

The ERM Crisis 1992 – 1993

“Why and how did the French Franc remain
in the European Exchange rate system ?”

By Jacques de Larosière

1. The conjunctural and political facts are well known

- The “No” expressed by the Danish people in response to the Maastricht referendum in June 1992
- The subsequent exit of the £, the Lira and other currencies from the ERM
- The tensions on the Swedish krone
- The ineffective realignment of September 13 1992, the fateful interview of President Schlesinger on the 15th and the £ exit on the 16th

After the timid “Yes” given by France to the Maastricht referendum on September 20, speculation was ready to attack the Franc and destroy what remained of the ERM.

Probabilities expressed by analysts on the markets were massively against the Franc remaining in the system.

2. But the “fundamentals” determining the exchange rate between the DM and the FF happened to be right.

- French inflation was low and even somewhat lower than in Germany
- The budgetary position in France was close to balance while Germany was about to embark on massive deficits due to reunification
- Therefore the exchange rate was not a “problem” : Exports were competitive and the existing rate between the French Franc and the DM was seen as adequate : French firms were not demanding a devaluation

3. This was different from the situation of the £. Sterling had entered the ERM in October 1990 at an overvalued exchange rate according to the prevailing views at the time.

This misalignment was to come back and haunt the UK later on.

I have never understood why the UK had insisted on such a high rate of entry and, actually, refused to even discuss it with ERM partners. Everyone knew that German monetary policy was going to be tightened because of the re-unification and of the economic budgetary transfers to the Eastern part of the country.

Therefore the combination of an overvalued rate coupled with the prospect of high interest rates on the DM (and, on top of everything, a reduction of UK interest rates) was lethal. Speculation was bound to capitalize on such a contradiction which could only be solved by the devaluation of the £ or its exit from the ERM.

4. How did the Banque de France manage to get through the storm ?

The strategy was simple and was constantly reaffirmed:

- France was ready to keep higher interest rates than in Germany and, if needed, to increase the differential during the crisis. As Governor, I insisted on interest rate hikes. That was the French “contribution” to the joint effort. A painful contribution for a low growing, non-inflationary country. But it was the manifestation of a joint effort and also a cost imposed on speculation.
- To the markets the two Central Banks had to be seen as totally on the same wavelength.

Therefore our common communiqués insisted on :

- The full adequacy and immutability of the FF/DM exchange rate
- The – practically unlimited – financial support from the Bundesbank to the Banque de France

The result that I wanted to achieve was that speculators would eventually realize that they were not attacking the FF but, in fact, the DM.

I expressed that view on several occasions and the magnitude of the Bundesbank support gave credibility to that affirmation.

So the amounts of DM support were more than significant, they were overwhelming (29 billion DM swap facility).

At the peak of the crisis, on September 23, 1992, the French net negative reserve position had reached minus 15 billion dollars.

5. How did it end ?

With the enlargement of the exchange rate band within the ERM, in August 1993. I fought in Brussels for 20%, eventually the agreed figure was 15%. Ken Clarke played an important role during that night in Brussels. He was conscious that the future of the Union was at stake and actively participated in the final decision.

Contrary to some views expressed, the enlargement did not lead to a devaluation of the Franc. Actually, the central rate regained very quickly its initial levels. Markets had been unsaddled. It would have made no sense in economic terms to speculate on a further 15% move. They thus unwound their positions – that were getting costly given the interest rate differentials between the two countries. The unwinding was extremely rapid. All the borrowed DM were repaid a few weeks after the enlargement of the ERM band. And France took quite a time to normalize its interest rates.

*

* *

There is a moral in this tale: fundamentals do count and exchange rate fixity can prevail if there are no obvious competitiveness problems at hand.

I should add, of course, that, contrary to the British developments, France and Germany – President Mitterrand and Chancellor Kohl – had embarked on a close political alliance that was to end up 7 years later in a common Monetary Union. Such a nascent project was worth a significant degree of support.

But it remains that the German policy mix at the time penalized a country like France where slow growth and low inflation would have justified loosening monetary policy.

*

* *

Was it a mistake to remain in the ERM at such a high cost ?

The answer depends on the importance given to the move towards Monetary Union.

An exit of the FF on September 21 or 22 would have had major consequences for the future of the Monetary Union project and would have most probably destroyed it.

It was not only the FF that was at stake in 1992-93. But the upcoming enforcement of Monetary Union.

In fact, the £ exit strengthened and accelerated the Monetary Union project. All members realized that massive speculation could always threaten the system and that the creation of a single monetary currency was the only solution to end such speculative exchange rate crises.

Of course, EMU could not, by itself, resolve the tensions and the structural discrepancies in the region. But it was seen, in a country like France, as a way of encouraging anti-inflationary policies. And, in effect, the move towards convergence was positive until 2010.

The irony is that national structural discrepancies in the EU were exacerbated from 2000 until 2010. Too little attention had been paid to structural reforms and to the need for a minimum of convergence.

*

* *

The paradox is this one :

The UK, which had a flexible economy, capitalized on its exit from the ERM and on the lower inflation that started to prevail thereafter. It felt free to regain its autonomy and not to abide by the ERM rules.

France, which has an inflexible economy because of major structural distortions, thought that the ERM (and later EMU) discipline would help to converge with Germany.

But, in fact, discrepancies have somewhat increased and tensions have not disappeared : now they show up in current account imbalances instead of exchange rates.

Jacques de Larosière