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Italy's Admission
to the Third Stage
of the European Monetary Union

A Case Study
on the Diplomacy of European Integration

Mauro Battocchi

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Abstract

In this paper I outline the diplomatic process that led to Italy's admission to the third phase of the European Monetary Union (EMU). I identify the key factors that contributed to Italy's breakthrough, addressing the question of whether Italy owes its success to its intergovernmental bargaining strategy or to its compliance with the Maastricht criteria. The issue has theoretical implications: political scientists are divided over whether the European Union (EU) remains an intergovernmental process or whether it is molded by supranational institutions. Through examination of the process, I put different theoretical accounts of European integration to the test.

Part 1 defines the problem of European policy confronting the Italian government in mid-1996. Part 2 describes the negotiation process that from April 1996 to May 1998 brought Italy into the EMU. Part 3 draws some lessons on the conduct of diplomacy in European policy-making and compares them with the prediction of competing theories on European integration.

This analysis is based upon my recollections from my time as a foreign service officer at the Italian embassy in Bonn (1995-1999).

Part 1. A definition of Italy's EMU Challenge

1.1 The framework

The Treaty of Maastricht, signed in February 1992 and entered into force in November 1993, set the timetable and the pre-requisites for the creation of the EMU. The process was planned to develop in three stages, with the third and decisive phase beginning at the latest in January 1999. At that time the exchange rate of EU currencies would be irrevocably fixed. Admission to the EMU would be granted only to the member states complying with fiscal and financial criteria.

After the Treaty's signature, an economic downturn, coupled with financial instability, raised the question of whether the EMU was a realistic target. In 1995, however, France and Germany renewed their political commitment to achieve the goal by 1999, despite the economic sacrifices that the project would imply.

Italy faced a dilemma: the Italian government was a supporter of the EMU, but in the mid-nineties its public finance was not in line with the Maastricht criteria. Despite a wave of far-reaching reforms, the country ran the risk of losing its vital link to Europe.

Beginning in mid-1996 the left-wing government led by Romano Prodi accelerated the reform process and challenged its European partners by committing itself to a timely admission to the EMU. For the following two years a complex diplomatic process unfolded between governments, central banks and European institutions.

1.2 Prodi's Objective

Immediately after taking office, following the general elections held on April 21, 1996, Prodi declared that his primary objective was Italy's admission to the EMU as a founding member. He tied his political destiny to this goal, promising he would step down in the event of failure. His engagement was highlighted by the choice of Carlo Azeglio Ciampi as Treasury Minister – a former Governor of the Bank of Italy and an advocate of THE EMU, he had the international credibility to back Prodi's bid.

1.3 National interests

Prodi and Ciampi made it clear that the EMU objective represented a vital national interest. Being left out, they declared, was tantamount to the political and economic ruin of the country.

European integration represented the anchor of Italy's foreign policy since the fifties. A strong link with the major European nations through the European Community ⁽¹⁾ had provided a stable framework for Italy's democratic institutions and economy. In the mid-nineties the country needed a European anchor as a guarantee that political and economic reforms started in 1992 would be ultimately successful. An exclusion from the EMU would also embolden the separatist movement in Northern Italy.

Admission to the EMU would bring considerable financial benefits. Italy would gain a hard currency. It would be shielded from instability in the currency markets and obtain a dramatic reduction in interest rates. Italy's budget deficit, which was mainly due to debt service, would be rapidly deflated. The burden of past fiscal laxity would be considerably reduced.

1.4 Constraints

¹ The Treaty of Maastricht turned the European Community into the European Union

The achievement of the EMU goal was constrained by internal and international factors. The government had to develop a bundle of policies to address a constellation of constituencies, representing different hurdles on the path to Italy's admission. Only by removing those obstacles would Prodi achieve his objective. At the beginning of his mandate, however, the relative weight of each of these constituencies and the kind of resistance they would exert was not clear.

The EU partners. The decision on the EMU was to be made by the EU heads of governments by a qualified majority ⁽²⁾.

Prodi, therefore, had to generate consensus among his EU partners about Italy's admission or explore the possibility of creating a blocking minority. Diplomatic contacts had to be intensified, focusing on the major EU leaders – in particular the two engines of European integration, Germany and France.

In the beginning Prodi was unsure of the attitude of the EU partners toward both the viability of the EMU project and Italy's bid. Did the EU partners consider a postponement of the start date as a viable option? The signals from Bonn and Paris pointed in the opposite direction. What interpretation were they willing to give to the convergence criteria? Germany was expected to be strict; Prodi, however, seemed to believe that there was scope for diplomatic action. In particular, he thought that German Chancellor Helmut Kohl could be persuaded to accommodate Italy's aspiration in light of his ideals of European unity.

EU rules and institutions. As mentioned, admission to the EMU was contingent on five criteria, aimed at making sure that the economies of the member states would reach a satisfactory degree of convergence. Compliance was monitored by the EU Council of Finance Ministers (ECOFIN), the European Commission in Brussels and the European Monetary Institute (EMI) in Frankfurt, the forerunner of the European Central Bank. The Commission and the EMI had the task of publishing periodic reports on convergence; ultimately they would recommend the admission of a certain number of countries.

The Italian government clearly perceived that the country was not in line with the criteria ⁽³⁾. In 1995 the budget deficit was still at 7.6 percent of GDP – well above the

² Qualified majority voting is based on different weights attached to the member states according to their populations. Britain, France, Germany and Italy have 10 votes each. Given a total of 87 votes, decisions are approved with 62 votes and can be blocked by a minority of 26.

