

# Fiscal Policy and Capital Mobility: The Construction of Economic Policy Rectitude in Britain and France

BEN CLIFT & JIM TOMLINSON

It is a commonplace of both political and academic argument that the last quarter of the twentieth century saw major diminution of national economic policy autonomy, with increased capital mobility identified as the key explanatory variable.<sup>1</sup> Schor charts the 'rise and fall of the national model',<sup>2</sup> and many concur, identifying a decline of the doctrines of 'Keynesianism' as synonymous with this declining national capacity.<sup>3</sup> Even leading politicians subscribe to the argument. Thus, for example, Tony Blair noted in his 1995 Mais lecture: 'We must recognise that the UK is situated in the middle of an active global market for capital—a market which is less subject to regulation today than for decades. An expansionary fiscal or monetary policy that is at odds with other economies in Europe will not be sustainable for very long. To that extent the room for manoeuvre of any government in Britain is already heavily circumscribed.'<sup>4</sup>

Responding to these widespread ideas about the constraints on national economic policy, Cohen identifies the key research agenda to which this article contributes:

The interesting question ... is not whether financial globalization imposes a constraint on sovereign states; it most clearly does. Rather, we should now be asking how the discipline works and under what conditions. What accounts for the remaining room for manoeuvre, and why do some countries still enjoy more policy autonomy than others? ... It is time to move beyond broad generalizations about the logic of the unholy trinity [see below] to more disaggregated analysis of the complex linkages between global finance and domestic performance.<sup>5</sup>

The existing literature offers some qualification regarding the strength of the constraint along two main lines. Firstly, empirical evidence shows that welfare states show no general cutbacks since the sharp increase in capital mobility, only an end of expansion.<sup>6</sup> Secondly, Mosley identifies the narrow focus of financial markets on a few macro aggregates in advanced capitalist democracies, notably

Ben Clift and Jim Tomlinson, c/o Department of Politics and International Studies, University of Warwick, Coventry CV4 7AL, UK.

the rate of inflation, deficit and debt ratio, in determining government credibility.<sup>7</sup> This focuses our attention on the *construction* of financial credibility as a key issue in determining the degree and nature of enduring policy autonomy (or conversely the constraints thereon). This in turn draws our gaze to the institutional and ideational context in which ‘credibility’ is constructed, and the crucial role herein of a number of agencies.<sup>8</sup>

Despite such qualification regarding capital mobility impact, the idea of the 1970s as a watershed for national policy autonomy is still pervasive.<sup>9</sup> This article looks at how economic policy credibility is constructed in the contemporary period (1997–2003) and goes on to analyse the degree of enduring fiscal policy autonomy in two advanced industrial economies—Britain and France.<sup>10</sup> Our selection of the British and French cases illustrates the different policy autonomy implications of choosing fixed or floating exchange rates.

The article is divided into three sections. The first sets out, and critiques, the prevailing orthodoxy regarding capital mobility and economic policy autonomy, namely, the ‘strong’ version of the Capital Mobility Hypothesis (CMH). The second establishes the ideational and institutional context within which financial credibility is constructed with reference to the International Monetary Fund (IMF), bond-rating agencies, and the euro and its Stability and Growth Pact (SGP). The third section explores fiscal policy-making autonomy, and the constraints thereupon, in the context of increased capital mobility in Britain and France since the early 1990s.

### **The changing international political economy and national policy autonomy**

The scale, instability and speed of capital flows has increased markedly since the collapse of the Bretton Woods system in the 1970s. This is not to say that capital mobility was not a prevalent feature of the international political economy under Bretton Woods,<sup>11</sup> rather that the scale and nature of mobility has increased very significantly since the 1970s. In the contemporary international political economic context, ‘world-wide trading of currencies and government bonds means that exchange rates and interest rates, the two critical variables in the formulation of national macroeconomic policy, are determined in the context of global financial markets’.<sup>12</sup>

Credibility with financial markets has become an inescapable priority for macroeconomic policy makers.<sup>13</sup> Governments are increasingly convinced of the merits of ‘stability’, or low and stable rates of inflation and fiscal discipline, adopting restrictive monetary policies in order to avoid incurring a ‘risk premium’ imposed on borrowing by investors suspicious of potentially inflationary macroeconomic stances.<sup>14</sup> Capital mobility and financial deregulation changed the cost/benefit analysis of macroeconomic strategies. Yet, whilst it is undoubtedly the case that the power balance has shifted in favour of private capital holders, such a disparate and diverse group of actors does not ‘impose’ a policy agenda on states.

There was, it should be recalled, more than one route to credibility. Many neoliberal opinion formers strongly favoured floating rather than fixed exchange rates because they explicitly rejected the Keynesian welfare state model that the

fixed rate regime of embedded liberalism permitted. An alternative ‘ordo-liberal’ path to credibility could be pursued in the European context by pegging to the Deutschmark and ‘importing’ German credibility—often initially at the cost of high interest rate premia and deflationary fiscal policies.<sup>15</sup>

### **The ‘Capital Mobility Hypothesis’**

The Capital Mobility Hypothesis posits (and, we argue, overstates) a powerful constraining effect of financial capital mobility upon macroeconomic policy.<sup>16</sup> Cohen’s ‘unholy trinity’ identifies the intrinsic incompatibility of exchange-rate stability, capital mobility and national policy autonomy.<sup>17</sup> With relation to exchange rates, one choice facing policy makers is: fixed or floating? Under fixed exchange rates, capital mobility increases the efficacy of fiscal policy but eliminates monetary policy autonomy; whilst, under floating rates, capital mobility renders fiscal policy ineffective, but monetary policy can be set independently.<sup>18</sup>

Increasing financial liberalisation and deregulation have facilitated capital mobility, structurally empowering investors (and particularly large financial institutions) vis-à-vis governments.<sup>19</sup> These empowered actors, Oatley argues, ‘prefer low inflation and balanced budgets and rapidly shift their funds in response to macroeconomic policies that threaten to generate inflation or otherwise reduce the return on investment relative to other national markets’.<sup>20</sup> The ‘stringent logic’ of the ‘unholy trinity’ imposes, according to Cohen, ‘an increasingly stark trade-off on policymakers’<sup>21</sup> which allegedly leads governments to eschew expansionary fiscal and monetary policies in favour of tight money and balanced budgets.

With regard to capital mobility, one putative policy choice is whether or not to employ capital controls. Yet, in the wake of the removal of all capital controls across the European Union (EU) in 1990, resorting to capital controls seems an unlikely (and probably ineffective) policy scenario.<sup>22</sup> Thus our analysis explores, in the absence of the re-imposition of capital controls, how much policy autonomy governments retain in the contemporary period.<sup>23</sup>

As noted above, empirical evidence, addressing both the 1980s and the 1990s, suggests that the fiscal ‘wiggle room’ or policy space is considerably greater than the stark logic of the unholy trinity suggests.<sup>24</sup> The reason the ‘hypothesis’ and ‘trinity’ may be not wrong but overstated relates to the causal mechanisms by which such complex processes impact on, or rather *interact with*, states and state actors. The logic of the ‘trinity’ is rooted in a ‘textbook’, perfectly integrated, open international economy. There is evidence that short-term markets exhibit a high degree of integration.<sup>25</sup> That said, a range of global finance scholarship points to home bias and limits of flows measured, as well as lack of profit equalisation between markets.<sup>26</sup> To the extent that the real conditions that obtain in international financial markets diverge from the textbook caricature, we may expect limitations on the operation of the constraints the CMH posits.

Our approach to capital mobility and its impact on national policy autonomy takes methodological issue with the dominant strand of international political economy analysis, which Sinclair terms the ‘structural approach’ to international

capital mobility, rooted in the 'state-centric ontology of neorealism'.<sup>27</sup> These scholars see international capital mobility as a purely exogenous constraint on states conceived as unitary actors with fixed preferences.<sup>28</sup> Yet Sinclair argues convincingly that 'linear structural models of cause and effect between [international capital mobility] and the state are ... likely to be inadequate understandings of what is really a reciprocal or dialectical process'.<sup>29</sup>

Our analysis involves a number of departures from the 'structural approach'. First, it is important to disaggregate beyond the level of the state. The changing international economic context has, Dyson points out, structurally empowered particular groups and constituencies within state elites, notably central bankers and finance ministries.<sup>30</sup> For example, one reason why Economic and Monetary Union (EMU), in Elie Cohen's term, set in marble the strategy of competitive disinflation<sup>31</sup> was that it bore the imprint of the 'conservative liberal' French financial elite of the *Trésor* and the *Banque de France*, empowered within the French state by the European Monetary System (EMS), and then the Exchange Rate Mechanism (ERM).<sup>32</sup>

Second, attention must be paid to this institutional and ideological context within which the constraint imposed on states is constructed. The role of key international institutions (such as bond-rating agencies and the IMF) needs to be addressed in shaping the preferences and understandings of economic rectitude that prevail within the international political economy.

