

THE WAY TO EMU :
LESSONS FROM THE FRENCH EXPERIENCE -
1986-1999

Warsaw, National Bank of Poland, October 2, 2003

I am particularly happy and honored to be invited today by Mr. Balcerowicz, President of the National bank of Poland -who has played such a decisive role in the opening up and adjustment of the polish economy-, to express some thoughts about the experience of the french monetary policy in the eighties and the nineties until the creation of the European Monetary Union (EMU) on January 1st 1999.

Since the end of the second world war, the performance of the french economy in terms of price stability had not been the best in Europe. In fact, inflation had been for decades a chronic ill in my country.

But, the policy of "competitive desinflation" which was put in place in France in the mid-eighties has been a true watershed. Over the last twenty years or so, France, with an average increase in prices of around 2 % per year, has become one of the countries of the OECD and of EMU where nominal evolutions have been the most successfully contained.

As I have been governor of the Banque de France from January 1987 until September 1993, I thought you might be interested to hear my own assessment of the french experience.

I shall divide my remarks into the four following points :

1. the foundations of french monetary policy ;
2. monetary policy strategy ;
3. its results ;
4. the lessons that can be drawn.

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1. The foundations of french monetary policy during the period :

1.1. The past experience has justified the adoption of a new strategy : that of a "competitive desinflation" :

Until the mid-eighties, the french economy was characterized by a strong level of regulation, a relatively limited recourse to market mechanisms, chronic inflation and recurrent deficits of the balance of payments. But in the years 1983-85, the french authorities decided to move towards a strategy geared to lowering inflation and to increasing the competitive position of the economy. That policy was established after the major economic and financial shocks and drawbacks that France suffered in 1981-82. Let me give you a few examples of the difficulties that were encountered at the time and which militated in favor of a radical policy change.

- Inflation had become a permanent feature of the french economy:

France had a greater tolerance to inflation than was the case in Germany. The lack of a social consensus nourished a "self perpetuated" inflationary process through the ex-post indexation of wages in the public sector. France, which had gone through bouts of inflation in the fifties, had experienced in the sixties and thereafter a persistent acceleration of inflation.

- The competitiveness of the french industry had deteriorated :

External oil shocks had been passed on to the enterprises which increased their own prices in order to protect their margins. Given the delays in exchange rate alignments, this process eventually led to the deterioration of corporate competitiveness and of the balance of payments. This, in turn, created tensions on the exchange rate. The "expansionist" plan of the French government in 1981-1982 led to a burst in inflation, a deterioration of the current account and an intense speculation against the french franc for a period of two and a half years. In such a context, long term interest rates were high.

- Monetary policy was accommodating :

Monetary policy accommodated the expansionist policies of 1981. This led to a series of devaluations (realignments) within the European Monetary System (ERM : "Exchange Rate Mechanism"). These devaluations increased the cost of imports, therefore eroding the competitive advantage gained by

the corporate sector. The failure of this policy led the authorities, after 1983, to put in place a competitiveness oriented policy based on reducing real costs. A significant turnaround was realized in the field of wage policies with the abolition of wage indexation in the public sector in 1983.

Eventually, after some debate, the french government opted for a full participation in the European construction notably concerning the European exchange rate system. Thus, in opting for the opening of our markets (this was called in France in the old days : the "external constraint"), France accepted the whole set of consequences of that option : deregulation, liberalization of trade, capital movements and foreign investment.

1.2. The strategy of "competitive desinflation" :

The policy called "competitive desinflation" was aimed at mastering inflation and reinforcing corporate competitiveness in order to catch up in terms of growth and employment.

This policy was based on three pillars :

- a monetary policy geared to the lowest rate of inflation possible ;
- a policy oriented towards reducing costs in order to improve the competitiveness of the french economy in its natural environment, that of the European market ;
- the beginning of structural reforms destined to provide more dynamism and competition to the french economy.

The deceleration of wage costs led to lower levels of inflation and to improved margins thus allowing enterprises to invest in order to enhance their structural position. Keeping a stable currency provided an incentive to french industry to restructure and increase its productivity without raising prices. It also allowed to import raw materials and equipment goods at lower costs.

