International Conference in honour of Niels Thygesen

Friday December 5th 2014 University of Copenhagen

Edmond Alphandéry*

Session I – Why did we get the Euro?

This event is a good occasion to celebrate the anniversary of our dear friend Niels Thygesen. It is also a real pleasure and an honour for me to belong to a panel chaired by Professor Harold James who wrote a very good book on the history of the Euro, together with Mario Monti and Onno Ruding for whom I have great respect and friendship.

This session is dealing with the 'raison d'être' of the European currency. The Euro area is still facing significant challenges. It has not yet been fully cured from the Euro crisis while it is being confronted with the risk of outright deflation. Look back on the origins is even more justified if it helps fully grasp the underpinnings of our present predicament.

As you know, I was a politician when we designed in the late eighties and early nineties the architecture of the Economic and Monetary Union. As a member of the Finance committee of the French Assembly, I had been given the task of presenting a report, which I did with the assistance of two economists, Pierre Jacquet and the late Rudi Dornbusch. I submitted this report in 1991 to François Mitterrand during a face to face meeting at the Elysée Palace. From 1993 to 1995, an important post-Maastricht period in the march towards the Euro, I was in charge of the Finance Ministry.

Of the two types of reasons which led to the European currency the first has to do with politics. The political dimension of the euro is encapsulated in the famous sentence of French economist Jacques Rueff: '*l'Europe se fera par la monnaie ou elle ne se fera pas' (Europe will build itself through a single currency or not at all').* The second is about economics: the European construction has been founded on the principle of a single market between member states. And the idea that the good working of the single market required a unique currency was widely shared at least among pro-European policy makers.

* President of CEPS, Emeritus Professor University of Paris II

You may remember the debate that opposed, before the adoption of the Maastricht Treaty in 1992, proponents of the creation of a parallel currency which would have circulated alongside the existing national ones, to those who were in favour of a unique European currency. In France in the early nineties, Edouard Balladur who was preparing himself to become Prime Minister in the aftermath of the legislative elections of 1993, had put in place at the National Assembly a few MP committees whose tasks were to reflect on the platform of his future government. One of them which I chaired together with Edouard Balladur himself was focused on the future European currency. Since we could not agree on the same text, we ended up presenting two different papers to the press: one written by Edouard Balladur proposing the creation of a parallel European currency, a position shared by many Gaullists. The other which I myself defended on behalf of my Centrist colleagues, was the establishment of a unique currency.

One of the strongest technical arguments pledging in favour of a European currency was the increasing instability of the European monetary system. After the full liberalization of capital in Europe, the EMS had to face what Bob Mundell used to call the 'impossible trinity': we cannot simultaneously have independent monetary policies with a fixed exchange rate system where movements of capital are totally free to circulate. At the time when we were adopting the Maastricht Treaty, we were confronted with this trilemma. Precisely at this moment, the European monetary system was being hit by an asymmetric shock coming from the reunification of Germany. The problem that we had to face came in France, and I presume in other member states as well, from a strong social and political pressure to resist the rise of interest rates in a context where the majority of the countries had fallen into a recession. The principle of the 'impossible trinity' was fully at work: in 1992 and 1993 many EMS countries devalued their currencies, the UK left the EMS, and finally we had to enlarge the EMS band to $\pm$ 15% in August 1993.

In the march towards the European currency, a core issue which has been hotly debated in France concerned the independence of the Central Bank. It is not exaggerating to say that the French political elite was not particularly in favour of this reform. The decision taken by the 'Front Populaire' in 1936 to hand over to the state the monetary power of the Banque de France supposedly confiscated by 'les deux cent familles' (the 200 most powerful French families) had remained on the left benches a highly symbolical political act. The full nationalization of Banque de France was completed in the aftermath of the Second World War with the support of the Gaullists. It is no wonder that thereafter for many politicians it became embedded in the principles underlying the French Republic.