Third, the ideational level must be afforded due weight in analysis. Structuralist and exclusively material accounts miss the role of ideational factors in shaping economic policy rectitude, neglecting what Dyson has termed 'the underlying importance of ideas as real phenomena and of their internalisation by domestic elites ... [which] ... underlines the complex interweaving and mutual interdependence between the material and the ideational'.<sup>33</sup> As Keynes pointed out with his beauty contest analogy, an early constructivist approach to credibility in financial markets, markets are often less interested in the economic fundamentals than in other actors' (not necessarily exhaustively well informed) perceptions of those fundamentals. Focusing on this ideational level requires taking account of the interaction of agency and structure. Structuralist accounts within the CMH framework neglect the agential role of governments, treasuries and financial elites within the core executive in the process of the construction of economic rectitude (demonstrated in the empirical sections below).

The mobility of different forms of financial capital has different implications for policy autonomy. For example, Mosley's analysis of the policy consequences of deregulated bond markets has revealed that, as far as developed economies are concerned, only specific indicators are of interest to key market actors, leaving extensive latitude to governments in how they deliver these indicators, and indeed to pursue policies which do not adversely affect the key indicators.<sup>34</sup> Inflation is a pressing concern and, to a lesser extent, budget deficits, although 'the influence of financial markets on government policy is much stronger on the monetary policy side than on the fiscal policy side'.<sup>35</sup> Little else is afforded significant attention, with quantitative analysis unearthing a surprisingly small impact on risk premia of sizeable shifts in budget balance.<sup>36</sup>

### **The contemporary international political economy and the institutional context of policy autonomy**

This more fine-grained analysis of how capital mobility operates, its interaction with domestic policy actors, and what institutions shape its impact, is necessary to unearth how financial credibility is constructed. The following sections set out briefly several key elements of the ideational and institutional context within which fiscal policy rectitude is constructed for advanced economies.

#### *The IMF*

In the period between the foundation of the IMF and the breakdown of the fixed exchange rate system in the early 1970s, the financial credibility of governments in advanced economies was closely tied to the role of the IMF. As the scale of private lending activity increased, and the role of private credit-creating bodies has expanded,<sup>37</sup> this intimate linkage became more arms-length. The IMF continues to perform the surveillance function laid down in the 1978 rewriting of Article IV of its Articles of Agreement, gathering large amounts of data and regularly publishing its opinion of the economic policy rectitude of governments. This remains a significant contributory factor to the intellectual climate of opinion. However, in the absence of the leverage it enjoyed as a lender, IMF influence on economic policy making within advanced capitalist democracies is greatly reduced.

The economic context of the climate of opinion has seen some quite dramatic shifts in very recent times. For the last three decades of the twentieth century fears of inflation dominated financial markets and much government economic thinking. Such fears formed a crucial element of the context in which economic policy was discussed. Yet by 2002 concerns about deflation, especially in Japan and China, led to the setting-up of an IMF task force.<sup>38</sup> This stressed the conjunction of declines in global equity markets, excess capacity in many industries, slow economic recovery, geopolitical uncertainties and higher oil prices as evidence of how deflationary pressures might emerge. Whilst noting that the danger of a global deflation was small, nevertheless the IMF warned of the potential difficulties of a falling price level, the need to prevent any such deflation before it occurred, and the desirability of constructing unorthodox policy responses if the threat strengthened. Although the deflationary threat has since abated, very low inflation itself involves a strikingly different economic environment from that prevailing since the 1970s, not least because of associated low interest rates. Such rates mean that government debt burdens are much reduced, making worries about fiscal unsustainability, so prevalent up to the 1990s, much less plausible. In turn, much of the edifice set up to constrain the fiscal 'irresponsibility' of national governments seems anachronistic. This highlights the contingency and context-specificity of financial credibility, something which is much underplayed in accounts which focus on neoliberal policy constraints 'imposed' by financial markets.<sup>39</sup>

*Bond-rating agencies*

In the wake of the internationalisation of capital markets in the contemporary period, as the scale of private lending activity increased,<sup>40</sup> the views of the major bond-rating agencies, Moody's and Standard & Poors, on the creditworthiness of governments became much more significant, especially as capital markets grew more important as sources of financing relative to traditional bank loans.<sup>41</sup> These agencies, in rating sovereign bonds, became an important indicator of the credibility of government economic policies, and today play a key role in inducing confidence regarding borrowing governments within these disintermediated international capital markets.

The apparently objective and scientific nature of the rating process is spurious. Analysis is both quantitative and qualitative, is bound up with prior assumptions about economic rectitude, and thus involves value judgements. A particular paradigm, strongly influenced by new classical macroeconomics and the political economy of the neoliberal 'New Right', prevails. Indeed, the peculiarly influential position of the bond-rating agencies within the international political economy has contributed to the dissemination of this world view and its emergence as a policy orthodoxy. Sinclair, for example, situates this ratings process within a wider 'construction' of 'deficit discourse' involving particular notions of fiscal rectitude.<sup>42</sup>

No doubt partly because of the low inflation and low interest rate international political economic context, the shifts in the relative importance of actors involved in the construction of rectitude does not appear to have reduced policy autonomy. Whilst bond-rating agencies have had some structural impact on the frameworks in which fiscal policy has been developed, these institutions have not been a source of fiscal policy constraint in the late 1990s and early 2000s. Whatever the misgivings felt by these agencies about fiscal prudence in Britain and France, they have deemed both governments as wholly creditworthy throughout the period under discussion here, with Moody's assigning the long-term sovereign bonds of each country a rating of AAA since the early 1990s.<sup>43</sup>

*The institutions of European economic and monetary integration*

Of primary importance in shaping credibility in the contemporary European context is the process of European monetary integration, and the political economic paradigm which has underpinned it.<sup>44</sup> As noted above, a particular set of core executive elites of the key countries (notably central bankers and finance ministry technocrats) was structurally empowered in the process of constructing EMU.<sup>45</sup> The imprint of this process can clearly be seen in the neoliberal sound money and finance orthodoxy that shaped the paradigm within which EMU was conceived, developed and implemented. The influence of this particular paradigm also 'fed through' into governments' credibility, bolstering fiscal policy rules, firstly in the Maastricht convergence criteria and subsequently in the Stability and Growth Pact.

This illustrates the *interaction* between capital markets and state actors. The relationship between policy elites, the institutional parameters noted above and financial market actors engaged in the construction of economic rectitude is a complex and reciprocal one. Mosley notes that the Maastricht criteria became widely used by global bond market participants as a metric of financial credibility. Financial elites within the core executives of the EMU participating countries were thus engaged in the construction of the yardsticks by which their fiscal rectitude would be judged, notably by specifying an ‘appropriate’ level of deficit at 3 per cent.<sup>46</sup>

As Dyson notes, ‘EMU involves powerful changes to material realities ... the form and impact of these effects is also shaped by ideas and their discursive construction’.<sup>47</sup> In this sense, state actors, and their interactions with financial markets, were constitutive of financial market policy constraints. Significantly, ‘governments that adhered to the rules quickly gained credibility with financial markets’. Thus advanced industrial economies are judged in global bond markets by a narrow set of rules, which, under certain conditions, governments are able to set.<sup>48</sup>

For members of the eurozone the SGP involves legally enforceable constraints on fiscal policies, which largely supplant the constraints maintained by financial markets and international financial organisations in the previous decades. The very existence of the SGP reflects worries that within monetary union individual national governments would face looser constraints, potentially leading to spillover effects from national policies to the wider eurozone.<sup>49</sup> How far this has a significant impact on national governments depends both on the rules of the SGP and the extent to which governments are persuaded/coerced into compliance.

To limit ‘bad behaviour’ by national governments the EU pursued a number of policies. One was to legislate a ‘no bail-out’ rule, so that financial institutions lending to individual governments would not be misled into believing that such lending would be guaranteed by the Union as a whole. Second, limits were placed on bank holding of government debt to prevent excessive monetising of the debt and the risk that excessive borrowing could threaten the stability of financial institutions.<sup>50</sup> Finally, the SGP was introduced, with its rules about the fiscal policies of individual governments, backed by sanctions.<sup>51</sup> The SGP, agreed after fraught political negotiation, reflected the German-led insistence on a tough regime. In addition to a reassertion of the 3 per cent and 60 per cent ceilings, a medium-term aim of a budget ‘close to balance or in surplus’ was inserted. As part of the Pact governments have to submit an annual stability programme. Only in exceptional circumstances (defined in terms of deep recession) will deficits be allowed to exceed 3 per cent.

Deficits fell most sharply in the run-up to 1999, signalling the political commitment of governments to accept the very rough and ready targets of the Maastricht Treaty and the SGP and bear this cost of the euro. The recent arguments about the crudity of the SGP should not blind us to the fact that fiscal discipline was asserted very successfully in the 1990s. In that context current differences appear so far at least quite marginal.<sup>52</sup>

While almost all commentators accepted the need for fiscal discipline, some questioned the desirability of any rules at all, while others questioned the particular rules applied. Although Article 104 of the Maastricht Treaty specified analysis of the role of public investment within the deficit, as well as assessment of the economic cycle and the medium-term budgetary position, these precisions have been largely forgotten.<sup>53</sup> The crude deficit rule made no allowance for the state of the economic cycle, nor the fact that most countries started with significant structural deficits (i.e. deficits not caused by the cycle). Nor did the debt rule address under what conditions debt becomes unsustainable.<sup>54</sup> In fact, the deficit rule would not be very restrictive in the medium term if we make a simple comparison with long-run fiscal policy.<sup>55</sup> Only rarely have governments run deficits of more than 3 per cent, which suggests that such a rule does not involve a tightening of rules enforced by previous institutional arrangements, although admittedly changing underlying conditions make such comparisons complex.<sup>56</sup> Had the euro been launched at a time when structural budgets were in balance, or had a period of faster growth preceded the 2002 slowdown, the 3 per cent rule would probably not have caused difficulties.