³ The five criteria for admitting a country to the union were specified as follows:

ceiling of 3 percent. The gross debt was at 123.2 percent of GDP, and still growing. Inflation was over 5 percent, far above the European average. Long-term interest rates, signaling market expectations about convergence, remained at 12.2 percent. The lira had not yet rejoined the Exchange Rate Mechanism (ERM), from which it had been ejected in 1992.

The government had only a few months to redress the situation – the EU leaders would be making the final decision during 1998 on the basis of figures for 1997. In the second half of 1996 immediate action had to be taken to slash the budget deficit, bring the lira back into ERM and reduce inflation.

Lobbying the Commission and the EMI was also important to highlight the progress made on the convergence path.

Financial markets. The markets were decisive for Italy’s admission. The yield differential between Italian and German treasury bonds measured the likelihood of Italy’s timely admission. The Italian government, therefore, had to generate credible expectations that Italy would successfully catch up.

Parliament. The government needed parliamentary backing to pass measures of fiscal consolidation. Its majority in the Chamber of Deputies, however, was not solid. Prodi had been elected with the votes of his coalition, the “Olive Tree”, and those of the radical left-wing *Rifondazione Comunista*. The party leader, Fausto Bertinotti, had to consent to cutbacks in welfare benefits. He was likely to ask for a dilution of the most significant reforms.

Labor unions. The government had an important ally: the labor unions, supporting the first left-wing government in Italy’s history. In 1993 Ciampi had persuaded unions and employers to sign a benchmark agreement on labor cost, removing the indexation of salaries to inflation. The union support encouraged Prodi to carry out structural adjustments.

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- *General government deficit* at less than 3 percent of GDP
 - *Gross debt* at less than 60 percent of GDP, “unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.” (art. 104c)
 - Consumer price *inflation* rate of no more than 1.5 percentage points above the average of the three countries with the lowest inflation rate.
 - Average nominal *long-term interest rates* of no more than 2 percentage points above those for the three countries with the lowest inflation rate.
 - Participation in the Exchange Rate Mechanism (ERM) pegging rates of European currencies and no *exchange rate* realignments for at least two years.

Public opinion. The government needed public support. Prodi knew that his perception of a vital national interest was shared by a large majority of Italians. They were ready to pay a high price for remaining part of Europe.

1.5 Options

It was certain that tough budget decisions had to be made in the following months. But the open questions about the EU partners' intentions left uncertainty about the size of the fiscal measures and about the diplomatic strategy to pursue. There were three main options:

- (a) Agree with the EU partners to postpone the EMU start. This would give Italy more time to catch up, but it would risk derailing the EMU process and damaging the credibility of the EU.
- (b) Negotiate with the EU partners in order to obtain a loose interpretation of the criteria. This would make the catch-up process less painful, but would probably cause a showdown with the EMI and the central banks.
- (c) Prepare for a lonely battle in case no loose interpretation was accepted. This option made the catch-up process a daunting task, but it was believed that the "hard numbers" would be a guarantee of Italy's admission.

1.6 Instruments

The Prime Minister's Office became the coordination node of two task forces – one dealing with the international constraints, the other with the internal constituencies. The close cooperation between Prodi's and Ciampi's teams was at the heart of the process. The Bank of Italy, defending its independence, played an autonomous role.

Table 1 outlines the policy instruments that the Italian government considered using to address the different constituencies listed above. My assessment of the relative importance of each instrument and the difficulty of its tasks, as Prodi took office, are marked on the right hand side.

Table 1. Policy constraints and instruments as perceived by the Italian government (mid-1996)

CONSTRAINT	POLICY INSTRUMENT	IMPORTANCE	DIFFICULTY
EU partners	Diplomatic action (persuasion, negotiation, threats) <i>Actors: Prime Minister's Office; Treasury Ministry; Ministry of Foreign Affairs</i>	High	High
EU rules and institutions	Fiscal consolidation Admission to Exchange Rate Mechanism Anti-inflationary policy Lobbying EMI, Commission <i>Actors: Prime Minister's Office; Treasury Ministry; Bank of Italy; Ministry of Foreign Affairs</i>	High High High Moderate	High Moderate Moderate ¹ High ²
Financial markets	Communication policy <i>Actors: Prime Minister's Office; Treasury Ministry; Bank of Italy</i>	High	Moderate ³
Parliament	Political leadership <i>Actors: Prime Minister, Olive Tree leaders</i>	High	High
Labor unions	Political leadership <i>Actors: Prime Minister, Olive Tree leaders</i>	High	Moderate
Italian public opinion	Political leadership Communication policy <i>Actors: Prime Minister's Office, Treasury Ministry, Olive Tree leaders</i>	High Moderate	Low ⁴ Low

Source: own evaluation

¹ The 1993 Agreement on labor cost had paved the way for a steady decrease in inflation

² EMI was expected to react negatively at attempts to "politicize" the criteria

³ Financial markets were believed to be "objective" in their evaluations

⁴ As mentioned, Italians were inclined to accept sacrifices in the name of Europe

Part 2. The Negotiation

2.1 Rude Awakening: April-December 1996

Testing Italy's isolation. Prodi quickly proceeded on both the internal and the international fronts. At home he anticipated his plans for the 1998 budget law, with drastic expenditure cuts. In Europe he announced that he would negotiate the re-entry of the lira into the ERM by the end of the year. His first diplomatic moves were aimed at testing the intentions of Germany and France on the date and the interpretation of the convergence criteria. The European Council held in Florence, in June 1996, which Prodi chaired, offered the occasion to meet with Helmut Kohl and French President Jacques Chirac.