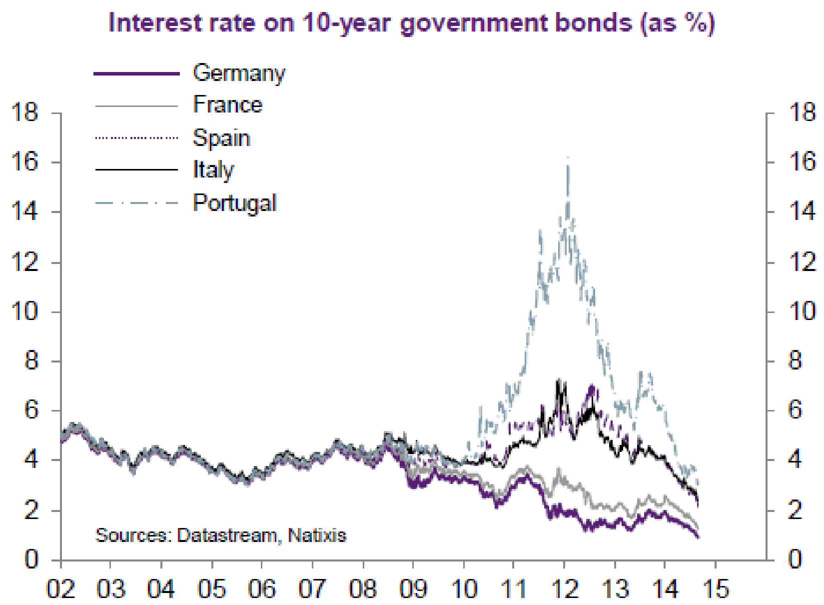
But the Germans on their side were extremely attached to the independence of the Bundesbank, which was the guarantor of monetary stability considered as a pillar of its economic success. It was clear that they were in no way ready to budge on this principle. They accepted the European currency under the strict condition of a full respect of the independence of the future European Central Bank.

We ended up in France by implementing the independence of the Banque de France which was a *sine qua non* prerequisite to the European currency because some politicians, mainly in the centre, considered that the existing situation did not provide for our country the best outcome in terms of confidence building.

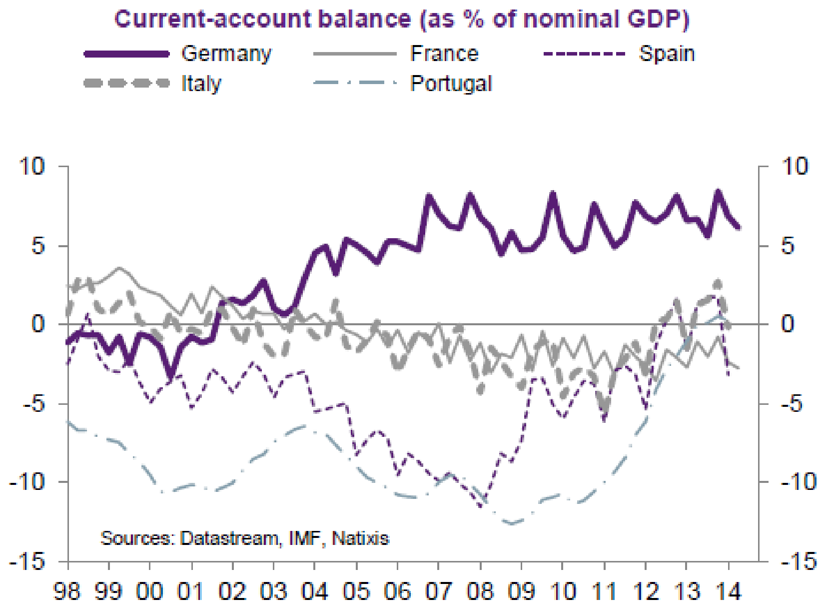
During the elaboration of the RPR-UDF platform for the 1993 legislative elections, I remember having fought, with the support of my political party, to have the independence of the Banque de France recorded among the reforms to carry out. But I have to say that there was no real appetite for this reform, neither from the left, nor from the Gaullists. When as a Finance Minister I had to defend the bill in front of the French parliament in the Spring of 1993, I had to endure harsh criticism from benches on both sides of the chamber. And when in my speeches, I used the term 'independence' of Banque de France, it is telling that the Prime Minister Edouard Balladur himself preferred the word 'autonomy' which has not, after all, the same meaning! The worst and most dangerous moment came when President François Mitterrand who was perfectly aware of the necessity of this reform for France to abide by the Maastricht treaty, asked the *Conseil constitutionnel* to cancel the main article of the bill, which obliged me to come back to Parliament to have the law finally adopted. For my country, this was a sea change to have a central bank not only fully independent, but also forbidden from directly making outright loans to the Treasury.