Slow growth of the euro area since 2001, exacerbated by the slow response of the European Central Bank (ECB) to the slowdown, forced fiscal policy into a more expansionary form.<sup>57</sup> The ECB's policy record has been unaccommodating and betrays its excessively inflation-oriented agenda, which in turn reflected the sound money and finance agenda instilled in the foundations and architecture of EMU,<sup>58</sup> despite the brief emergence of deflationary fears detailed above.<sup>59</sup> In 2002 warnings were issued to Germany and Portugal, and later France, about excessive deficits. This created a political crisis for the European Union, not least because of the founding assumption of the SGP that Germany would be the model of fiscal rectitude.<sup>60</sup>

This account of the evolution to date of the SGP emphasises how *contingent* on political and economic circumstances its terms have been. More significantly, it does not seem that the SGP has made any major difference to the capacity of national governments to conduct their own fiscal policies. Analysing budgetary policy pursued in the eurozone during the period 1997–2002, Mathieu and Sterdyniak conclude that the Commission's infrastructure for enforcing the SGP 'seems to have had almost no impact on national policies'.<sup>61</sup> Contrary to the Commission's desire for balance, the structural budget deficit (not including debt servicing costs) grew by 1.2 per cent of gross domestic product (GDP) between 1997 and 2002. The eurozone public deficit in 2002 was 2.3 per cent (not the 0.3 per cent of the 2001 Stability Plan). Moreover, no fewer than nine euro countries are set to miss the 2004 target for budgetary equilibrium, despite the Commission's exhortations.

### **French fiscal policy**

Increasing financial liberalisation and deregulation facilitating capital mobility allegedly leads governments to eschew expansionary fiscal and monetary policies in favour of tight money and balanced budgets.<sup>62</sup> Yet the degree of constraint and starkness of policy trade-offs posited by CMH scholarship and



outlined above are difficult to reconcile with the recent history of French fiscal policy making.

In the early 1990s, as recession took hold, Bérégovoy's government pursued a bold, countercyclical, expansionary fiscal policy, justified in Keynesian terms by the need to counter the demand squeeze. This must also be situated in its appropriate electoral context. The socialist government was trying, unsuccessfully, to stave off a crushing defeat, punishment for its having overseen rising unemployment and a growth in inequality in the post-1983 U-turn period.<sup>63</sup> This countercyclical fiscal stimulus, in combination with a deepening recession, led to a decisive breach of the Maastricht 3 per cent public deficit criteria. Peaking at 5.6 per cent in 1993, France remained in breach until 1998.<sup>64</sup> As slow growth, compounded by the need to steer a path consistent with the Maastricht convergence criteria, continued to exert pressure on the public finances, fiscal policy became more restrictive. The public deficit was progressively reduced between 1995 and 1997 as the 3 per cent reference value became a key policy concern. Austerity measures and fiscal tightening brought the deficit down, according to official figures, to 3.1 per cent in 1997.<sup>65</sup>

Meeting, or just missing (depending on which figures you trust), the 3 per cent reference target in time for accession to EMU involved some creative accounting. This illustrates the socially mediated nature of economic credibility, and the role that states, and in particular finance ministries, can play in constructing their own fiscal rectitude. The French state agreed to take over the future pension obligations of France Télécom in return for a payment of 45 billion francs to the French state.<sup>66</sup> This enabled the French state to massage downwards its public deficit figure, bolstering perceptions of soundness but not improving the 'economic fundamentals' upon which those perceptions were supposedly based.

French public finances subsequently improved considerably, in no small part as a result of the economic upswing between 1997 and 2000. The extent to which French fiscal policy was directed at the Jospin government's employment and redistributive priorities illustrates the existence of the room to manoeuvre. Targeted redistributive measures gave an expansionary boost to purchasing power in the French economy. From 1999 onwards, public spending accelerated and budgets became more redistributive.<sup>67</sup> Combined with redistribution to lower income brackets with a higher propensity to spend, this kept demand buoyant during the growth period. Purchasing power as a proportion of household revenue increased by 16 per cent between 1997 and 2002 (the largest 5 year increase in over 20 years).<sup>68</sup> Thus there has been continuity in the role and importance of automatic stabilisers within the French fiscal policy framework through both the recession of the early 1990s and the downturn which followed a decade later.

The degree of policy autonomy in both decisions appears considerable and gives the lie to the supposed tight constraints imposed by capital mobility. Indeed, the critique of the SGP that it takes no account of the economic cycle is double-edged. Some point to a lack of symmetry in the SGP arrangements which leave governments excessively *unconstrained* during economic upswings.<sup>69</sup> In 2000, for example, the Jospin government embarked on the biggest tax cut in 20 years.<sup>70</sup> Given the subsequent worsening of the economic

climate and the public finances between 2001 and 2003, many retrospectively criticised it for being excessively profligate with its *cagnotte* (tax windfall), using it to cut taxes rather than repay more debt.

The Jospin government reduced its debt-servicing burden due to lower interest rates, not debt reduction. Indeed, debt levels were rising in this period. In the last decade, although dipping as a result of the upswing to just below 57 per cent of GDP in 2001, French public debt has increased substantially, with government forecasts predicting 65.6 per cent of GDP for 2005.<sup>71</sup> Although a considerable burden, the costs of debt would have been more punitive in the absence of EMU, with investor confidence in the advent of the euro reducing interest rate risk premia in the mid-to-late 1990s.<sup>72</sup> Further ‘wiggle room’ was afforded by the specific context of the restructuring of French capitalism in the late 1990s and early 2000s.<sup>73</sup> Given the draw on the public purse of debt-servicing, (attempted) deficit reduction and tax cuts, receipts from the government’s privatisations programme provided a valuable source of income—50 billion francs per year between 1997 and 1999, which also helped contribute to social spending priorities.

Room to manoeuvre is further provided by the role that governments and finance ministries play in constructing the narrative of their own fiscal rectitude. Specifically, they are able to exploit the inherent inaccuracy of economic forecasting to present deficit reduction forecasts, and prognoses of future debt levels, in an unrealistically positive light. The SGP-stipulated stability plans explain how, over four years, the public deficit will approach equilibrium. Even annual forecasts are always inaccurate; given this time horizon, governments are tempted to make over-optimistic growth predictions (since pessimistic ones are equally flawed), which would, in a relatively painless way, deliver the budget balance.

French policy makers, it seems, value the room to manoeuvre that can be gained from the role they play in the construction of perceptions of their economic rectitude. This is amply demonstrated in the French stability plan for 2005 to 2007.<sup>74</sup> All forecasting is based on two predicted growth levels (2.5 per cent and 3 per cent); the former, characterised as ‘prudent’ in the document, is still rather optimistic.<sup>75</sup> These documents play a legitimising role, containing solemn, if often vague, pledges of prudence and belt tightening, whilst retaining planned tax cuts. French budgetary policy in 2003 was less restrictive than had been set out in the stability plan,<sup>76</sup> and this is by no means an exception. These are an exercise in reframing perceptions to legitimise government policy, speaking the language of fiscal austerity, whilst using the opportunity to create more room to manoeuvre.

If and when real growth parts from the optimistic prediction, do governments engage in restrictive budgetary policy and further stifle weak growth? Or do they allow the budget deficit to grow? Evidence from France between 2001 and 2004 suggests the latter is at least as viable an option as the former without incurring punishment from financial markets. Despite Commission rebukes for excessively expansionary fiscal policy, and reaffirmations of the 3 per cent rule,<sup>77</sup> France’s September 2002 SGP stability plan, and budget plans for 2003 (based on extremely optimistic growth forecasts), did not conform to the budget balance

requirements by 2004, *nor even* by 2006.<sup>78</sup> France thus remained an ‘unrepentant sinner’.<sup>79</sup>

Perceived absence of tight constraint becomes most evident at crucial moments in the electoral cycle. In the election year of 2002 budgetary policies were sharply expansionary, as spending increased by almost 3 per cent in volume and taxes were significantly reduced.<sup>80</sup> The more expansionary fiscal policy pursued in France, and its impact on internal demand, in part explains the hitherto superior growth performance of France compared to the eurozone as a whole—in both upswing and downswing phases.