A result as well as a condition of this strategy, the stable currency policy triggered this virtuous circle. In turn, the improvement of structural industrial competitiveness enhanced the balance of payment surpluses which, themselves, after 1990, buttressed the exchange rate.

But one must recognize that a fourth pillar required by the adjustment of the french economy was, to a large extent, deficient. I have in mind the conduct of budgetary policies. The general government deficits in France have been, indeed, significantly higher than those of Germany during the eighties until the mid-nineties (see annex I). Thereafter, the performances of the two countries

have converged benefiting, in a first stage, from the economic expansion of 1998-2000, but deteriorating together as we know too well over the last two to three years.

There is no doubt that the results of the french economic policies in terms of growth and long term interest rates would have benefited significantly from a stricter fiscal policy.

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2. Monetary policy strategy in France :

As I have just mentioned, monetary policy strategy also changed : a consensus had emerged in the mid-eighties to give it a fundamental mission : that of monetary stability.

2.1. The final and quantified objective of price stability :

The final objective had become a policy priority in the mid-eighties and was formalized some ten years later in the first article of the new statute of the Banque de France.

In conformity with the Treaty creating the European Monetary Union which was ratified by France, the law dated August 4, 1993 instituting the independence of the Banque de France, has given the central bank the mission to "define and carry out monetary policy with the goal of ensuring price stability" (article 1). The definition of price stability was, later on, quantified explicitly by the Banque de France: price increases, measured by the index of consumer prices, were not to exceed 2 % a year in a medium term perspective. This definition is now the one adopted by the Euro system.

2.2. Two intermediate objectives : external and internal :

For nearly twenty years, the French monetary policy referred to two intermediate objectives, one external, based on the stability of the currency, the other one, internal, geared to the evolution of money supply.

- External objective : this intermediate objective -stability of the exchange rate- has been pursued with France's participation in the ERM since its inception in 1979. The objective was to ensure the stability of the french franc vis à vis the most credible currencies of the system.

This commitment to an exchange rate policy of stability has been an essential factor in moderating inflationary expectations. In an economy as open as France's, where external trade accounts for about one quarter of GDP, the stability of the exchange rate was indeed a condition for domestic price stability.

This external objective has been -in spite of a number of realignments until 1987- a fundamental element of monetary policy. The movement towards EMU has of course strengthened this strategic orientation.

- Internal objective : furthermore, the Banque de France was following another intermediate objective since 1977 related to the growth of M2. After 1991, M3 was substituted to M2 because of its better protection against portfolio shifts.

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3. The results :

The objectives of french monetary policy have been met.

France can prevail itself of a relatively low and stable inflation rate over a number of years. Since 1990, France's rate of inflation has been maintained at a lower level than that of its main trading partners. This trend has increased the competitiveness of the french currency given the fixity of its exchange rate vis à vis its European neighbors. One has also observed the almost elimination of the risk premia which, on monetary and financial markets, used to affect french interest rates as compared to those of the most stable members of the ERM.

3.1.Price stability :

While the inflation rate had gone up to 14 % at the beginning of the eighties, it has strongly decelerated until 1987 and then stabilized at around 3 % and later on at 2 %. After 1985, the french inflation rate has become lesser than the european average, whilst the inflationary differential with Germany gradually reduced and then reversed in favor of France in July 1991.

3.2.Exchange rate stability :

Since 1987, the french franc was not affected by any relignment within the ERM. Conditions had indeed gradually improved. After years of depreciations vis a vis the deutsch mark the franc had become one of the strongest currencies of the ERM. It resisted with success to the speculative pressures when exchange

markets became turbulent in 1992-1993. Indeed, market participants knew that a devaluation of the franc would not have been justified by the fundamentals of the french economy. The franc had benefited from the macroeconomic policy of price stability which had led to a strong competitive position of french industry. It also was strengthened by the excellent monetary cooperation with Germany within the ERM.