That the Maastricht Treaty contained both convergence criteria and a fixed start date was the result of a compromise ⁽⁴⁾. The criteria had been inserted under pressure from the German government, reflecting the views of the *Bundesbank*. During the negotiations, Germany had taken advantage of its political weight and its financial credibility, molding the EMU after its monetary institutions and values.

France and Italy had accepted the criteria in return for a deadline on January 1, 1999. They believed that this clause would avoid indefinite deferrals on technical grounds. But for Italy, plagued by dismal public finances, the compromise was hardly an improvement: it substituted the risk of being left out of the EMU in perpetuity with the necessity to force its way in through political acrobatics.

One can speculate that Giulio Andreotti, Italy's Prime Minister at the time of the Maastricht Treaty and a leading political figure of Italy's post-war system, probably relied on his masterful diplomatic skills to redress the situation. He may have also been driven by the Cold-War time persuasion that Italy was necessary in any European order, given its strategic importance. But the Cold War was already over, and Italy's old political system crumbled soon after.

In Florence, Prodi found Kohl and Chirac resolutely opposed to any idea of modifying the terms of Maastricht's compromise. They were determined to stick to the date of January 1, 1999. They also rejected a loose interpretation of the criteria, which they said would undermine the credibility of the new currency and make the changeover

⁴ Kenneth Dyson, Kevin Featherstone, *The Road to Maastricht, Negotiating Economic and Monetary Union*, Oxford, 1999, p. 437

unacceptable for the German public. If Italy wanted to join the EMU in time, it would have to comply with the criteria and ask for no discount.

The talks were enough to persuade Prodi that a postponement (option 1) was by then out of the question, but he still considered the possibility of forging an alliance with other countries in order to create a blocking minority. At the Spanish-Italian Summit in Valencia in September 1996, Prodi floated the proposal of a joint Italian-Spanish initiative to loosen the criteria interpretation. Spanish Prime Minister Jose-Maria Aznar not only rejected the idea, but also disclosed Prodi's demarche in an interview to the *Financial Times*.

Aznar's snub buried option 2 as a viable strategy. The government was left with a sense of complete isolation in Europe and no strategy other than option 3. It appeared that only fiscal consolidation could give Italy an entry ticket for the EMU. Prodi's efforts had to be directed toward the parliamentary majority, the labor unions and public opinion.

The Internal Front. At the end of September 1996, the government presented a revised budget proposal including draconian measures. A proposal disclosed in July aimed at achieving a reduced budget deficit of 3.6 / 3.8 percent of GDP in 1997, above the Maastricht ceiling. The new package would reduce the deficit to 3 percent through expenditure cuts and tax increases worth 41 billion dollars ⁽⁵⁾. Italians, as expected, showed overwhelming support for the government. The odds that Parliament would pass the package appeared high.

Reactions from Germany and France, on the contrary, were anything but encouraging. Prodi was to meet Chirac in Naples on October 3 and Kohl in Bonn on October 17. Both meetings were preceded by signals that dampened Italy's expectations. In a speech, Chirac questioned Italy's ability to rein in its deficit and qualify for the EMU. He also attacked lira devaluations, described as unfair competition against French manufacturers. The President of the *Bundesbank*, Hans Tietmeyer, warned about the dangers that unspecified countries posed through "creative accounting". In the meetings with his colleagues, Prodi demanded that Italy should be given at least a fair hearing and not be judged on past failings.

Another blow to Italy's position came from the European Commission at the beginning of November: its report on convergence predicted a budget deficit for Italy at 3.3 percent in 1997, despite the proposed budget package. Prodi reacted furiously, but

⁵ A contentious one-off "Europe-tax" was also included

obtained from Brussels only an ex-post statement, clarifying that the forecast did not prejudice the Commission's final evaluation.

The negative reactions to Italy's policy from EU partners and institutions did not shake Prodi's determination to bring the lira back into the ERM. ECOFIN made the decision on 24 November 1996, after a two-day negotiating marathon on the value of the central parity. The German delegation was the most tenacious opponent at the negotiating table, asking for a considerable revaluation of the lira to protect its market from Italian exports. Tietmeyer and the French Finance Minister Arthuis stressed that the decision did not prejudice the final verdict on Italy's bid for the EMU.

Prodi's plan received a decisive boost by the parliamentary approval of the budget package on December 22. The markets were also responding positively: the interest-rate differential between long-term Italian and German bonds had fallen in one year from 5.38 percentage points to 1.88 percentage points. A major reason for Italy's shrinking yields was the sharp reduction in inflation to a level of 2.5 percent.

Focus on Bonn. In their end-of-the-year provisional assessment, Prodi and Ciampi found reasons for satisfaction and for concern. They had masterfully tacked the internal constituencies. The Italian public had understood their message. Parliament and labor unions moved along in unison. The international challenge, however, appeared as difficult as ever; the main EU partners gave the impression of being alarmed by Italy's resolve.

For Romano Prodi, the position of Chancellor Kohl represented a rude awakening. Prodi had political affinities with Kohl's Christian Democratic Party (CDU). He was convinced that Germany, a co-founder of the European Community, would not sacrifice Italy on the altar of financial rigor. Yet that was precisely what was happening.