Whilst on the spending side the electoral cycle doubtless provided some impetus for the expansion, its impact has been still more dramatic on the receipts side. Many saw the Jospin government’s tax cuts outlined above as an electoral stunt, driven at least in part by a partially populist logic, given the ‘war chest’ provided by economic growth and the proximity of decisive elections.<sup>81</sup> Yet this example pales into insignificance when compared to the tax promises made by Chirac, in a considerably worse economic climate, in the context of the 2002 elections. A centre-piece of Chirac’s campaign was a 5 per cent income tax reduction pledge. The rhetoric of his campaign emphasised expansionary domestic policies and chose to draw a veil over European constraints that these policies blatantly flouted (an approach which had served him well in his 1995 presidential campaign). Excessively optimistic (3 per cent growth) forecasting allowed Chirac to promise the reduction of income taxes by a third by 2007. This was also the date by which he pledged *domestically* to achieve budget balance (in March 2002, Chirac was still telling the Commission and France’s European partners that balance would be achieved in 2004). Unsurprisingly, Chirac and the Raffarin government called for a ‘softening’ of the SGP in the summer of 2003; yet the government did not abandon plans for a 3 per cent income tax cut.<sup>82</sup> A combative Commission initiated Excessive Deficit Procedures against France in May 2003.

The ‘freezing’ of the Excessive Deficit Procedures, against the wishes of the Commission and a number of euro member countries, in the wake of the Ecofin meeting of 24–25 November 2003 provoked a crisis within the SGP. Interestingly, the impact on the financial markets of this crisis of the institutional framework of EMU, which the newly appointed governor of the ECB, Jean-Claude Trichet, warned was a grave danger to the credibility of the euro, was negligible. Indeed, the collapse of SGP coincided with the highest ever value of the euro to the dollar at the end of a 16 per cent appreciation in 2003. Long-term interest rate indicators suggest actors on financial markets continue to have confidence in French policy. Long-term French sovereign bond rates rose slightly from 4.33 per cent to 4.44 per cent<sup>83</sup>—but this was simply a fluctuation and there is no indication of any discernible effect on the costs of borrowing.<sup>84</sup>

Contradicting European Commissioner for Economic and Monetary Affairs Pedro Solbes, French Finance Minister Francis Mer insisted that the ‘spirit of the Pact’ was still being respected,<sup>85</sup> and in this he has some justification—notably the pledge to reduce deficits below 3 per cent by 2005 (in September 2003 French officials had been angling for 2006). That said, French government predictions of a 2.9 per cent deficit in 2005 were again based on

optimistic growth forecasts,<sup>86</sup> with more sober forecasters putting the likely figure at 3.4 per cent.<sup>87</sup>

French economic policy makers' attitudes to European constraint appear schizophrenic. The 2003 budget explicitly rejected the Commission's target of budget balance by 2004, and indeed 2006.<sup>88</sup> Its budget for 2004 contained further tax cut promises which, once again, flouted commitments made to European partners (this time at the Stresa Ecofin meeting) that the deficit would be brought below 3 per cent by 2005. That said, the shift to a more restrictive path (further emphasised in the wake of European disputes in late 2003) was in part a reflection of a concern to keep within striking distance of SGP reference points.

In the context of weak growth France's more austerity-oriented fiscal policies in 2003 and 2004 (including increased social charges to more than offset tax cuts, and plans to cut certain social programmes, notably health insurance) risk establishing a vicious circle whereby the more growth is dampened down by restrictive budgetary policies, the more austerity will be needed to tackle the public deficit and try and rein it in under 3 per cent.<sup>89</sup> A recent IMF report endorsed this view, warning against 'rigid adherence to annual deficit targets [which] can impart a procyclical bias to fiscal policy through contractionary measures to buttress revenues in a downswing', and argued that binding rules which 'allow cyclical revenue fluctuations to be reflected in annual outcomes for the budget balance ... would not sacrifice—and perhaps ... would even enhance—policy credibility'.<sup>90</sup> The IMF raises long-term concerns about fiscal sustainability with relation to pension and health policy reform in particular, but in the short term the Fund is content to endorse the 'full play being given to automatic fiscal stabilizers' in contributing to recovery.<sup>91</sup>

Ironically, although conditions should permit a return to growth of around 3 per cent in 2004–5, which would enable France to meet its commitments as undertaken at Ecofin in November 2003, the likely fly in the ointment is the more restrictive budgetary stance adopted since 2003, dampening demand and consumption and hampering growth. Despite government predictions of a 3.6 per cent deficit in 2004, other estimates put the figure at between 3.9 per cent and 4.2 per cent as a result of weaker growth.<sup>92</sup>

### **British fiscal policy**

Britain was ahead of France in the pace of financial liberalisation, with exchange controls abolished in 1979, and the City of London opened up to much greater competition in the 1980s. Yet, despite substantial institutional and political differences between the two countries, the same broad theme may be repeated: despite this liberalisation the British authorities have been able to maintain a substantial degree of fiscal policy autonomy.

The debacle of Britain's exit from the ERM in 1992 was followed by an attempt to establish a new monetary regime by the specification of an inflation target (2.5 per cent) and the creation of much greater transparency in the conduct of monetary policy. This latter involved the introduction of a regular Inflation Report spelling out the basis of policy monetary judgements and the use of 'seven wise men' to give independent policy advice.<sup>93</sup> This attempt to recon-

struct monetary credibility initially went along with extraordinarily large fiscal deficits. From surpluses in the fiscal years 1988–9 and 1989–90, the recession of the early 1990s saw deficits in both 1992–3 and 1993–4 of 7.8 per cent of GDP—higher even than the alleged *annus horribilis* of 1975–6 when the figure was 7.1 per cent.<sup>94</sup>

Unlike in 1975–6, however, these deficits did not have disastrous effects on confidence. The initial departure from the ERM saw a substantial fall in the exchange rate, but this then stabilised until the end of 1994, to be followed by a 6 per cent fall between January and April 1995. Similarly, widening differentials in interest rates with the United States and Germany only appeared from 1994.<sup>95</sup> Hence through the peak of the deficits the government was not under great pressure for their reduction. Partly this was because, from 1993, the government was imposing very large tax increases to try and get the deficit down; indeed, the two budgets of 1993 together imposed the biggest ever peace-time tax rises in British history. But perhaps most important was the fact that inflation remained strikingly low in the early 1990s; at its lowest point in 1993 it was under 2 per cent.<sup>96</sup> Also of help was the fact that the debt/GDP ratio, though rising, was well inside the Maastricht 60 per cent figure, running between 40–50 per cent at its peak. The Conservative government of the mid 1990s had a proclaimed objective to eliminate public borrowing entirely, although in fact it remained in deficit until it lost office in 1997. However, there was a notable fiscal tightening in the mid 1990s, so that, even allowing for the economic recovery, the fall in the public sector borrowing requirement was very sharp, to 1.2 per cent of GDP in 1997–8.<sup>97</sup>

These policies have of course been conducted against the background of a floating exchange rate since the ERM debacle of 1992. Under the Conservatives the Maastricht fiscal criteria were officially deployed as benchmarks for policy, but without any commitment to the idea that this was paving the way for Britain to enter the projected single currency. By contrast, the Labour government elected in 1997 committed itself ‘in principle’ to euro membership, but in practice this has remained a distant prospect. Although Britain is not therefore a signatory to the SGP, Labour’s commitment to eventual euro entry has led to a clear statement of adherence to the principles of the Pact and its use as one, though by no means the only, benchmark in discussions of British fiscal policy.<sup>98</sup>

A major reason for continuing British wariness about euro entry was the buoyancy of the British economy through the 1990s, with a long upswing in activity after 1992 and only minor interruptions at the end of the 1990s. This upswing, as noted above, allowed a sharp reduction in fiscal deficits from the mid 1990s, albeit in combination with tight controls over expenditure. Initially, these tight controls were maintained by the Blair government, one consequence of the reassessment to which Labour’s macroeconomic policies had been subject in the long years in opposition between 1979 and 1997. The broad thinking behind New Labour’s approach was spelt out succinctly by Ed Balls, a key adviser in Labour’s Treasury team.<sup>99</sup> At the core of his argument was the belief that ‘credibility is the elusive elixir of modern macroeconomics’, a belief founded not only on developments in economic theory in the 1980s and 1990s, but also on the manifest failure of the previous Labour government to maintain

such credibility in the mid 1970s. Bringing together structural and political elements, Balls argued that ‘the rapid globalization of the world economy has made achieving credibility rather more than less important, particularly for an incoming left-of-centre government which has been out of power for two decades’.<sup>100</sup> Ruling out what was seen as the previous errors of fixed and intermediate policy rules (e.g. money supply or exchange rate targets), Balls argued that what was needed was ‘stability through constrained discretion’. In practice, this meant a strategy of establishing a track record on stability which would, after a period, give the government room for short-run manoeuvre.

After its election the Labour government sought to secure this credibility for its macroeconomic policies by two key moves: granting the Bank of England independence in the conduct of monetary policy and committing itself to fiscal prudence. Independence for the Bank of England had in fact been discussed in government circles as far back as 1988, when the Conservative Nigel Lawson was Chancellor.<sup>101</sup> But for a Labour government to grant such independence marked a decisive conversion, both to the priority of low inflation as a policy objective and more broadly to the logic of credibility as the defining issue. Under the new arrangements a Monetary Policy Committee dominated by the Bank has set interest rates on the basis of minuted discussions which, after a short lag, have been placed in the public domain. The aim of policy has been to achieve the existing target of 2.5 per cent inflation, albeit that this would now be ‘symmetrical’ (i.e. the figure would not be allowed to move substantially below nor substantially above this figure).<sup>102</sup> For their part, the principles of fiscal prudence were spelt out in 1998, with two key rules enunciated.<sup>103</sup> The first, the ‘golden rule’, stated that the government would, over the cycle, borrow only to invest and not to fund current spending. The second, the ‘sustainable investment rule’, said that public sector net debt as a proportion of GDP would be held stable, and would normally be less than 40 per cent over the cycle.

