence with Germany, together with the reconstruction of a robust and distinctly Austrian identity. Natural advantages and traditional networks reasserted themselves. Strong export-led growth was crucial, and for a land-locked country in the heart of central Europe, diversification options were limited. The path reopened after the war led within fifty years to an economy in which trade accounted for over 60 percent of GDP, nearly 40 percent of exports and imports were to and from Germany (with Italy a distant second at around 9 percent), and trade in goods resulted in a perennial deficit requiring balancing receipts from services (such as tourism) and investment.

Manufacturing, however, always played the central role in the strategy for recovery and prosperity. Prevented by its neutrality commitment from joining the European Community during the Cold War, few doubted the practical necessity of redeveloping bilateral linkages with Germany in such industries as machine tools, chemicals, metal goods, and steel. That basic idea certainly appealed to the labor unions in what had always been a highly organized workforce. At its root lay the logical necessity of keeping Austrian wages competitive with German wages. Logic is one thing, however, and natural human impulses another—how to manage the trick? Enter the exchange-rate regime.

#### *Exchange-Rate Policy and the Austrian Model*

The aim of Austrian authorities, like their counterparts in other small states, was to take the best from the external markets but to leave the rest. Peter Katzenstein traces the delicate processes through which Austrians went down precisely this road after 1955; but he spends surprisingly little time on the monetary dimension of their crafting of the institutional and then functional sinews of a secure nation.<sup>36</sup> In this regard, whereas the Canadians relied on a flexible exchange rate, the Austrians consistently made the opposite choice.

During the delicate years after neutrality was proclaimed, the independent design of the Austrian fixed exchange-rate regime was acceptable both to the Soviet Union and to the United States. Over time, however, such a regime proved stable because it tended to be underpinned by anti-inflationary monetary policies. Most important, the essential buffering mechanism—necessitated by domestic preferences for both economic openness and political autonomy—was internalized.<sup>37</sup> A hard-currency peg became part of the formula to stabilize postwar social arrange-

72; Audrey Cronin, *Great Power Politics and the Struggle over Austria, 1945–1955* (Ithaca: Cornell University Press, 1986).

36. Katzenstein, *Corporatism and Change*.

37. Beth Simmons demonstrates on various dimensions how the country proved incapable of just such internalization during the interwar years. See Beth A. Simmons, *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years* (Princeton: Princeton University Press, 1994).

ments for distributing the economic and political costs and benefits of gradually opening the country once again to the German economy.

It is true that there was no automatic consensus on the notion of fixing the bilateral Austrian-German rate at a level marginally favorable to the cause of Austrian competitiveness. Certainly no one could talk of such things openly. For one thing, German workers would not like to hear it. For another, both before and after 1955 the Russians were highly attentive to such matters, and bilateral concertation tended to sound like a new *Anschluss* to them.<sup>38</sup> Austrian employer groups and industry leaders, moreover, were of two minds. They understood the logic of bilateralism, but they also hoped to create options for export diversification in the future. In this light, a flexible exchange rate, especially a downwardly flexible one, could in principle be of considerable assistance.<sup>39</sup> Along that second line, even labor unions focused on Germany could be tempted by the lure of devaluation.

During the 1960s, such matters were not so much the subject of academic disputation as of practical experimentation. In 1961 and again in 1969, broad revaluations of the deutschmark on world markets seemed to present opportunities. The schilling was then still formally pegged to the dollar and did not therefore automatically follow the deutschmark upward. The social partners—business, labor, and government—clearly hoped in each case that the resulting undervaluation of the schilling would open new markets for Austrian exports. What they wound up experiencing, in fact, was domestic inflation, with real and palpable wage losses. Pensioners and others on fixed incomes spoke darkly about the 1920s. For their part, central bank officials eventually used the experience of the 1960s to teach a lesson about real effective exchange rates to all who would listen. Whether or not social learning can really account for the depth of the subsequent political commitment to the peg, ever since 1969 only minor adjustments have occurred in the nominal bilateral exchange rate (see table 9.1). Since the early 1980s, indeed, the rate has been completely frozen.<sup>40</sup> The few nominal changes that preceded that period are nevertheless worth some attention because they marked the points at which buffering mechanisms were deemed most clearly to be needed between powerful economic forces and countervailing political exigencies.