This new awareness shifted the focus of the government's efforts on Bonn. It brought about a more in-depth analysis of German motives. Kohl's line of argument was that the German public shared the worries expressed by the *Bundesbank*. Deviating from the strict interpretation required by Frankfurt, he claimed, would risk alienating public opinion, discredit the government's policy and undermine the whole EMU project.

But an alternative explanation appeared plausible. It viewed the convergence criteria not as constraints on Kohl's actions, but as instruments to be used in the pursuit of his overall strategy. Italy's initial successes alarmed the Chancellor not because they endangered a strict interpretation of the criteria, but rather because they conflicted with Kohl's post-cold war *Konzept* of Europe.

This vision was no secret. It had been explicitly formulated in a CDU strategy paper in September 1994 ⁽⁶⁾. The enlargement to the east, contended the document, was likely to reduce the ability of EU member states and institutions to deepen integration. The EU risked turning into a free-market zone. Germany, as the strongest state in the middle of the continent, had a vital interest in avoiding such a power vacuum. The response was the creation of a hard core of integration-prone countries, taking the lead in all EU policies. The hard core would be comprised of Germany, France and the Benelux countries. “Also in the monetary field,” stressed the document, “there is a strong trend toward the five-country hard core. The five (together with Denmark and Ireland) are the closest to the Maastricht Criteria. This is all the more significant as the EMU is the hard core of political union ⁽⁷⁾.” Italy was mentioned as a possible candidate for the hard core “once it has solved its present problems ⁽⁸⁾.”

For the Chancellor, keeping Italy out of the EMU was essential to ensure that it would not gain a place in the hard core of political union – not until it had successfully completed its political and economic transformation. Prodi and Ciampi, however, believed that Italy’s transformation would not be complete until Italy joined the hard core. The CDU doctrine, therefore, came to be seen as a threat to Italy’s national interest, and the government strategy was modified accordingly. Renewed diplomatic efforts were directed at the German government; a communication campaign was launched with the target of showing the German public Italy’s reliability as a key partner.

Prodi made more and more references to the geopolitical implications of the EMU, emphasizing that Europe without a Mediterranean dimension went against history and against logic.

2.2 Reality Test for Germany: January-May 1997

Rumors and Leaks. 1997 opened with renewed attacks on Italy’s bid. Its opponents knew that Italy’s strategy had a chance to succeed if the financial markets thought it to be credible. Spreading doubts in the press could modify market expectations and prevent Prodi’s self-fulfilling prophecy from materializing.

Some days before the German-Italian Summit in Bonn in early February, at a business conference in Davos, Switzerland, a *Deutsche Bank* board member said that Italy’s

⁶ Wolfgang Schäuble, Karl Lamers, *Überlegungen zur europäischen Politik*, CDU-CSU Bundestagsfraktion, Bonn, September 1, 1994

⁷ *ibid.*, p. 6, as translated by the author.

⁸ *ibid.*, p. 6, as translated by the author.

creative accounting was jeopardizing the credibility of the future single currency. At the same time, the *Financial Times* revealed a Franco-German plan for postponing Italy's admission to the EMU till 2002. Prodi reacted angrily, declaring that no such plan would be accepted, and reasserted the determination of his government to push ahead. At the meeting, Kohl denied the existence of the plan. The markets, however, received the message: the fall in the long-term interest rates stopped and showed signs of a possible reversal.

The British press played a central role in this destabilizing campaign. The attacks on Italy's credibility were recurrent and tinged with stereotypes. The *Financial Times* derided the "Club Med" efforts to join the circle of leading European nations – overlooking the fact that the Italian economy was as large as that of Britain. Having no intention of renouncing its monetary sovereignty, the United Kingdom had strategic reasons for fearing the creation of a vast monetary block on the continent. Italy's bid seemed to be an easy instrument for dividing continental powers and play havoc with the whole EMU project.

This supposition is corroborated by the recurrent warnings of the Governor of the Bank of England, Eddie George. At the end of February, for example, he presented a study showing that financial markets were increasingly skeptical about the future ability of the European Central Bank to preserve price stability "in the light of the on-going debate about prospective membership ⁽⁹⁾."

German Unemployment. While the EMU debate was revolving around the risks that Italy posed, economic indicators started to point at a different source of danger. In February, German unemployed soared above the level of 12 percent. This figure was worrying in two respects. In general terms, it signaled persistent structural problems in the main economy of the continent. After reunification, Germany had been unable to grow at a sustained pace and generate new jobs. It was lagging behind in the development of high technologies. Its service sector was undersized and unable to absorb the workforce expelled by traditional industries. In terms of the convergence criteria, high unemployment implied swelling budget deficits.

The deficit figures for the first months of the year showed that indeed something unimaginable was occurring. Germany, France and Italy displayed similar budget deficit trends, slightly below 3 percent. The possibility of discriminating against Italy on the basis

⁹ *Financial Times*, March 1, 1997, Markets Section, p. 2

of the deficit criterion was becoming unsustainable, because of Italy's stunning performance and Germany's worsening conditions.

The German government entered a phase in which it gave the impression of reacting to events rather than molding them. In March, the *Financial Times* repeatedly quoted anonymous German officials envisaging a postponement of the EMU, or even a cancellation of the project. As a consequence, the financial markets hit Italy again. While a deferral had been desirable for Italy the previous year, before it started implementing its strategy, by now it had turned into a nightmare scenario. It entailed higher interest rates – and therefore a higher debt service and a higher deficit. It risked destabilizing the lira within the ERM. Prodi rejected the idea and pushed through additional budget cuts at the end of March.