It is interesting that these rules differed from those of the SGP. The first rule was less restrictive than the SGP’s commitment to overall budgetary balance or surplus, in part because of the British backlog of public investment, which had been low since the 1970s and significantly below eurozone levels at the turn of the century.<sup>104</sup> The second rule also allowed scope for some expansion of public investment as long as debt did not rise sharply. British debt levels were in any event well below the SGP’s 60 per cent maximum, at around 35–40 per cent at the turn of the century depending upon the precise mode of calculation. Finally, the British rules, by emphasising the need for assessment over the cycle, reflected British recognition of the exceptional severity of the recessions of the early 1980s and 1990s, and the consequent desire to let automatic stabilisers do their work. The British rules should not be seen as in any simple sense ‘slacker’ than the SGP; rather it could be said that they reflected a similar commitment to fiscal prudence but in the context of a different national history. This history, contrary to common perceptions, has seen more budget surpluses in Britain than in any other major Western economy since 1970,<sup>105</sup> albeit that these surpluses seem to have been bought at too high a price in cyclical instability.

In its first period in office after 1997 the Labour government accompanied this prudent fiscal framework with tight limits on public spending growth. However,

from 1999, and especially after its second election victory of 2001, it launched an ambitious spending programme, focused on health, education and infrastructure. The timing of this programme broadly coincided with the deterioration of the international economic environment: hence the characterisation of this period of policy as ‘unintended Keynesianism’.<sup>106</sup> By allowing the deficit to increase the government facilitated a milder slow-down in activity than was experienced in most Western economies. This policy was in line with the commitment to allow the automatic stabilisers to be effective.

The combination of rising spending (including financing the invasion of Iraq) and slowing growth brought the government’s fiscal ‘prudence’ under strain in 2003. Where in the run-up to the budget of 2002 a current budget deficit of £5.7 billion had been predicted for fiscal 2002–3, the outturn was a deficit of £11.7 billion.<sup>107</sup> The government argued that over half of this deterioration was due to the workings of the automatic stabilisers and that, having generated large surpluses from 1999 onwards, it was still on target to return to surplus in 2005–6 and have a current balance over the cycle.<sup>108</sup> By the time of the 2004 budget the fiscal balance had further deteriorated, with a deficit in 2003–4 of £37.5 billion, equivalent to 3.4 per cent of GDP.<sup>109</sup>

The government argues that the projected pattern is still ‘consistent with the Government’s prudent interpretation of the SGP’.<sup>110</sup> This is based on forecast data, which suggest that, on the Pact definitions, the budget deficit will have peaked at a *cyclically-adjusted* 2.3 per cent of GDP in 2003–4, with a small rise in the debt ratio to around 36.5 per cent by 2008–9.<sup>111</sup> However, some authoritative doubts have been expressed about these projections, not in the current cycle, but the next one. The government’s projections, it is argued, depend upon a higher rate of economic growth than is plausible, and therefore tax increases may be required to achieve the fiscal targets.<sup>112</sup>

While some members of Ecofin have expressed doubts about British policy, in general its fiscal rules have been seen as broadly in line with the SGP, but with a recognition of the importance of viewing policy over the cycle. Such assessments are partly underpinned by the recognition that, unlike several members of the eurozone, Britain’s debt ratio (having fallen from the late 1990s) is likely to rise to levels a long way below the SGP criteria, even on pessimistic projections. Indeed, the general point can be made that the SGP criteria are much more of an issue for some members of the eurozone than for three of the EU non-members (Britain, Denmark and Sweden), who, Mathieu notes, are the Commission’s three ‘best pupils’.<sup>113</sup>

New Labour’s macroeconomic policy can thus be seen as a success in its own terms. As one commentator noted: ‘What he [Gordon Brown] really wanted was to be in a position where a Labour Chancellor could comfortably borrow £20 billion a year for public spending without being accused of profligacy and irresponsibility’.<sup>114</sup> This has been done with only minor discomfort. While accusations of profligacy have indeed been made, as might be expected, by political opponents, they have not come with any seriousness from financial markets. In consequence, New Labour has been able to pursue a ‘Keynesian’ policy based on expanding public spending on health and education on a very

large scale during an economic slow-down. Allowing such a deterioration in the fiscal position has been represented as ‘a gamble’ by some commentators,<sup>115</sup> but there is little evidence of loss of credibility. Partly, this is because the growth of the economy in 2003 and after has matched the Treasury’s forecasts, despite the claim of many commentators in 2003 that these were over-optimistic. In addition, the policies pursued have the broad endorsement of the IMF. The Fund’s 2004 country report on Britain expressed some concern at how far the budget deficit really was as cyclical as the Treasury claimed, and therefore looked for a somewhat faster fall in the deficit in future years. But in broad terms both monetary and fiscal policy were seen as appropriate.<sup>116</sup>

### **Rules, credibility and policy space**

Thus in both our cases, although in different ways, policy elites have established tough rules to build credibility, then used the policy space so created to pursue policies which might otherwise be unsustainable. New Labour’s policies in power have followed the prospectus laid out by Balls in 1998.<sup>117</sup> However, all has not gone entirely to plan. The initial fiscal prudence of 1997–9 proved more difficult to reverse than expected, so that for the whole period 1998–2002 public spending and public investment as a share of GDP were below the levels of the government’s Conservative predecessor.<sup>118</sup> Then, when the big public spending increases did start coming through, they coincided with a slow-down in the economy, so that the fiscal balance deteriorated much further than had been anticipated. In response, the government has stuck to its expansionary spending policies, although with substantial slow-downs in the rate of growth proposed for the years after the end of fiscal 2004–5.<sup>119</sup>

In relation to the SGP (in part as a result of the lesser degree of interpretive flexibility inherent in the original rules), French policy makers have also begun to engage in a degree of revision of those rules, again without any demonstrable adverse effects on credibility. Dyson has characterised the SGP as ‘tightened fiscal discipline’, ‘monitoring of convergence programmes’, and “‘hard” coordination with sanctions in the background’.<sup>120</sup> However, after November 2003, this last point requires qualification. Notwithstanding the European Court of Justice ruling of 13 July 2004, which found in favour of the Commission and ‘annulled’ the Excessive Deficit Procedures suspension,<sup>121</sup> this whole episode illustrates the enduring relevance of states (and governments within them) as agents in determining the degree of softness or hardness of fiscal policy coordination.

The virtues of sound money and sound public finances remain a priority, but they have been set in the context of other priorities. The potential for conflicts and trade-offs between them has been recognised, as has the need to allow the free play of automatic stabilisers without straitjackets of tight deficit rules insensitive to the economic cycle or economic circumstances. Credibility could be retained whilst breaching the rules (for ‘sound’ economic reasons given the economic conjuncture). There was nevertheless a desire to retain the rules as reference points and medium-term objectives. The shift can be explained with reference to the different ideational and political economic context in which this re-evaluation took place. The harsh fiscal consolidation in



the mid 1990s was successful in achieving low interest rates and credibility in the eyes of bond and currency market operators.

So solid have been the neoliberal sound money and finance foundations of the EMU project, and the prevalent perceptions arising from them, that French and German governments in particular have been able to attenuate, indeed neglect, budgetary rigour within the policy mix without any resultant ebbing away of confidence and credibility (and lower interest rates). Even the shift from 'hard' coordination, involving fines and penalties, to an altogether 'softer' regime in the wake of the Ecofin agreement to halt Excessive Deficit Procedures against France and Germany has not as yet demonstrably damaged the credibility of French government bonds with financial markets.<sup>122</sup> Whilst untrammelled fiscal recidivism would doubtless damage the credibility of the euro, with impacts on currency and bond markets, clearly the judgement of actors in financial markets suggests that the SGP's fall into abeyance, with France enduring (although, more recently, curtailed) 'unrepentant sinner' status, has not brought us close to that threshold.

## **Conclusion**

The CMH depicts a world of deregulated global finance and eroded autonomous fiscal 'policy space'. The empirical evidence drawn from our case-studies suggests that this view requires significant qualification, and that governments enjoy a good deal more fiscal policy 'wiggle room' than the CMH suggests. The British and French cases incorporate the experience of both fixed and floating exchange rates. Theoretically, very different kinds of policy autonomy should ensue. Significantly, both cases revealed substantial degrees of policy autonomy and offer evidence of fiscal 'wiggle room' both within and outside fixed exchange rate regimes, thus confounding the predictions of open economy macroeconomics (assuming perfect capital mobility). Admittedly, these findings are based on just two cases, and the time period under consideration was, for the most part, an economic upswing. This clearly limits the generalisability of the findings, but the picture which nevertheless emerges contrasts starkly with the predictions of the CMH. Our evidence suggests little or no sign of significant budget deficits and expansionary fiscal policies in Britain and France incurring penalties from anxious financial market actors. CMH scholarship tends to underplay *interaction* and thus neglects the ways in which a range of international and supranational institutions mediate market forces, as indeed do national political authority structures. The importance of the ideational dimension has also been insisted upon here. Economic rectitude is more politically and economically contingent than the inexorable logic of the unholy trinity suggests. In this deeply political process actors are able to shape their room to manoeuvre to a considerable degree.