#### *After Bretton Woods*

Central bank officials from the 1960s recall the governor and the finance minister spending considerable time with trade union officials, especially with the head of the ÖGB, explaining the wisdom of a productivity-based wage policy. Such a policy centered on the fixed link to the deutschmark and a follow-the-leader strategy on both interest rates and labor costs. The beauty of the Bretton Woods system, they

38. In interviews with senior monetary officials with memories of the 1950s and 1960s, Russian sensitivities come up again and again. It is clear that this weighed heavily on many minds for many years. Interviews by David M. Andrews, Vienna, March 2001.

39. Retired senior National Bank official, interview by Andrews, March 13, 2001.

40. See von Riekhoff and Neuhold, *Unequal Partners*, 164–65.

**Table 9.1** Exchange rate: Austrian schilling to deutschmark, 1955–1995<sup>a</sup>

<i>Year</i>	<i>Rate</i>
1955	6.19
1960	6.19
1965	6.48
1970	7.09
1975	7.08
1980	7.12
1985	7.03
1990	7.03
1995	7.03

*Source:* Austrian National Bank data

<sup>a</sup>No change in later periods, and the same nominal rate was embedded in the final transition to the euro on December 31, 1998.

held, was that no one had to be explicit about such a strategy. The excessive inflation experienced after the deutschmark revaluations in 1961 and 1969 suggested that Austria should simply have realigned in lock-step, a lesson union leaders were eventually willing to acknowledge. But central bankers initially confronted resistance to this reasoning from business groups, from the chancellor, and from the IMF.

From the point of view of the IMF, the Austrian structural trade deficit suggested then, and well into the 1970s, the need for a devaluation of the schilling. The moment of truth came when the Bretton Woods arrangements finally began to break down. At one level, the 1971 devaluation of the dollar and the final decision to float in 1973 raised an obvious, awkward, and politically sensitive problem. Inside Austria, an understanding had emerged among the social partners concerning the basic industrial strategy decisively shaped by Austrian-German production networks. The straightforward monetary dimension of this reality before 1971 meant simply importing low inflation from Germany via a fixed link between the deutschmark and the dollar. To the extent this may sometimes have necessitated flexibility in wages and production costs inside Austria, the social partners finally stood ready to comply—and to the extent that they could better Germany's performance on inflation, to profit thereby.<sup>41</sup>

As the dollar ceased to be a reliable anchor for that core relationship, however, it was politically impossible to shift to an explicit schilling-deutschmark link. Two things were at work. First, the Russians were still interested and still watching; at the very least, Austrian policy makers were still absolutely convinced of their interest right through to the 1980s. Second, in its own deeply conflicted, historically conditioned way, Austrian nationalism was now a political fact. In the ironic phrase of one former governor, this meant (and still means) that Austrian policy had to be one

41. Note that the social partners were, and are, represented on the governing council of the National Bank.

of “autonomous solidarity” with Germany.<sup>42</sup> The solution that eventually developed, beginning in the early 1970s, was to explicitly tie the Austrian schilling to a basket of currencies while implicitly pegging it to the deutschmark. Inside the central bank, considerable analytical resources were devoted to calculating the basket rate on a daily basis and, whenever necessary to keep the implicit peg rigid, to re-jigging the basket. For Bank traders engaged in actual open-market operations, however, the task was uncomplicated: the target was understood.<sup>43</sup> For those who set Austrian interest rates, somewhat more delicacy was required. Eventually, a standard practice emerged—the board would meet the same day the Bundesbank board met; and whenever the Bundesbank changed its base rate, the National Bank would within the hour “autonomously” decide to match it.