Let me now briefly make two remarks drawn from the Prolegomenas to the European currency.

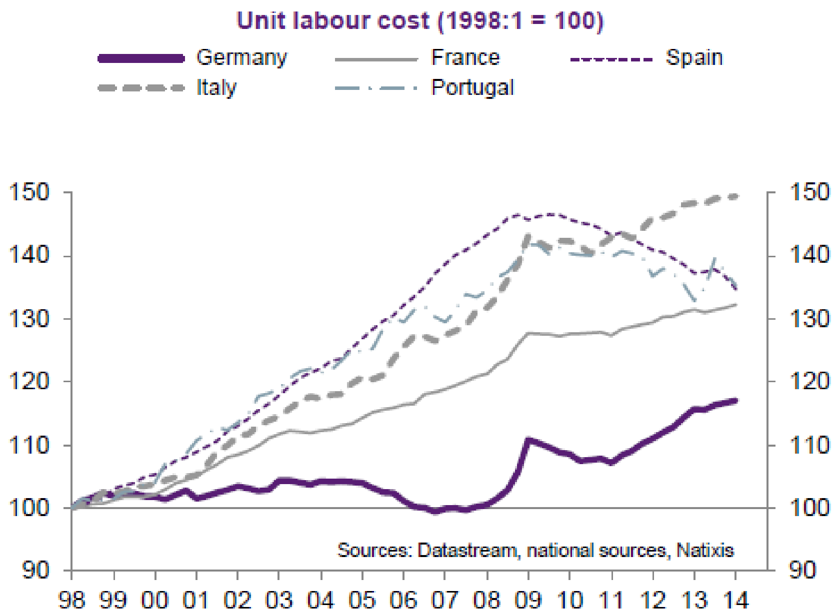
I will start with a comment on the Euro crisis. One of the arguments in favour of the creation of the Euro was that it would prevent member states from any currency crisis: with the euro, the 'impossible trinity' was vanishing *de facto*. Nevertheless, we did experience a serious crisis in the Euro zone which manifested itself on the sovereign bond markets.