Furthermore, the recent shift to a more restrictive fiscal policy stance in France has not been driven by the inexorable logic of the unholy trinity. If the constraints do bite harder (and the current and planned French macro policy stance suggests they may), the explanation is to be found in the political and institutional configuration of the eurozone's infrastructure and rules.

Future developments depend much more on the internal politics of the eurozone and the stand-off between the Commission and member states (and more specifically on the reworking of the SGP) than on levels of international capital mobility and changes thereto.

Fiscal policy rectitude is at least in part constructed by actors (notably central bankers and finance ministries) and is not exclusively a tale of exogenous structural constraints (although constraining material conditions clearly play their part). As a result, these goal posts can shift to some degree. The agential role of governments, treasuries and financial elites within the core executive in the process of the construction of economic rectitude and the shaping of the yardsticks by which their credibility levels are judged has been amply illustrated with relation to the Maastricht criteria and SGP.

On a broader canvas, British and French governments' macroeconomic strategies can be seen as powerful illustrations of the continuing room for manoeuvre for national governments (even centre-left governments) in a world of capital mobility. As always, the extent of this room is partly a matter of contingency. The not-wholly-explained continuation of world-wide low inflation has undoubtedly favoured the governments' position. But a considerable part of what has occurred must be put down to a well-crafted strategy of recognising the concessions that have to be made to sustain financial credibility, while also seeing that these concessions by no means rule out the pursuit of quite traditional social democratic policies designed to achieve fuller employment and significantly higher spending on core public services.

In sum, what emerges from the preceding analysis is the context dependency of fiscal and economic policy credibility. In the contemporary context of low inflation and low interest rates, government debt burdens are much reduced. Earlier worries about fiscal unsustainability look implausible and the edifice set up to constrain the fiscal 'irresponsibility' of national governments somewhat anachronistic. Furthermore, it does not seem that, overall, the SGP or UK fiscal prudence rules have made a significant difference to the capacity of national governments to conduct their own fiscal policies. Considerable policy discretion endures and there is little evidence of governments which exploit this policy space losing credibility with financial market actors and being punished accordingly.

## Notes

The authors would like to thank Tony Payne, Timothy Sinclair and three anonymous referees for their comments on an earlier draft of this article.

1. See, for example, David Andrews, 'Capital Mobility and State Autonomy: Towards a Structural Theory of International Monetary Relations', *International Studies Quarterly*, Vol. 38, No. 2 (1994), pp. 193–218.
2. Juliet Schor, 'Introduction', in: J. Schor & T. Banuri (eds), *Financial Openness and National Autonomy* (Oxford University Press, 1992), pp. 4–5.
3. See, for example, Egon Matzner & Wolfgang Streeck, *Beyond Keynesianism* (Elgar, 1991), pp. 3–4; and Anthony Giddens, *The Third Way* (Polity, 1998), p. 16.
4. 'Blair sets out framework to cure economic ills: Mais lecture', *Financial Times*, 23 May 1995.
5. Benjamin Cohen, 'Phoenix Arisen: The Resurrection of Global Finance', *World Politics*, Vol. 48, No. 2 (1996), pp. 283–4.

6. See, for example, John M. Hobson, 'Disappearing taxes or the "race to the middle"? Fiscal policy in the OECD', in: Linda Weiss (ed.), *States in the Global Economy* (Cambridge University Press, 2003); Duane Swank, *Global Capital, Political Institutions, and Policy Change in Developed Welfare States* (Cambridge University Press, 2002); Geoffrey Garrett, *Partisan Politics in the Global Economy* (Cambridge University Press, 1998); and Geoffrey Garrett, 'Global Markets and National Policies: Collision Course or Virtuous Circle?', *International Organization*, Vol. 52, No. 4 (1998), pp. 787–824.
7. Layna Mosley, 'Room To Move: International Financial Markets and National Welfare States', *International Organization*, Vol. 54, No. 4 (2000), pp. 737–73; and Layna Mosley, *Global Capital and National Governments* (Cambridge University Press, 2003).
8. See Timothy Sinclair, 'Deficit discourse: the social construction of fiscal rectitude', in: Randall Germain (ed.), *Globalisation and Its Critics: Perspectives from Political Economy* (Macmillan, 2000), pp. 185–203; and Timothy Sinclair, 'International capital mobility: an endogenous approach', in: T. Sinclair & K. Thomas (eds), *Structure and Agency in International Capital Mobility* (Palgrave, 2001), pp. 93–110.
9. See, for example, Barry Eichengreen, *Globalizing Capital* (Princeton University Press, 1996), Chapter 5.
10. We put primary emphasis here on fiscal policy partly for space reasons. This article is part of a broader research project which aims to look at other policy areas in more depth, and also to historicise the account through diachronic comparison with the 1960s. Yet it is also because it is in the area of fiscal policy that many of the bolder claims about eroding policy autonomy are made.
11. See Margaret Garritsen De Vries, *The International Monetary Fund, 1966–1971: The System Under Stress* (International Monetary Fund, 1976); and Susan Strange, *International Monetary Relations* (Open University Press, 1976).
12. David Held, Anthony McGrew, David Goldblatt & Jonathan Perraton, *Global Transformations: Politics, Economics, Culture* (Polity, 1999), p. 189.
13. The degree of autonomy under Bretton Woods, however, should not be overstated. 'Embedded liberalism' [see John Gerard Ruggie, 'International Regimes, Transactions and Change: Embedded Liberalism in the Post-War Economic Order', *International Organization*, Vol. 36, No. 2 (1982), pp. 379–415] did not remove the necessity to adjust macroeconomic policy in response to balance of payments deficits or surpluses, as numerous examples demonstrate. Britain and the US in the 1960s both had to respond to deficits, and Germany to surpluses, albeit that the pressures to do so were more muted in the latter case.
14. Ed Balls, 'Open Macroeconomics in an Open Economy', *Scottish Journal of Political Economy*, Vol. 45, No. 2 (1998), pp. 113–32.
15. See Ben Clift, 'The changing political economy of France: *dirigisme* under duress', in: Magnus Ryner & Alan Cafruny (eds), *A Ruined Fortress? Neo-Liberal Hegemony and Transformation Europe* (Rowman & Littlefield, 2003), pp. 179–83; Magnus Ryner, 'Disciplinary neoliberalism, regionalization and the social market in German restructuring', in: Ryner & Cafruny, *A Ruined Fortress?*, pp. 204–6; and Kenneth Dyson, 'The Franco-German Relationship and Economic and Monetary Union: Using Europe to "Bind Leviathan"', *West European Politics*, Vol. 22, No. 1 (1999), pp. 25–44.
16. Andrews, 'Capital Mobility and State Autonomy', pp. 194–201.
17. 'In an environment of formally or informally pegged rates and effective integration of financial markets, any attempt to pursue independent monetary objectives is almost certain, sooner or later, to result in significant balance of payments disequilibrium, and hence provoke potentially destabilizing flows of speculative capital. To preserve exchange-rate stability, governments will then be compelled to limit either the movement of capital (via restrictions or taxes) or their own policy autonomy (via some form of multilateral surveillance or joint decisionmaking). If they are unwilling or unable to sacrifice either one, then the objective of exchange-rate stability itself may eventually have to be compromised. Over time, except by chance, the three goals cannot be achieved simultaneously.' Benjamin Cohen, 'The triad and the unholy trinity: lessons for the Pacific region', in: Richard Higgott *et al.* (eds), *Pacific Economic Relations in the 1990s: Cooperation or Conflict* (Lynne Rienner, 1993), p. 147.
18. Thomas Oatley, 'How Constraining is Capital Mobility? The Partisan Hypothesis in an Open Economy', *American Journal of Political Science*, Vol. 43, No. 4 (1999), pp. 1007–9; and Paul Krugman & Maurice Obstfeld, *International Economics* (Addison Welsey, 2003).
19. Jeffrey Frieden, 'Invested Interests: The Politics of National Economic Policies in a World of Global Finance', *International Organization*, Vol. 45, No. 4 (1991), pp. 425–51.
20. Oatley, 'How Constraining is Capital Mobility?', p. 1004.