Only in 1975, in unusual political circumstances, was there a brief attempt to step away from this post-Bretton Woods consensus by allowing a slight depreciation of the schilling. Once again, certain business groups and trade union leaders were apparently tempted by a strengthening deutschmark. This seemed, at least to some, an opportunity to expand exports and to secure an extra wage increase, partly to compensate for price hikes occasioned by continuing actions by the Organization of Petroleum Exporting Countries (OPEC) in the world oil markets.<sup>44</sup> But when the National Bank chose not to follow the Bundesbank in a particular interest rate hike, a brief run on the schilling ensued, significant reserves were lost, and accelerating inflation again followed. The lesson of money illusion was relearned, and the fundamental consensus reasserted itself. One central bank official recalls that in the year following this incident, the chancellor for the first time explicitly defended the necessity of the fixed tie to the deutschmark in talks with senior trade union officials.<sup>45</sup>

One final political struggle occurred in 1978–79 when the chancellor and the finance minister took different sides on the question of how to restructure aging industries such as steel. The IMF and the Organization for Economic Cooperation and Development (OECD), in particular, were quite critical of the excessive rigidity introduced in this context by the deutschmark peg. As one National Bank official explained, “We knew that if we gave up the peg, it wouldn’t have changed anything; we also noted the experience of Norway and Sweden, for they had abandoned external discipline but without positive results.”<sup>46</sup> In the event, the Bank

42. Former National Bank governor, interview by Andrews, Vienna, March 12, 2001. As Andrews has pointed out to me, an additional dimension of this creative ambiguity developed in the late 1960s and early 1970s when a Socialist government in Austria opposed the formation of the European Economic Community and its underlying liberal-market principles and also criticized Germany for joining it; in such an environment, an explicit deutschmark link would have been especially problematic. The expanding literature on money and identity is relevant to this point. See, for example, Eric Helleiner, *The Making of National Money: Territorial Currencies in Historical Perspective* (Ithaca: Cornell University Press, 2003); Matthias Kaelberer, “The Euro and European Identity: Symbols, Power, and the Politics of European Monetary Union,” *Review of International Studies* 30, no. 2 (2004): 161–78.

43. Retired policy makers and currency traders of the Austrian National Bank, interviews by Andrews, Vienna, March 2001.

44. Von Riekhoff and Neuhold, *Unequal Partners*, 165.

45. National Bank official, interview by Andrews, Vienna, March 14, 2001.

46. National Bank official, interview by Andrews, Vienna, March 15, 2001.

briefly delayed responding to a rise in German interest rates, a minor devaluation of the schilling ensued, and the skeptics were again proved right. Shortly thereafter, the devaluation was reversed and the exchange rate was rigidly (but unofficially) fixed at 7.03 schillings to the deutschmark. When a similar controversy with the IMF occurred in 1991, the government and the central bank rejected outright its advice to loosen the hard-currency policy, and they even demanded a rewriting of the IMF annual surveillance report on the country.<sup>47</sup>

### *Austria and the Euro*

Throughout the 1990s and until today, the hard-currency consensus remains dominant, even though the success of the peg continues to be subject of some debate both externally and internally.<sup>48</sup> It certainly has made issues of fiscal adjustment more difficult to avoid and contributed to recent political crises, especially those associated with the challenge of pension reform.<sup>49</sup> The rise of the Freedom Party and its frontal attack on the social partnership system brought underlying tensions to the fore in the mid-1990s. A few years later, however, we would have been hard-pressed to find compelling evidence of the dismantlement of that system.<sup>50</sup>

The end of the Cold War, the 1994 move to join the European Union, and the subsequent decision to become a founding member of Europe's Economic and Monetary Union (EMU) opened a new chapter in this continuing story. On one level, there is no puzzle surrounding the ease with which the schilling followed the deutschmark into EMU—the fixed link of both currencies to the euro simply replaced a bilateral connection. On another level, however, a subtle but important change was involved.