3.3. The elimination of spreads on interest rates :

The spreads on short term and long term interest rates vis à vis our main partner, i.e. Germany, have considerably reduced (see Annex II). From more than 300 basis points on the ten year German bond, the french spreads came down to 50 basis points in 1995 and have been eliminated in 1998. On short term rates, the same convergence has been observed. On December 3, 1998, the last national decision in terms of monetary policy brought down the main rate to 3 % within a coordinated movement of lowering interest rates decided at the time by the monetary authorities of the eleven members of EMU.

3.4. Cost competitiveness and balance of payment surpluses :

The improvement, since 1987, of the competitiveness of the French economy (measured by unit labor costs calculated by the OECD) has reached 13.2 % vis a vis the Euro zone, 17.4 % vis a vis the European Union and 20.9 % vis a vis the OECD. Within the single market, our natural market, France is today in a competitive condition which is better than that, already satisfactory, reached in August 1992 before the depreciation of the pound, the lira and the peseta in september 1992. France has reached during each of the three years 1997-98-99, the second most important current account surplus in the world and the first in Europe, accounting for 2.5 to 2.8 % of its GDP.

3.5. The french performance had become a reference for the measurement of EMU criteria :

Before the creation of the euro, french monetary and financial performance was in line with each of the three monetary criteria governing the entry into the Euro (exchange rate, prices, long term interest rates). When convergence was assessed, France had a currency which was stable within the ERM, the second lowest rate of inflation and the lowest long term interest rates, together with the Netherlands. The results of France were therefore used as a reference to calculate the average of the three best performances against which were measured the results of all the other acceding EMU countries.

4. The lessons that can be drawn from this experience :

4.1. The exchange rate was an essential element of monetary policy :

The stability of the exchange rate has been the essential element of the nominal anchor chosen as the basic monetary strategy. This implied that the exchange rate could not be used as a short term adjustment instrument.

In this respect, one of the determining factors in reducing and mastering inflation has certainly been the external stability of the franc whose fluctuations vis à vis the other currencies of the ERM were contained in spite of the very strong tensions which affected the exchange markets notably in 1992-1993. The commitment of the french authorities to a stable exchange rate was confirmed on August 2nd 1993, with the decision to maintain unchanged the central rate of the franc within a fluctuation band enlarged to 15 %. The other Central Banks of the Union also recognized that this central rate was justified by the fundamentals of the french economy. In fact, this assessment was vindicated by the markets : the french franc remained stable within the ERM until its transformation into the Euro.

4.2. Monetary policy contributed to economic growth :

The "competitive desinflationary" strategy described above was not intended to reward the French economy with the "price of the lowest inflation" nor to achieve a form of extreme "monetary orthodoxy". Monetary stability was chosen to enhance a strategy oriented towards economic growth, competitiveness and job creation.

One observation underlines the fact that the french economy had reached over the years a satisfactory level of competitiveness : a rate of growth significantly higher than that of our large European partners, combined with the highest balance of payments surplus in the EMU. In sum, during the four years 1997-2000, the accumulated growth of the french GDP in volume has been higher by 3 percentage points than that of Germany and 4 points above that of Italy.

4.3. The independence of the Central Bank has strengthened the credibility of monetary policy :

Worldwide experience has shown that the efficiency of monetary policy is strengthened by the credibility and the reputation of Central Banks. A necessary

condition -albeit not sufficient- for this credibility is a clear, solemn and irreversible commitment to a monetary policy geared to price stability. The new statutes of the Banque de France which are in force since the beginning of 1994 have been clearly established on that basis, the elaboration and execution of monetary policy being of the responsibility of the Council of Monetary Policy which, by law, is independent and collegial.

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This presentation which has focused on the french experience of the last twenty years or so, may appear to you rather far from your immediate concerns. The situation of my country and the conditions observed at that time were, indeed, quite different from the present realities in Poland.

Nonetheless, the analysis that I have shared with you contains a number of thoughts that can help, in my view, to reflect on the major subject which is in your minds, i.e. the future entry of Poland in the EMU.

In this perspective, I shall make a few observations which transcend the circumstances faced by my country over the last twenty years.