The *Bundesbank*, for its part, announced a new approach to tackle the Italian challenge. It shifted focus from the 3 percent deficit threshold to the concept of “sustainability”. Even if a country achieved the 3 percent objective, so went the argument, it had to prove that the goal could be attained in the long run. Budget cuts had to be structural. The level of overall debt was emphasized as a key indicator of sustainability.

The EMI's Annual Report echoed this approach. The institute wrote that “short-term or one-off measures, which are only effective in one year, which improve the current budgetary situation at the expense of future budgets, or which have mere presentational effects, cannot be regarded as contributing to sustainability ⁽¹⁰⁾.” Heavy reliance on higher revenues rather than spending cuts to rein in deficits was “a ground for concern ⁽¹¹⁾”.

The first signs of change in the German public – and a victory for Italy's communication strategy – came from Hans-Olaf Henkel, the President of the German Manufacturers Association. Breaking a taboo, he pleaded for Italy's admission to the EMU in a radio interview. German industrialists had good reasons to want Italy in the single currency area: lira devaluations had wreaked serious competitive damage in the past.

Kohl's Priorities Revealed. At the beginning of April Kohl tried to dispel the climate of uncertainty surrounding the EMU by announcing his intention to run again for the

¹⁰ European Monetary Institute, *Annual Report 1996*, April 1997, p. 19

¹¹ *ibid.*, p. 19

Chancellor's Office in September 1998. Ciampi welcomed the decision. "It confirms that Germany intends to respect the Maastricht criteria", he added ⁽¹²⁾.

His announcement could not redress Germany's dire economic situation. In May the projections for tax revenues fell short of the expectations. Germany looked bound to overshoot the budget deficit criterion. The government did not intend to hit its electors with spending cuts or tax increases. In mid-May, a revealing decision was made; the Finance Ministry announced plans to revalue the *Bundesbank's* gold reserves and use about 11 million dollars worth of profits to cover the budget shortfall. The measure was highly controversial. While no objection could be made to use the profit to reduce the debt stock, EU accounting rules did not allow recording them in the annual budget. A scandal erupted.

The *Bundesbank* severely criticized the government for indulging in creative accounting tricks. Tietmeyer was reported to be pondering his resignation. The German public was outraged. After some hesitation, the government beat a retreat.

But surprises were not over yet – political events in France took an unexpected turn. Chirac had anticipated legislative elections at the end of May. As the 3 percent hurdle was also becoming difficult for France to achieve, he reckoned that budget cuts would be more easily approved by a new Parliament. But the French electorate did not like the prospect. They delivered a solid majority to the Socialist Party led by Lionel Jospin, ushering in a period of *cohabitation* ⁽¹³⁾.

Jospin's views on the EMU were rather different from Chirac's; he feared German hegemony over a monetary area with few members; he believed that the EMU had to pursue policies aimed at economic growth; and he believed that the presence of Italy and Spain was necessary to balance Germany's preference for price stability.

A Significant Test. Events in Germany and France dramatically improved Italy's position. Germany had lost much of its credibility in asking for a strict interpretation of the criteria. France came to support Italy's bid. The *Konzept* of a hard-core EMU was in tatters.

The events also seemed to provide a significant test to the question of whether Italy's major constraint was represented by the convergence criteria or by a strategy of its most influential member states. When the criteria turned out to constrain Germany, Kohl reaffirmed his political objective – the EMU – and did not hesitate to challenge the

¹² Reuter News, *Italy Welcomes Kohl's Decision to Stand Again*, April 4, 1997

¹³ In French this term is also used to identify a situation in which the President and the Prime Minister do not belong to the same coalition.

criteria, the EMI or the *Bundesbank*. It was becoming apparent that German and French opposition, more than the criteria themselves, was the real obstacle for Italy.

In the meantime, however, the criteria had acquired new significance. While being used instrumentally by Germany and France, they had become part of the political discourse. Public opinion had been persuaded of their importance. The EMI and the central banks, furthermore, had provided them with increasingly ambitious interpretations. The concept of sustainability and the prescription of structural reforms appeared as a challenge not only to the outer-circle countries, but also to the hard-core ones.

On this new terrain, paradoxically, Prodi and Ciampi could feel more confident than Kohl or Chirac. In static terms, Italy still had difficulties in achieving certain quantitative objectives, but in dynamic terms Italy was changing at a rapid pace. Microeconomic reforms had been implemented since the early nineties: pension reforms, an agreement on labor cost, privatization of government-owned companies, market liberalizations, significant primary budget surpluses. The willingness shown by the Italian public to accept sacrifices for the EMU attested Italy's dynamism.

As Prodi and Ciampi reviewed the government strategies, the challenge appeared in a different light. In the internal arena, the focus on sustainability and structural reforms had the potential to generate a confrontation with *Rifondazione Comunista*. In the international arena, Italy had to cooperate with the German government in order to mold a new, inclusive long-term strategy. Italy also had to help the German leadership to alleviate the anti-Italian worries that it had previously kindled. The communication campaign had to be extended and intensified.

2.3 Breakthrough: July 1997 - May 1998

The Thaw. At the end of June, at the conclusion of an intergovernmental conference on political union, the Amsterdam European Council approved an amendment to the Treaty of Maastricht. However, it did not contain significant reforms. The clause that would allow a few countries to develop some policies autonomously – advocated by Germany and France as a tool for their hard-core vision – had lost much of its content in the negotiation with other partners.