21. Cohen, 'Phoenix Arisen', p. 286.
22. See Louis Pauly & John Goodman, 'The Obsolescence of Capital Controls? Economic Management in the Age of Global Markets', *World Politics*, Vol. 46, No. 1 (1993), pp. 50–82; and Benjamin Cohen, 'Money in a globalized world', in: Ngaire Woods (ed.), *The Political Economy of Globalization* (Palgrave, 2000), pp. 79–80.
23. Some empirical dissent from the orthodoxy asserting the enduring 'policy space' for (particularly left) governments despite the constraining conditions highlighted by the capital mobility hypothesis relies primarily on data from the 1970s, 1980s and early 1990s—i.e. largely before financial deregulation had reached its zenith (Oatley, 'How Constraining is Capital Mobility?'; Garrett, *Partisan Politics in a Global Economy*). Whilst understandable, this may understate the nature of constraint under deregulated conditions.
24. Swank, *Global Capital, Political Institutions, and Policy Change in Developed Welfare States*; and Mosley, *Global Capital and National Governments*.
25. Oatley, 'How Constraining is Capital Mobility?', p. 1006.
26. Gerald Epstein & Herbert Gintis, 'International Capital Markets and National Economic Policy', *Review of International Political Economy*, Vol. 2, No. 4 (1995), pp. 693–718; Martin Feldstein & Charles Horioka, 'Domestic Savings and International Capital Flows', *The Economic Journal*, Vol. 90, No. 358 (1980), pp. 314–29; Gerald Epstein, 'International capital mobility and the scope for national economic management', in: Daniel Drache & Robert Boyer (eds), *States Against Markets: The Limits of Globalization* (Routledge, 1996), pp. 211–26; and Matthew Watson, 'Rethinking Capital Mobility: Re-regulating Financial Markets', *New Political Economy*, Vol. 4, No. 1 (1999), pp. 55–75.
27. Sinclair, 'International capital mobility', p. 99.
28. Andrews, 'Capital Mobility and State Autonomy'.
29. Sinclair, 'International capital mobility', p. 101.
30. Kenneth Dyson, 'EMU as Europeanization: Convergence, Diversity and Contingency', *Journal of Common Market Studies*, Vol. 38, No. 4 (2000), pp. 645–66; and Kenneth Dyson, 'Introduction: EMU as integration, europeanization, and convergence', in: Kenneth Dyson (ed.), *The European State in the Euro-Zone* (Oxford University Press, 2002), pp. 1–30.
31. Elie Cohen, *La Tentation Hexagonale* (Fayard, 1996), pp. 343–47.
32. David Howarth, 'The French state in the euro zone', in: Dyson, *The European State in the Euro-Zone*, pp. 147–9.
33. Dyson, 'EMU as Europeanization', p. 647.
34. Mosley, 'Room To Move'; and Mosley, *Global Capital and National Governments*. See also Balls, 'Open Macroeconomics'.
35. Mosley, 'Room to Move', p. 759.
36. Indeed, Mosley's analysis indicates that a hypothesised shift from a deficit of 10 per cent to a balanced budget within an advanced capitalist economy would, 'holding all other indicators equal, only lead to a 0.5 per cent improvement in the cost of government borrowing'. See 'Room to Move', p. 759.
37. Randall Germain, *The International Organisation of Credit* (Cambridge University Press, 1997).
38. Manmohan S. Kumar, Taimur Baig, Jörg Decressin, Chris Faulkner-MacDonagh & Tarhan Feyziogülu, *Deflation: Determinants, Risks, and Policy Options*, IMF Occasional Paper, No. 221, Washington DC, 2003.
39. See, for example, John Gray, *False Dawn* (Granta, 1998).
40. See Germain, *The International Organisation of Credit*.
41. See Timothy Sinclair, 'Global Monitor: Bond Rating Agencies', *New Political Economy*, Vol. 8, No. 1 (2003), pp. 147–8. See also Sinclair, 'International capital mobility', p. 102; and Sinclair, 'Deficit discourse'.
42. Sinclair, 'Deficit discourse', p. 195.
43. The last change to long-term sovereign bond rates for France was an upgrade to AAA on 25 February 1992, for the UK an upgrade to AAA on 28 April 1993. See <http://www.moodyseurope.com>
44. Kenneth Dyson & Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford University Press, 1999); and Barry Eichengreen & Jeffrey Frieden (eds), *The Political Economy of European Monetary Union* (Westview, 1994).
45. Dyson, 'Introduction: EMU as integration, Europeanization, and convergence', pp. 7 & 16; Dyson, 'EMU as Europeanization', p. 646; and Dyson & Featherstone, *The Road to Maastricht*, pp. 777–9.

46. Mosley, 'Room to Move', p. 752; and Mosley, *Global Capital and National Governments*, pp. 66–9. Indeed, this yardstick became widely applied to non-EU states *even though* participants themselves recognised there was no good or logical reason for plucking 3 per cent out of the sky. This is no doubt largely because, shaped by central bankers and finance ministry technocrats, these criteria reflected a political economic paradigm that the two sets of actors shared.
47. Dyson, 'EMU as Europeanization', p. 648.
48. Mosley, 'Room to Move', p. 753.
49. There is much debate in the economics literature on the existence/scale of these effects. See, for example, Barry Eichengreen & Charles Wyplosz, 'The Stability Pact: More than a Minor Nuisance?', *Economic Policy*, Vol. 13, No. 26 (1998), pp. 67–113; and Sylvester Eijffinger & Jakob Hahn, *European Monetary and Fiscal Policy* (Oxford University Press, 2000), pp. 81–7.
50. Malcolm Crawford, *One Money for Europe?* (Macmillan, 1996), pp. 304–7.
51. The core commitment of the Stability and Growth Pact is to fiscal discipline and stabilisation. It commits states to the 'medium-term objective of budgetary positions close to balance or in surplus' which 'will allow Member States to deal with the normal cyclical fluctuations while keeping the government deficit within the 3 per cent [of GDP] reference value'. Formally, the Pact consists of three elements: preventive elements which through regular surveillance aim at preventing budget deficits going above the 3 per cent of GDP; dissuasive elements which in the event of the 3 per cent level being breached require member states to take immediate corrective action and, if necessary, allow for the imposition of sanctions; and, lastly, a political commitment by all parties involved in the Pact (Commission, member states, Council) to the full and timely implementation of the budget surveillance process. See European Commission, *The European Economy: Public Finances in EMU* (European Commission, 2000), pp. 45–7.
52. Marco Buti, Sylvester Eijffinger & Daniele Franco, 'Revisiting the EU's Stability Pact: A Pragmatic Way Forward', *Oxford Review of Economic Policy*, Vol. 19, No. 1 (2003), pp. 100–111.
53. Catherine Mathieu & Henri Sterdyniak, 'Réformer le Pacte de Stabilité: L'Etat du Débat', *Revue de l'OFCE*, No. 84 (2003), p. 148.
54. The debt ratio has proved a much less problematic issue, helped by lower interest rates.
55. Mathieu & Sterdyniak, 'Réformer le Pacte de Stabilité', pp. 150–1.
56. Marco Buti, Daniele Franco & Hedwig Ongena, *Budgetary Policies during Recessions* (European Commission, 1997).
57. Christopher Allsopp & Michael Artis, 'The Assessment: EMU Four Years On', *Oxford Review of Economic Policy*, Vol. 19, No. 1 (2003), pp. 12–16.
58. Dyson, 'Introduction: EMU as integration, Europeanization, and convergence'; and Dyson, 'EMU as Europeanization'.
59. Romano Prodi, President of the Commission, called the SGP 'stupid', above all because it restricted counter-cyclical policy at a time when there appeared no threat of inflation, which was fundamentally the problem the rules were supposed to combat. See 'Prodi says euro rules are "stupid"', *Financial Times*, 18 October 2002.
60. Kenneth Dyson, 'Benign or Malevolent Leviathan? Social Democratic Governments in a Neo-Liberal Euro Area', *Political Quarterly*, Vol. 70, No. 2 (1999), p. 198.
61. Mathieu & Sterdyniak, 'Réformer le Pacte de Stabilité', p. 156.
62. Oatley, 'How Constraining is Capital Mobility?', p. 1004.
63. Ben Clift, *French Socialism in a Global Era: The Political Economy of the New Social Democracy in France* (Continuum, 2003), pp. 132–57 & 185–95; and Clift, 'The changing political economy of France', pp. 179–84.
64. This was a historically significant shift in French macroeconomic policy making. Since the Second World War France had avoided ever having a public spending deficit greater than 3 per cent.
65. France, alone amongst EMU participant countries, *officially* failed to respect the 3 per cent deficit figure for its 1997 budget, although other authoritative sources indicated that France *had* met the 3 per cent deficit criterion. See Gael Dupont, 'La politique économique', in: OFCE, *L'économie Française 2000* (La Découverte, 2000), p. 65.
66. Dupont, 'La politique économique', p. 65.
67. Public spending accelerated in 1999 (+2.4 per cent in volume, compared with average of 1.2 per cent 93–7). See Gael Dupont, 'La politique économique', in: OFCE, *L'économie Française 2001* (La Découverte, 2001), pp. 63–5. On the redistribution front, the Solidarity Tax on Wealth (ISF) was made more progressive. It was increased in the 1998 budget, its coverage was extended to close a number of