1. Monetary stability is a primary condition for long term growth. Obviously, it is not a sufficient condition. But, without such stability, confidence in the currency is undermined, exchange rates become more volatile and monetary uncertainties have a negative impact on consumers and investors, domestic as well as foreign. This is all the more obvious in a world where capital flows are free.
2. A monetary policy geared to stability is all the more successful when it is backed by a satisfactory "policy mix", i.e. by a consistent setting of fiscal and monetary policies. Excessive structural fiscal deficits tend to push interest rates higher and to reduce investors access to local savings. They also weaken the external position and compound the task of monetary policy. This is why the commitment to a responsible fiscal policy contained in the Pact for Stability and Growth is so crucial.
3. Monetary and exchange rate stability can provide a powerful engine for adjustment. When short term "fine-tuning" and repeated depreciations are no more available, economic and political agents have no other choice but to act on real variables.
4. The more monetary policy succeeds in stabilizing prices, the more inflationary expectations will be reduced and the less exchange rates

fluctuations will become a major problem. Reaching an inflation rate as close as possible to the average rate of the Euroland will maintain economic competitiveness and reduce the negative impact of "structural inflation" linked to economic adjustment and transition. Such a monetary policy does not, of course, protect, in all circumstances, a country against speculative capital movements. The french experience of 1992-1993 has shown how a currency, in spite of good fundamentals and a strong competitive position, could be the target of speculation. Eventually, in order to calm the markets, the ERM fluctuation band was enlarged from 2.25 % to 15 %. But, the markets **did** calm down because of the accumulated good performance of the franc in terms of inflation and competitiveness.

5. Lastly, I would like to underline a central issue : that of credibility. In a world dominated by uncertainties, it is all the more indispensable to ensure monetary stability. Such stability is indeed the foundation of a market economy. It gives credibility to the Central Bank and to the currency. It protects the purchasing power of the weaker segments of the population. It is a crucial element of the social unity of a nation, an "ethical obligation" as Dr. Otmar Issing has recently stated in his remarkable paper : "Monetary policy in a world of uncertainty"¹.

Poland is facing a major challenge : to ensure under the best conditions its participation in the Euro. I have no doubt that your nation will live up to that challenge and that macroeconomic stability, structural reforms and monetary stability will be key priorities that will foster growth, productivity, investment and employment in your country.

¹ Economie Internationale (2002) pages 165/180.

Annexe : Tableau 28. Solde financier des administrations publiques
Excédent (+) ou déficit (-) en pourcentage du PIB nominal