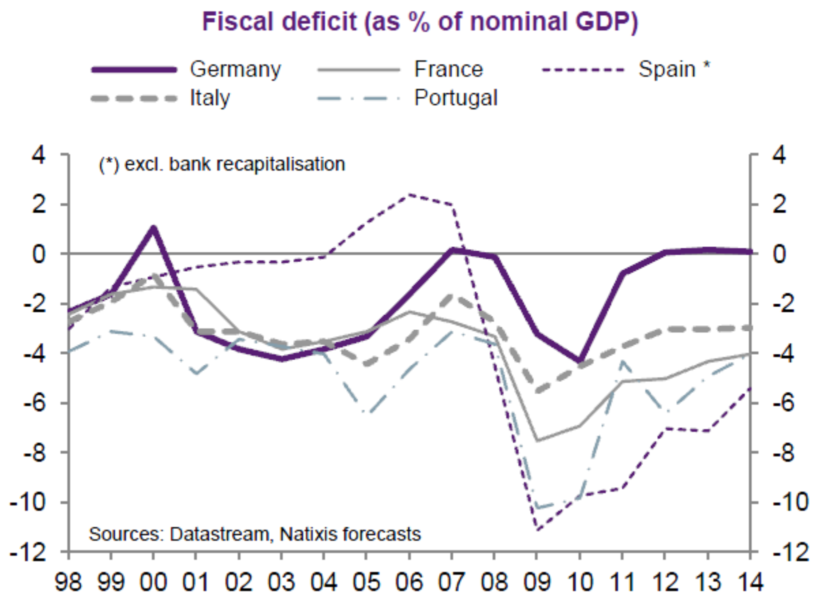


During the first ten years of the Euro, there did not seem to be any problem: spreads between interest rates among Member states had nearly disappeared. But in the meantime, there was a build-up of current account imbalances between countries inside the Euro zone.



In a 'true' currency union like in the US, nobody cares about current account imbalances between the states, because the market forces that are at play in all parts of the currency union make the very notion of balance of payments inside the currency union void of any significance. With the euro, since Member states keep control of their own economic policies, during the first ten years there have been diverging economic orientations which can be seen in the evolution of labour costs or of fiscal positions:





The European currency brought with it another phenomenon which, let us confess it, had been overlooked by the architects of EMU. In the pre-Euro world, living durably beyond its means world would have led a country to devalue its currency and would have forced it to put its house in order to restore confidence. Since 1999, it is well known that there have been two different reactions to the new monetary environment: the Germans on one side, who had entered into this new world with an overvalued Deutschmark and a current account deficit, focused their economic policy on the restoration of their competitiveness. The structural reforms implemented under Chancellor Schroeder led them eventually to finally pile up current account surplus. Peripheral countries on their side (and France as well), could indulge in demand pushed policies which led them to live beyond their means for 10 years and therefore to post current account deficits without tears.

Strangely enough, for ten years there was no backlash from the markets. Investors behaved as if the Eurozone were functioning like a 'genuine' currency union in which there is trust in the mechanisms that automatically adjust the supply of goods, services and capital to the needs which exist in any part of the area. Peripheral countries could therefore easily fund their current account deficits by the outflow of saving coming from the core (mainly Germany).

Then came the Greek crisis, and with it a change in the perception of risks by market participants which I experienced myself as the chairman of CNP Insurance, a 300 billion € life insurance company, which had as the chairman of its finance committee the late Tomaso Padoa-Schioppa. When a country is facing aggregate imbalance, the question of market confidence becomes key. If the country owns its own currency, a lasting current account deficit leads to loss of confidence and hence to sales of its currency on the Forex market. In the Euro area, mistrust directly affected sovereign debt markets of countries in deficits, with a flight of capital back to the core which accentuated the enlargement of the spreads.

By creating a common monetary policy, we were certainly getting rid of 'Mundell's trilemma', but not of the risk of a crisis. In a currency area with decentralized economic policies, loss of confidence in a member State economy may trigger capital outflows which due to contagion mechanisms spreading through the banking sector in the first place, can lead the crisis to spill over into other member countries. All the more so since, before the 'whatever it takes' of Mario Draghi, investors tended to consider that there was no lender of last resort on sovereign debt markets in the Eurozone. The risk of having to bear a 'haircut' (which manifested itself with Greece) was pushing them to shed their holdings of these public bonds.

The second lesson that we learned with hindsight (and it will be my brief concluding remark since it will be discussed in the next panel) is that it is far from being sufficient to put into place a common central bank with a set of fiscal rules that member states have to respect, to have a stable and sustainable currency union. During the first ten years of the Euro, too many member states which were lured by the apparent success of the European currency, lost sight of the importance of making the reforms necessary to foster competitiveness of their economy. It is now clear that among the missing piece of the Maastricht Treaty was a series of obligations imposed on Member states for undertaking the structural reforms (be it on labour markets, on social or public expenditure) necessary for the good functioning of the Euro area. This is why the macroeconomic imbalances procedure has been put in place to fill this gap.