In the economic chapter, the Treaty was amended to include the “Stability and Growth Pact”. Put forward by the German Ministry of Finance with the *Bundesbank's* backing to reinforce the Maastricht criteria, it was paradoxically approved when Germany had a hard time complying with them. The pact turned the deficit and debt

criteria into permanent features of the EMU. An excessive deficit procedure was institutionalized to ensure future compliance.

The Italian leaders appeared on the European stage with more optimism and self-confidence and began receiving encouraging signals from their partners. Jospin pledged his political support. The EU Monetary Committee, consisting of the representatives of EU Finance ministers, welcomed Italy's three-year budget plan for economic convergence ⁽¹⁴⁾. The Austrian Finance Minister, Rudolf Edlinger, said that his country "would not be happy" if the EMU started without Italy ⁽¹⁵⁾. In Germany, a young member of Bundestag's European affairs committee, Armin Laschet, was the first CDU politician to endorse Italy's bid: "Italy currently posts very good numbers, they could lead it into the EMU ⁽¹⁶⁾." Italy's desire to be part of the EMU from the start "is no longer a hope", said Ciampi on June 25 ⁽¹⁷⁾.

The changed attitude was reflected by the comments of the media. The *Financial Times* wrote on July 21 that "at last Italy is close to a virtuous economic path... It will be increasingly hard to find an excuse to exclude Italy from the first wave of countries joining the Euro single currency ⁽¹⁸⁾." In Germany, the team that coordinated the communication campaign at the Italian embassy detected a wave of friendliness in many interlocutors. Business people, journalists and politicians who had repeatedly turned down invitations to take part in conferences and promotional activities were now asking to participate. German banks started voicing their support publicly. *Deutsche Bank* extended an invitation to Ciampi to visit its premises in Frankfurt.

In September a strategy paper of the German Christian Democrats ⁽¹⁹⁾ sketched a new German vision for Europe. The document identified Europe's ultimate challenge in its inability to generate economic growth and employment. Europe needed structural reforms to tackle the challenge of globalization. The EMU and the Stability Pact were constraints that forced the EU countries to undertake reforms. In this light, the single currency was no longer a circle of financially virtuous countries, as depicted in the 1994 strategy paper, but an extended community of reforms, in which every country had to question its own achievements. Italy's progress was praised.

¹⁴ Market News International, *Italy's Ciampi Confident EMU to Start on Time, Italy to Be In*. June 25, 1997

¹⁵ Financial Times, *Austria Hitches Italy to Its Euro-Wagon*, July 29, 1997

¹⁶ Market News International, *German CDU Official Sees Large Initial EMU, Supports Italy's Bid*, July 14, 1997

¹⁷ Market News International, *Italy's Ciampi Confident EMU to Start on Time, Italy to Be In*. June 25, 1997

¹⁸ Financial Times, *Perseverance on Monetary Union is Close to Reward*, July 21, 1997, Survey on Italy, p.

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¹⁹ Wolfgang Schäuble, Michael Glos, Rudolf Seiters, Karl Lamers, *Die Europäische Währungsunion: Deutschlands Interesse und Verantwortung*, CDU-CSU Bundestagsfraktion, Bonn, September 16, 1997

Same Old Italy? As predicted by Prodi and Ciampi, in this new season of sustainability and structural reforms the internal constraints would be more difficult to tackle than the international ones.

Some of the fiscal measures previously adopted were temporary and had to be replaced by permanent cutbacks in 1998. Pensions were by far the largest expenditure item and the main threat to long-term financial stability, given Italy's low birth rate. Prodi therefore resolved to continue on the path of pension reforms inaugurated in the early nineties. He proposed to phase out the so-called baby-pensions – the right for public sector employees to retire after a certain number of years in service, regardless of their age. Bertinotti opposed the plan and threatened to overthrow the government. When at the beginning of October Prodi defied his threat and presented the proposal in Parliament, relying on the support of defecting right-wing MP's, he was voted down. Italy was yet again without a government.

Significantly, the crisis did not cause panic in the financial markets. The lira lost little ground – unscathed by the financial instability that was spreading at that time through in Asia. The German government expressed its appreciation for Prodi and its hope that a last-minute compromise would be found.

Bertinotti, struck by a wave of unpopularity among its own electors, settled for a compromise with Prodi after ten days' negotiations. He gave way to partial pension reform in return for the promise of a 35-hour workweek along the French model. By mid-October Prodi was back in power.

Despite its brevity, the crisis nourished German fears that Italy remained “the same old Italy” in spite of Prodi's reassurances. An issue raised by a former official in the Italian Treasury, Francesco Giavazzi, and echoed by the international press, rekindled the fear of budget tricks. Giavazzi claimed that the public accounting law had a loophole that endangered financial stability despite EU oversight: the law allowed local authorities to carry over unspent appropriations over time. This considerably complicated the management of cash resources and created the risk of sudden peaks in public spending.

The German Ministry of Finance, the Commission and the EMI required clarifications. Ciampi's deputy, Piero Giarda, and Treasury officials conducted shuttle diplomacy with Brussels, Bonn and Frankfurt. They conveyed the message that the law gave the Treasury Ministry the last word as to whether local authorities could spend their carried-over appropriations. The central government could exert effective control on public finance.

At the year drew to a close, Parliament's timely approval of the 1998 budget law, containing significant structural measures, came to reassure the EU partners and the financial markets. The results already achieved were remarkable: inflation was at 1.5 percent; the yield differential between Italian and German long-term bond was by then negligible; the budget deficit trend was satisfactory.