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Prévisions 2003	2004
Australie	-5.1	-4.2	-2.2	-0.3	-0.3	-1.8	-3.8	-6.0	-3.7	-4.6	-5.5	-2.2	-0.5	0.6	1.1	0.3	-0.6	-0.1	0.2	0.5
Autriche	-2.6	-3.8	-4.4	-3.5	-3.1	-2.4	-3.0	-2.0	-5.3	-5.0	-4.2	-4.0	-2.0	-2.4	-2.3	-1.5	0.2	-0.6	-1.3	-1.1
Belgique	-10.2	-10.1	-7.9	-7.5	-7.7	-6.8	-7.5	-8.1	-7.5	-9.0	-4.3	-3.8	-2.0	-0.7	-0.5	0.1	0.4	0.0	0.0	0.2
Canada	-8.9	-7.2	-5.4	-4.3	-4.6	-5.9	-8.4	-9.1	-8.7	-6.7	-5.3	-3.8	0.2	0.1	1.7	3.1	1.8	1.3	1.1	1.0
République tchèque ^a	..	..	..	..	..	..	..	-0.4	-2.3	-3.4	-12.3	-3.0	-2.4	-4.7	-3.7	-4.0	-2.8	-4.5	-6.3	-6.2
Danemark	-1.4	3.3	2.5	1.5	0.3	1.0	-2.4	-2.2	-2.9	-2.4	-2.3	-1.0	0.4	1.1	3.2	2.5	2.8	1.8	1.6	1.9
Finlande	3.2	3.6	1.3	4.8	6.5	5.1	-1.4	-5.8	-7.5	-5.9	-3.9	-3.0	-1.3	1.5	2.0	6.9	5.1	4.7	3.1	2.9
France	-3.0	-2.2	-2.0	-2.5	-1.8	-2.1	-2.4	-4.2	-6.0	-5.5	-4.1	-3.0	-2.7	-1.8	-1.4	-1.4	-1.5	-5.2	-3.6	-5.3
Allemagne	-1.1	-1.1	-1.8	-2.0	0.3	-2.0	-2.9	-2.6	-3.1	-2.4	-3.3	-3.4	-2.7	-2.2	-1.5	1.1	-2.8	-5.6	-3.7	-5.3
Grèce	-11.6	-9.6	-9.6	-11.4	-14.2	-15.9	-11.4	-12.6	-13.6	-9.9	-10.2	-7.4	-4.0	-2.5	-1.8	-1.9	-1.4	-1.2	-1.0	-0.7
Hongrie	..	..	..	..	..	..	..	-3.0	-7.1	-6.6	-11.0	-7.6	-8.3	-8.3	-5.2	-2.9	-5.2	-6.4	-5.6	-5.0
Islande	-1.7	-4.1	-0.9	-2.0	-4.6	-3.3	-3.0	-2.9	-4.6	-4.8	-3.0	-1.6	0.0	0.5	2.4	2.5	0.5	0.2	0.0	0.1
Irlande	-10.3	-10.2	-8.2	-4.2	-1.7	-2.8	-2.9	-3.6	-2.3	-2.0	-2.1	-0.1	1.4	2.3	2.0	4.5	1.6	-0.3	-0.8	-1.2
Italie	-12.7	-12.2	-11.8	-11.5	-11.7	-11.8	-11.7	-10.7	-10.3	-9.3	-7.6	-7.1	-2.7	-3.1	-1.8	-0.7	-2.7	-2.5	-2.4	-2.8
Japon ^b	-6.6	-6.7	0.3	1.1	1.8	2.0	1.8	0.8	-2.4	-3.7	-4.7	-5.0	-3.8	-5.5	-7.2	-7.4	-6.1	-7.1	-7.7	-7.8
Corée	1.2	1.6	2.7	3.6	3.5	3.5	1.8	1.4	2.5	3.1	4.3	3.8	3.6	3.0	3.1	6.2	5.3	6.0	3.4	3.9
Luxembourg	..	..	..	..	..	..	4.9	1.2	0.8	1.6	2.8	2.1	1.9	3.2	3.0	3.5	6.1	6.4	2.6	6.2
Pays-Bas	-3.2	-4.5	-5.3	-4.2	-5.0	-5.3	-2.7	-4.2	-2.8	-3.5	-4.2	-1.8	-1.1	-0.8	0.7	2.2	0.1	-1.1	-1.6	-2.0
Nouvelle-Zélande	..	-6.4	-2.1	-4.6	-3.4	-4.6	-3.5	-3.1	-0.4	3.1	2.9	2.8	1.6	0.4	0.2	0.9	1.8	1.3	0.8	0.5
Norvège	9.7	5.6	4.4	2.5	1.8	2.5	0.1	-1.9	-1.5	0.3	3.4	6.5	7.8	3.6	6.1	15.0	14.8	12.8	11.3	10.7
Pologne	..	..	-7.2	-3.8	-3.1	-6.6	-7.6	-4.8	-8.1	-7.7	-5.5	-2.9	-2.8	-2.3	-2.0	-3.0	-5.1	-5.7	-6.2	-5.9
Portugal	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
République slovaque	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Espagne	-7.0	-6.0	-3.1	-3.1	-2.6	-3.9	-4.6	-3.7	-6.9	-6.5	-6.6	-4.9	-3.2	-2.7	-1.1	-0.6	-0.1	-0.1	-0.4	-0.2
Suède	-3.7	-1.5	3.8	2.9	4.7	3.7	-1.9	-7.6	-11.6	-10.5	-7.4	-2.9	-1.7	2.3	1.3	3.4	4.6	1.1	0.7	1.2
Royaume-Uni	-2.9	-2.6	-1.8	0.5	0.8	-1.6	-3.1	-6.4	-7.9	-6.7	-5.8	-4.4	-2.2	0.2	1.1	3.9	0.8	-1.2	-1.9	-2.2
Etats-Unis ^c	-3.1	-3.3	-4.3	-3.6	-3.2	-4.3	-5.0	-5.9	-5.0	-3.6	-3.1	-2.2	-0.9	0.3	0.7	1.4	-0.5	-3.4	-4.6	-4.2
Zone euro	-5.0	-4.9	-4.6	-4.4	-3.8	-4.7	-5.1	-5.1	-5.0	-4.3	-5.1	-4.3	-2.6	-3.3	-1.3	0.1	-1.6	-2.3	-2.5	-2.4
Union européenne	-4.9	-4.6	-4.0	-3.6	-3.0	-4.1	-4.7	-5.4	-6.4	-5.7	-5.4	-4.3	-2.5	-1.7	-0.8	0.7	-1.1	-2.0	-2.3	-2.2
Total de l'OCDE	-4.2	-4.1	-3.3	-2.6	-2.1	-3.0	-3.8	-4.6	-5.2	-4.3	-4.1	-3.2	-1.8	-1.4	-1.0	0.0	-1.3	-2.9	-3.6	-3.5