- loopholes, and a new band was introduced in the 1999 budget. See Gérard Cornilleau & Henri Sterdyniak, 'La politique économique', in: OFCE: *L'économie Française 1999* (La Découverte, 1999), p. 63; Ministère de L'Economie, des Finances, et du Budget, 'Project de loi de finances pour 2002', *Les Notes Bleues* Hors-série, September 2001, p. 20; and Clift, *French Socialism in a Global Era*, pp. 158–66.
68. Ministère de L'Economie, des Finances, et du Budget, 'Project de loi de finances pour 2002', p. 11.
69. In November 2002 the Commission, while reaffirming the medium-term balanced budget rule, did recognise some of the difficulties of the SGP. It suggested *inter alia* that countries should not pursue pro-cyclical policies during periods of growth (so reducing their room for manoeuvre in the downswing). See Ian Begg, Dermot Hodson & Imelda Maher, 'Economic Policy Co-ordination in the EU', *National Institute Economic Review*, No. 183 (2003), pp. 74–6.
70. In March 2000 a 10 per cent income tax cut was introduced for 5 million lower earners, and 650,000 particularly low earners were exempted from taxation altogether (*Financial Times*, 23 March 2000). In September 2000 income tax was further reduced (*Libération*, 31 August 2000). Whilst this disproportionately favoured low and non-earners, the reorganisation of income tax 2000–2003 included a reduction in income tax rates for all income bands.
71. Debt servicing costs did remain significant—14 per cent of general budget spending in 2000.
72. Dupont, 'La politique économique', in: OFCE, *L'économie Française 2000*, p. 63. It should be noted that, for all the talk of eroding autonomy, capital mobility offers opportunity as well as constraint. International capital markets, which advanced industrialised countries 'seem to be able to access ... with relative impunity', offer a means of funding current account deficits. This, combined with lower interest rates attendant upon the improved creditworthiness which comes with membership of the euro, has relaxed current account constraints to a very considerable degree. See Erik Jones, 'Liberalized Capital Markets, State Autonomy, and EMU', *European Journal of Political Research*, Vol. 42, No. 2 (2003), pp. 212–3 & 218–19.
73. Ben Clift, 'The French Model of Capitalism: Still Exceptional?', in: Jonathan Perraton & Ben Clift (eds), *Where Are National Capitalisms Now?* (Palgrave, 2004), pp. 91–110; and Clift, 'The changing political economy of France', pp. 173–96.
74. Ministère de l'Economie, des Finances, et de l'Industrie, 'Programme de stabilité 2005–2007', available at <http://www.minefi.gouv.fr>
75. OFCE, 'Méprise sur la reprise: Perspectives pour L'Economie Française 2004–2005', *La Lettre de l'OFCE*, No. 248 (2004), pp. 6–8.
76. Odile Chagny, Gael Dupont & Paola Monperrus-Veroni, 'Politiques Budgétaires en Europe: L'Heure de vérité', *La Lettre de L'OFCE*, No. 234 (2003), pp. 3–4.
77. Pedro Solbes, 'Budgetary Challenges in the euro area', *Communication*, SEC 1009/3, 24 September 2002.
78. Deficit forecasts for 2002 and 2003 had to be significantly revised upwards given a less favourable economic conjuncture. The government told the Commission its 2002 deficit was 3.04 per cent of GDP and claimed that—if the figure was rounded down—this meant it was not liable for excessive deficit procedures. See *Le Monde*, 'Querelle de chiffres entre Bruxelles et Paris autour du déficit', 3 March 2003. The figure, however, was contested—not least by the Commission itself. Authoritative sources calculated the deficit at 3.1 per cent of GDP (see e.g. OFCE, 'France: Les Illusions Perdus', *Revue de l'OFCE*, No. 85 (2003), p. 188).
79. Jérôme Créel, Gael Dupont, Jacques Le Cacheux, Henri Sterdyniak & Xavier Timbeau, 'Budget 2003: Le pécheur non repent', *La Lettre de L'OFCE*, No. 224 (2002), pp. 1–4; and Mathieu & Sterdyniak, 'Réformer le Pacte de Stabilité', pp. 154 & 159.
80. Overall, the boost or impetus to the economy provided by budgetary policy for 2002 has been calculated at 1.1 per cent of GDP. See Chagny, Dupont & Monperrus-Veroni, 'Politiques Budgétaires en Europe', pp. 1 & 3; and OFCE, 'France: Les Illusions', p. 159.
81. Clift, *French Socialism in a Global Era*, p. 160.
82. 'Impôts: la quadrature de la baisse. Chirac veut 3 pour cent, Raffarin environ 1 pour cent. Alors que le déficit public est à la dérive.', *Le Monde*, 8 August 2003.
83. *Le Monde*, 1 December 2003.
84. *Banque de France Bulletin Digest*, Nos. 121–123, January–March 2004.
85. *Le Monde*, 27 November 2003.
86. France in 2003 saw its growth rate dip to the lowest rate since the recession of 1993. This was in part due to the competitive shock of the appreciation of the euro vis-à-vis the dollar between 2001 and 2004.

87. OFCE, 'Méprise sur la reprise: Perspectives pour L'Economie Française 2004–2005', p. 8.
88. Chagny, Dupont & Monperrus-Veroni, 'Politiques Budgétaires en Europe', p. 4.
89. *Ibid.*, p. 2; Créel, Dupont, Le Cacheux, Sterdyniak & Timbeau, 'Budget 2003: Le pêcheur non repentini'; and OFCE, 'Méprise sur la reprise: Perspectives pour L'Economie Française 2004–2005'.
90. Teresa Dabán, Enrica Detragiache, Gabriel di Bella, Gian Maria Milesi-Ferretti & Steven Symansky, 'Rules-Based Fiscal Policy in France, Germany, Italy, and Spain', *International Monetary Fund Occasional Paper*, No. 225, Washington, DC, 2003, available at <http://www.imf.org/external/pubs/nft/op/225/index.htm>
91. IMF, 'France: 2003 Article IV Consultation Concluding Statement of the Mission, June 30, 2003', available at <http://www.imf.org/external/np/ms/2003/063003.htm>. Echoing the SGP, the IMF urged 'a small structural budget surplus within the next five years' and that the French state should 'run such a surplus for as long as needed to reduce the public debt-to-GDP ratio to deal with the costs of ageing and to create room for a desirable reduction in the tax burden'.
92. OFCE, 'Méprise sur la reprise: Perspectives pour L'Economie Française 2004–2005', p. 8.
93. Phillip Stephens, *Politics and the Pound* (Macmillan, 1996), pp. 269–70.
94. Treasury, *Budget 2000: Prudent for a Purpose* (HMSO, 2000), p. 215.
95. OECD, *Economic Survey: United Kingdom 1995/6* (OECD, 1996), pp. 35–7.
96. Stephens, *Politics and the Pound*, p. 293.
97. Treasury, *Budget 2000*, p. 215.
98. Treasury, *Budget Report* (HMSO, 2003), p. 20.
99. Balls, 'Open Macroeconomics in an Open Economy', p. 120.
100. *Ibid.*, p. 122.
101. Stephens, *Politics and the Pound*, pp. 278–81.
102. Stephen Nickell, 'The Assessment: The Economic Record of the Labour Government since 1997', *Oxford Review of Economic Policy*, Vol. 18, No. 2 (2002), pp. 109–110.
103. Treasury, *Code for Fiscal Stability* (HMSO, 1998); and Gordon Brown, 'Mansion House Speech', Treasury Press Release, 11 June 1998.
104. Tom Clark, Andrew Dilnot, Alissa Goodman & Michael Myck, 'Taxes and Transfers 1997–2001', *Oxford Review of Economic Policy*, Vol. 18, No. 2 (2002), pp. 187–201; and Catherine Mathieu, 'Politique Economique: La Clé Anglaise', *La Lettre de L'OFCE*, No. 233 (2003), p. 2.
105. Mathieu & Sterdyniak, 'Réformer le Pacte de Stabilité', p. 151.
106. William Keegan, *The Prudence of Mr Gordon Brown* (Wiley, 2003), p. 332.
107. Treasury, *Budget Report* (HMSO, 2003), Chapter 2, p. 9.
108. *Ibid.*, Chapter 2, pp. 9–12.
109. Treasury, *Financial Statement and Budget Report* (HMSO, 2004), p. 246.
110. Treasury, *Budget Report* (HMSO, 2003), p. 20.
111. Treasury, *Financial Statement and Budget Report*, p. 244.
112. National Institute, 'Economic Overview', *National Institute Economic Review*, No. 185 (2003), pp. 3–4.
113. Mathieu, 'Politique Economique: La Clé Anglaise', p. 2.
114. Keegan, *The Prudence of Mr Gordon Brown*, p. 275.
115. *The Economist*, 20 March 2004.
116. International Monetary Fund, *IMF Article IV Country Report: United Kingdom Report*, No. 04/56, 2004, pp. 10–14.
117. Balls, 'Open Macroeconomics in an Open Economy', pp. 113–32.
118. Keegan, *The Prudence of Mr Gordon Brown*, p. 17.
119. Treasury, *Financial Statement and Budget Report*.
120. Dyson, 'Introduction: EMU as integration, Europeanization, and convergence', p. 7.
121. 'Pacte de stabilité: la justice européenne condamne Paris et Berlin', *Le Monde*, 13 July 2004.
122. In fact, the two major agencies have shown some differences of opinion, with Moody's assigning all EMU countries an AAA rating, but Standard and Poor's downgrading Belgium, Ireland, Italy, Spain, Finland and Portugal to varying degrees. See Paul Temperton (ed.), *The Euro* (Wiley, 1998), pp. 273–5. For all that, the downgradings have been quite small and none of these countries seems to have suffered in their ability to borrow from these less than triple A ratings.