In January, Prodi and Ciampi breathed a sigh of relief as ECOFIN approved Italy's three-year convergence plan. The EU Finance Ministers asked Italy to reduce the backlog of unspent appropriations, but they substantially cleared the way for Italy's admission to the EMU. Prodi obtained Kohl's tacit consent in a meeting in Milan on January 20.

In February, on the eve of the decision of German Parliament on the EMU, Italy's communication campaign in Germany reached its peak. On February 5 and 6, Ciampi charmed Germany's political and business establishment. In a moment of personal triumph, at the *Bundesbank* he obtained acknowledgement of Italy's progress from his former colleague Hans Tietmeyer.

The Moment of Truth. In March 1998 the figure for Italy's 1997 budget deficit turned out to be 2.7 percent of GDP – the same level as Germany, lower than France.

The EMI Convergence Report published soon afterwards still left some room for doubt about Italy's performance: "notwithstanding the efforts and the substantial progress made towards improving the current fiscal situation," wrote the document, "there must be an ongoing concern as to whether the ratio of government debt to GDP will be 'sufficiently diminishing and approaching the reference value at a satisfactory pace' and whether sustainability of the fiscal position has been achieved ⁽²⁰⁾." The Commission report, however, dispelled any remaining uncertainty and recommended Italy's admission. The *Bundesbank's* assessment alone cast serious doubts on the sustainability of Italy's public finance.

The German Bundestag authorized Chancellor Kohl to vote in favor of a timely start of the EMU, with the admission of the countries recommended by the Commission. On May 2, under British Presidency, the EU leaders unanimously made the decision to give birth to the single currency on January 1, 1999. 11 countries would participate, including Italy. The Italian government had achieved its objective.

²⁰ European Monetary Institute, *Convergence Report 1997: Report Required by Article 109j of the Treaty Establishing the European Community*, March 1998, p. 158

Part 3. An Evaluation

3.1 Lessons on the Conduct of Diplomacy

(a) As Table 1 at page 7 shows, objectives of EU policy were pursued with a variety of policy instruments, aimed at both internal and international constituencies. The case bears out the image of EU policy as a typical “two-level game”, as described by Robert Putnam ⁽²¹⁾. The more diplomatic action is coordinated with the other tools, the more effective it becomes. The Italian government displayed a remarkable ability to integrate different tools in an overall and constantly updated strategy.

(b) When a policy objective is connected to a vital national interest – and perceived as such by the public – diplomatic action acquires greater edge. It is doubtful whether Prodi’s strategy would have succeeded without his conviction, shared by the Italian populace, that the fate of the country was at stake.

(c) Political leadership, especially if backed by credible commitments, makes diplomatic action more effective. Prodi’s and Ciampi’s credibility, and the former’s vow to resign in the event of failure, enhanced Italy’s position.

(d) The relative power of a country and its ability to forge coalitions determine the range of diplomatic tools it can employ. Diplomacy is comprised of cooperative instruments such as persuasion and bargaining, as well as conflictual instruments such as threats. Italy’s total isolation, highlighted by Aznar’s snub, deprived Prodi of the possibility of threatening to block the EMU start. Diplomatic action was therefore confined to persuasion and negotiation.

(e) Traditional diplomacy can benefit from public diplomacy campaigns. Prodi ultimately profited from them. Nevertheless, public diplomacy must not be overvalued. It cannot replace traditional diplomacy in winning other governments over to one’s position. This case indicates that, even in an advanced democracy, governments exert enormous leverage over the media. Public diplomacy can effectively help governments to sell agreed-upon policies to their internal constituencies.

²¹ Robert D. Putnam, *Diplomacy and Domestic Politics: The Logic of Two-Level Games*, International Organization, no. 42, 3, 1988

3.2 Competing Theories on European Integration

The paragraph above deliberately omits the crucial question of what explains the success of Italy's strategy. Was Italy admitted because of its compliance with the convergence criteria? Or was it principally the result of intergovernmental bargaining? Since this issue has a theoretical nature, I briefly outline below the predictions of competing theories on EU integration. The following paragraph will compare them to the findings of this case study.

(a) Intergovernmentalist accounts of European integration consider the EU as a sophisticated, yet standard international regime. Its constituent elements are national preferences and intergovernmental bargaining. EU institutions are seen as deliberate instruments to improve the efficiency of bargaining between states. In game-theory terms, the possibility of moral hazard prompts governments to transfer sovereignty to EU institutions when traditional diplomatic means are not enough to secure the implementations of agreements ⁽²²⁾.

Intergovernmentalist models tend to focus on disaggregated cases of European integration. Particular attention is devoted to the so-called "grand bargains", i.e. those sets of decisions that have propelled integration and laid the ground for successive periods of consolidation.

In this particular case, intergovernmentalist theorists are likely to explain Italy's admission as the result of the decisive influence of Germany's and France's interests on interstate bargaining.

(b) Functionalist accounts depict the EU as a quasi-federal political system. They emphasize the limits that EU institutions place on the member states' preferences. Their models tend to concentrate on policy areas in which policymaking cannot be explained in terms of traditional diplomatic bargaining.

In the case presented in this paper, functionalist theorists are likely to explain Italy's admission as the implementation of EU rules, supervised by impartial EU institutions.

²² Andrew Moravcsik, *The Choice for Europe, Social Purpose and State Power from Messina to Maastricht*, Cornell University Press, 1998, p. 9

(c) A third account is offered by historical institutionalist theorists. They attempt to reconcile elements of both the intergovernmentalist and the functional theories of European integration in a temporal perspective.