^a Pour référence

Solde financier des administrations publiques hors sécurité sociale

Etats-Unis	-5.1	-5.4	-4.8	-4.4	-4.2	-5.4	-5.9	-6.7	-5.7	-4.5	-3.9	-5.1	-2.0	-0.9	-0.7	-0.1	-2.1	-5.0	-6.1	-5.8
Japon ^b	-3.1	-3.5	-2.5	-2.0	-1.4	-1.4	-0.8	-1.7	-4.7	-5.7	-6.6	-6.8	-5.9	-6.8	-8.2	-7.9	-6.2	-7.2	-7.7	-7.8

Notes : Le solde financier comprend les recettes perçues par le biais de licences de téléphone mobile pour les pays où les services réglementés sont la Belgique (1990), l'Autriche (2000), l'Allemagne (2000), la Belgique (2001), l'Espagne (2000), la France (2001-2002), la Grèce (2001), l'Italie (2000), la Nouvelle-Zélande (2001), les Pays-Bas (2000), le Portugal (2000) et le Royaume-Uni (2000). De plus, ces chiffres sont sur une base comptable nationale pour certains pays de l'Union européenne et pour certains autres, ils peuvent être différents de ceux transmis à la Commission européenne dans le cadre de la procédure de déficit excessif. Voir les Perspectives économiques de l'OCDE. Sources et méthodes des données : OCDE, *Accounting and statistical data* (www.oecd.org/dataoecd/0/0/20000000).

^a En 1991 et 1995 les données reflètent l'imputation comparative de privatisation qui a transféré la propriété de certaines entreprises publiques à la population par l'intermédiaire de coupons de privatisation. Les données sont sur la base SIC 95 avant 2001. À partir de 2001, elles s'appuient sur la méthodologie utilisée par le FMI pour les statistiques de finances publiques.

^b Les données d'impôts différés sur les comptes d'épargne postaux sont incluses en 2000, 2001 et 2002. En 2000, les dépenses financières des monstres en espèces à la compagnie qui assure les dépôts bancaires.

^c Les chiffres concernent uniquement les entreprises publiques.

^d À partir de 1991, les données sont définies sur la base SIC 95 et excluent les fonds de pension privés.

Source : OCDE.

Annex II

*Écart entre les taux d'intérêt France-Allemagne
(moyennes mensuelles de janvier- en pourcentage)*

	Taux à 3 mois	Taux longs (emprunts phare) à 10 ans
1988.....	+ 4,85	+ 3,36
1989.....	+ 2,97	+ 1,95
1990.....	+ 3,02	+ 1,96
1991.....	+ 0,94	+ 0,91
1992.....	+ 0,46	+ 0,52
1993.....	+ 3,26	+ 0,83
1994.....	+ 0,42	+ 0,03
1995.....	+ 0,72	+ 0,66
1996.....	+ 1,05	+ 0,55
1997.....	+ 0,20	- 0,11
1998.....	0,00	0,00