The full significance of Austria's efforts to move beyond the dogma of neutrality as the Cold War was ending, and to embrace European integration as it was deepening and broadening, goes beyond the scope of this chapter. For present purposes, it is necessary merely to note the clear-eyed perception of Austrian monetary policy makers as they oversaw the transition from the era of the hard schilling to the era of the euro.<sup>51</sup> At base, the move meant abandoning a reliable but relatively passive set

47. Interviews by Andrews, Vienna, March 15, 2001.

48. For an exhaustive look at the economic performance data over time, see Karl Pichelmann and Helmut Hofer, "Austria: Long-Term Success through Social Partnership," International Labor Organization Employment and Training Papers 51, Geneva, Switzerland: International Labour Organization, 1999. Note, in particular, the data on long-term interest rates, flexible real wage rates, and changes in productivity indicators, all of which closely track German equivalents.

49. For detailed comparative assessments of the common challenges and diverse responses of European welfare states, see Fritz Scharpf and Vivien Schmidt, *Welfare & Work in the Open Economy*, Vols. 1–2 (Oxford: Oxford University Press, 2001); Vivien Schmidt, *The Futures of European Capitalism* (Oxford: Oxford University Press, 2002).

50. Reinhard Heinisch, "Coping with Economic Integration: Corporatist Strategies in Germany and Austria in the 1990s," *West European Politics* 23, no. 3 (July 2000): 67–96.

51. For one thing, as Andrews concludes on the basis of his interviews, the National Bank made clear that it would not rely overtly on the European exchange-rate mechanism in the run-up to the start of EMU. Instead, autonomous solidarity with Germany remained the order of the day.

of policy practices. After all, once the euro was adopted, the notion of autonomous solidarity with Germany became a less ironic turn of phrase. By joining EMU, Austria gained a voice in the making of the monetary policy that it now explicitly shared with Germany and other European partners. To be sure, the volume of the Austrian voice would not match that of Germany in the arcane processes through which European monetary policy was set. But Austria had had no voice in the Bundesbank when it used to call the shots, and it now did indeed have a place at the table when the European Central Bank (ECB) made monetary policy decisions for all member states.<sup>52</sup>

Through EMU, Austria was able to maintain its hard-currency policy in relation to Germany. It therefore had two buffering mechanisms at its disposal as it confronted external markets and the raw economic and financial power of Germany: a cooperative multilateral institution, of which it was now an intimate part, and a continuing internal capacity to match changes in German production costs. But it had lost one as well: the implicit peg with the deutschmark had become explicit and was, thus, more easily subject to scrutiny and criticism by potential opponents of the social market consensus. How this aspect of the change in regime will affect the social partnership remains to be seen.

## Conclusion

“Trust, but verify,” Ronald Reagan is famous for advising U.S. policy makers when they sought new arms-control arrangements with the Soviet Union in the 1980s. If he had been a monetary policy maker in Canada or Austria at any time since 1945, he may similarly have opined, “Cooperate, but maintain room for maneuver.”

As in other arenas of power, neither Canada nor Austria ever really wanted directly to challenge the international monetary priorities of the leading states on their borders. But they also were not supine dependencies with no choice but to accept the external effects of those priorities. Specific monetary decisions taken by those leaders affected them and could either be acquiesced in or countered. Canada and Austria wanted to get as much as they could for their societies from their most important economic relationships, but they also sought to build and maintain separate nations.<sup>53</sup> To accomplish their objectives, carving out as much practical autonomy as possible was the critical task. For these states, monetary statecraft meant crafting institutional and policy buffers. Those buffers specifically promised to limit the power of their lead partners to deflect on to them the transitional costs of bilateral adjustment and sometimes of system maintenance. They also worked to sustain distinctive national identities, although it remains difficult to assess their precise contribution to this effort.

52. Interview by Andrews, Vienna, March 16, 2001.

53. This theme deserves more extensive study. For background on the Austrian case, see John Breuilly, *Austria, Prussia and Germany 1806–1871* (London: Longman, 2002); on the Canadian case, see John Holmes, *Life with Uncle* (Toronto: University of Toronto Press, 1981).