Historical institutionalism recognizes that member states are indeed at the center of European decision-making as sovereign entities aiming at the maximization of their interests. The institutional arrangements they carry out, however, change their positions and confront them with outcomes that are unintended or undesired. EU institutions, born as mere instruments for the pursuit of the objectives of member states, do assert an autonomous role over time. This conclusion is based on an analysis that considers grand bargains and periods of consolidation as equally important elements of a long-term process.

In the Italy-EMU case, historical institutionalists are likely to explain Italy's admission as a result of a specific interstate bargaining in which the EU member states were forced to modify their preferences because of EU rules and institutions.

3.3 A Tentative Explanation of Italy's Success

As pointed out in paragraph 2.2, the case discussed in this paper seems to show that the convergence criteria were considered by the major continental powers as instruments for the pursuit of their national objectives. From the point of view of a member state in a weak bargaining position like Italy, the criteria appeared as unquestionable supranational rules. From the point of view of the two leading powers, Germany and France, the criteria were mainly policy tools. The test to this assertion came in the first months of 1997, when it became clear that Germany had difficulties in complying with the rules of financial stability, and that the viability of the EMU was at risk: Kohl did not hesitate to try and bend the rules and challenged the monetary authorities. At the same time, Jospin stated clearly that the criteria were policy instruments: he pleaded for a looser interpretation in the name of France's new national target – an EMU more inclined to Keynesian policies.

This finding is in step with Moravcsik's intergovernmentalist account of EU integration.

The Italy-EMU case, however, also indicates that, at a certain stage, the leading member states lost control over their instruments. The rules acquired a political weight of their own, and came to constrain the same leading member states that had inspired them. The central banks gradually added substance to the criteria, transforming them from simple reference points for policy-makers into indicators of structural change. When the

focus shifted from the 3-percent deficit value to the concept of sustainability, the criteria lost their function of discriminating between financially stable and unstable countries. They came to question the very basic structural flaws of the economies of most European countries, Germany and France included. The leading member states had to reconsider their own strategies, redefine their priorities, and identify new paradigms.

This finding bears out historical institutionalist accounts of EU integration like Paul Pierson's⁽²³⁾. Pierson believes that European integration increasingly constrains member states in a two-step process: at first "gaps" emerge in member state control over institutions. Once emerged, gaps are difficult to close, and member states reach the subsequent grand bargain with reduced freedom of action. "Studying processes of policy and institutional change over time," he claims, "reveal that gaps may well be extensive and the prospect for recapturing lost control are often quite limited⁽²⁴⁾."

Table 2 provides an analytical scheme of Pierson's theory. He identifies four factors contributing to the emergence of gaps, and three additional factors that make it difficult to close them.

In the case presented here, the gap emerged when Germany lost control over the convergence criteria by showing difficulties in complying with them⁽²⁵⁾. The first and third factors – increasing autonomy of EU institutions and unintended consequences – can indeed explain the opening of the gap. The decisive factor, however, does not appear in the table. It is the gradual loss of control of national policy makers over economic variables. In a globalized economy, open to the movement of goods and capitals, national policy tools are increasingly powerless in the face of financial markets. The German government discovered too late that its economic situation was not up to its power status.

The difficulty in closing the gap can be identified with Germany's inability to reshape or manipulate the criteria, once it had lost control over them. All three factors – resistance from the monetary authority, complex legal procedures for modifying the norms and sunk costs – are valid explanations. The third one is particularly significant. The sunk costs of an open challenge to the criteria were indeed enormous: a credibility loss that would have shaken the EMU as a whole and Germany in particular.

²³ Paul Pierson, *The Path to European Integration: A Historical Institutional Analysis*, Columbia International Affairs Online, Political Relations and Institutions Research Group, Working Paper 2.39, November 1996

²⁴ *ibid.*, p. 17

²⁵ Here I refer solely to Germany, because it is the member state that inspired the criteria.

Table 2. Paul Pierson's Historical Institutional Model of EU Integration

STEPS LEADING TO INCREASING CONSTRAINTS ON MEMBER STATES	SUGGESTED CAUSE
“Gaps emerge in member state control over the evolution of European institutions and public policies”	1. EU institutions are partially autonomous. Over time EU organizations will seek to use grants of authority for their own purposes
	2. Decision-makers have restricted time horizons. Long-terms effects are often heavily discounted.
	3. Unintended consequences are widespread because of high issue density; governments are overloaded.
	4. The preferences of member states shift over time.
“Once such gaps emerge, they are difficult to close”	1. Supranational actors resist member state efforts to exercise greater control.
	2. EU institutions are difficult to reform.
	3. Sunk costs make policy reversal unattractive; previous decisions “lock in” member states.

Source: own elaboration from Paul Pierson, *The Path to European Integration: A Historical Institutional Analysis*, Columbia International Affairs Online, Political Relations and Institutions Research Group, Working Paper 2.39, November 1996

3.4 Conclusions

In light of these considerations, I propose the following interpretation of the case presented in this paper:

- Italy's admission was primarily the result of an intergovernmental bargain;
- Italy was substantially co-opted by Germany and France on the basis of their national strategies;
- France modified its national strategy because of Jospin's victory;
- Germany had to modify its national strategy because it lost control over the convergence criteria;
- The criteria had been previously employed by Germany as instruments to build a hard core of European nations;
- The criteria later came to assume an autonomous role of indicators of structural change;
- If Germany had kept control over the convergence criteria and France had elected a right-wing government, it is questionable whether Italy's convergence might have sufficed to win admission to the EMU.