In the face of such follower strategies, what was left for the leaders? Acquiescence to the buffers when the leaders were leading wisely and fruitless confrontation when they were not. As previously noted, the willing acquiescence of followers is commonly viewed as the key distinction between coercive power and authoritative leadership. In the two special relationships explored here, acquiescence by the leaders to the use of effective buffers by their followers was the best response. Coercive attempts to make the follower change strategic tracks, most overtly in the 1971 U.S.-Canadian dispute, failed. In other words, monetary power conceived in the relational sense confronted distinct limits.

In comparing the Canadian and Austrian cases, it is not the existence of buffers in the crucial bilateral currency relationships that varies but their character. This variance seems functionally related to the deeper historical trajectory of internal political economies. At particular times in both cases, windows opened on the possibility of serious participation in truly multilateral institutions that just might substitute for less subtle buffering mechanisms. Only very recently in the German-Austrian case did such a choice seem partially to meet the basic political requirements of the follower state. In terms of effectively responding to the Austrian insistence on having a real voice in making shared monetary policies, the ECB may satisfy Austria in a way not dissimilar from the way Louis Rasminsky once hoped a Keynesian currency union might satisfy Canada. Austria may, as a consequence, already wield more regional monetary influence than Canada does in its context. In the end, however, it remains doubtful that cooperative multilateral mechanisms have ever convinced many people in either country that they should be relied on as the ultimate political buffers. After all, Austria and Canada both retain their own central banks, and both continue, each in its own way, tenaciously to defend their room for maneuver in more deeply integrating regional economies.

In the Canadian case, the final buffer was always a flexible exchange rate; only once was another option briefly pursued. When Rasminsky advised the federal Cabinet to consult with business and labor groups on measures to support a repegged exchange rate, he meant coordinated measures to render domestic prices and wages downwardly flexible. This was a pipe dream because Canadian society has always lacked the sense of solidarity and social cohesion necessary either to design or to implement such measures; the Austrian ideology of social partnership has no counterpart in liberal Canada. But neither does the alternative ideology of neoliberalism resonate deeply in a dualistic nation built across a continent of diverse regions. A flexible exchange rate is the one instrument under national control that can limit the capacity of the United States to export the costs of bilateral adjustment and system maintenance. It is also the one instrument the state could reliably use to ameliorate the adjustment burdens generated within Canada and to distribute those burdens across a fractious society.

Austria could have pursued a similar course over the decades since World War II. Certainly many Canadian economists expected them to do so, as did the IMF. At times, even industrialists within Austria advocated exchange-rate flexibility. But actual experience reinforced the contrary view. Useful for those advocating a hard-cur-

rency policy were memories of the 1920s, but especially important was a remarkably enduring social consensus on the wisdom of keeping inflation low so as to ensure that Austrian production costs would always marginally undercut competing German costs. Even so, such a consensus would have meant little in the absence of workable political mechanisms for rendering real prices and wages within Austria seriously flexible when circumstances so required. The social partnership system born in the bloody class conflict of the interwar period proved robust enough to serve this purpose throughout the postwar era. Some skeptical observers now argue that the country's coordinated market economy is under serious threat because the necessity of pension reform and rising regional demands push it to the breaking point. Such a contention remains doubtful, at least with respect to monetary policy, and it downplays the historical success of negotiated flexibility within the Austrian economy.

It may be true that only certain follower states, mostly located in the advanced industrial core of the global system, can now craft, defend, and use such buffers at the interface of their societies and leading external markets; that is, it may be true that only a few states today can seriously contemplate monetary statecraft. There is, however, no reason to accept such an assertion without further empirical research. Certainly Scott Cooper (chap. 8 in this volume) suggests otherwise. Diverse monetary strategies certainly remain possible for some, and not only for the powerful. Moreover, the specific choices follower states can make appear, on the evidence of this chapter, remain deeply conditioned by underlying institutional idiosyncrasies. Monetary power and its limits, the Canadian and Austrian cases also suggest, must be understood not only in straightforward relational terms but also in light of the various domestic political arrangements that continue to exist within modern capitalism. Future scholarship on the dynamics of monetary power, as well as on grand strategic projects to transform such power into meaningful authority, needs to take such domestic arrangements seriously.

