Mr. Trichet discusses Franco-German monetary cooperation and monetary union Speech by the Governor of the Bank of France, M. Jean-Claude Trichet, on the occasion of the fiftieth anniversary of the Land central bank of Rheinland-Palatinate and the Saarland in Mainz on 2/6/97.

It is a great honour to speak in Mainz today and to celebrate the fiftieth anniversary of the Land central bank of Rheinland-Palatinate and the Saarland. Everybody knows that Mainz played a decisive role in spreading culture and ideas in Europe, in particular thanks to the invention of printing by Gutenberg.

And the celebration of the fiftieth anniversary of your institution gives me the opportunity to underline once again the prominent role played by the Bundesbank for the stability, credibility and prosperity of the German economy. As you know, the Banque de France deeply supports this culture of stability, which sets the basis for monetary cooperation between France and Germany, the basis for European monetary union. The celebration of an anniversary is a good opportunity to draw lessons from the past and to foresee the future. That is why I have decided today to speak about Franco-German monetary cooperation during the last fifty years and the prospects for monetary union. In this respect, the creation of the single currency on January 1st, 1999 is a major event for our respective countries. Far from being a breaking off with the past, the creation of monetary union is the logical crowning of Franco-German monetary cooperation. Indeed:

- *Franco-German monetary cooperation is based on solid foundations and has steadily developed during the last fifty years (1)*
- *this cooperation will be crowned by the creation of monetary union in 1999 (2).*

FRANCO-GERMAN MONETARY COOPERATION IS BASED ON SOLID FOUNDATIONS AND HAS STEADILY DEVELOPED DURING THE LAST FIFTY YEARS

In order not to bother you by an unduly long speech, I will focus on the last fifty years only! Nevertheless, one could easily demonstrate that our respective monetary histories have been deeply linked since the Middle Ages. Indeed, Emperor Charlemagne enacted a bill creating a unit of account common to its whole empire, which enshrined most of the present territories of France and Germany. The global features of the system (in particular the subdivisions) experienced an exceptional longevity of almost 1000 years.

The last fifty years constitute, however, a rather homogeneous period, during which Franco-German monetary cooperation really developed. First, it is useful to underline the solid roots and foundations of this cooperation. These foundations paved the way for the emergence of a common destiny, which is best illustrated by the creation of the EMS. This community of views and interests have been crucial in the decision to create a European monetary union and a single currency.

I will first explain the solid roots and foundations on which Franco-German monetary cooperation is based

Franco-German monetary cooperation is based on historical and economic foundations.

The ***historical roots*** of Franco-German monetary cooperation can easily be identified.

Both countries had first to rebuild the whole economy in 1945, in a period when sacrifices were difficult to impose on populations. Germany tackled these disturbances rapidly and efficiently. The monetary reform implemented in 1948, aimed at definitively eradicating inflation, paved the way for monetary stability and economic prosperity. A new currency - the Deutschemark - was introduced, and a strong and independent central bank was founded.

France followed a similar strategy with the creation of the “nouveau franc” or “new franc”, whose nominal value was 100 “anciens francs” or “old francs”. This reform contributed to stabilizing the French currency, which did not experience any devaluation for ten years.

In 1971, the collapse of the Bretton Woods system and the currency instability which followed convinced European Governments that an exchange rate system had to be set up. The first experience, known as the Snake, was not completely successful, but was the first step towards a common monetary destiny between European countries.

As far as ***economic foundations*** are concerned, our two economies have been increasingly interlinked for decades.

First of all, the various obstacles to foreign trade in Europe have been progressively lifted. Indeed, the Treaty of Rome signed in 1957 aimed at creating a common market. The removal of all sorts of barriers to trade proved nevertheless difficult to achieve. That is why the European authorities felt that another step was indispensable, and signed the Single Act in 1987. By now all persons, goods, services and capital can move freely from one country to another. This is the case for France and Germany.

Trade is a good example of this integration. The share of French imports coming from Germany is currently about 19%, while the share of German imports coming from France is about 15%. Each country is the other's first trading partner. Beyond these gross figures, it is interesting to note that this trade is largely made of complementary goods as opposed to substitutable goods, thus increasing interdependence.

This interdependence is not only commercial, it is more generally macroeconomic. Econometric work has indeed shown that French and German GDPs are closely correlated. This means that national economic policies cannot deviate excessively from each other.

<u>These foundations progressively convinced France and Germany that they needed a common monetary destiny</u>

As I said earlier, the collapse of the Bretton Woods system led European Governements to organize monetary relations between each other. France and Germany were among the most prominent actors in this strategy. I personally see two main elements in this common destiny: the creation of the European monetary system (EMS) in 1979 and the emergence of a conceptual convergence between our two countries as regards monetary issues.

The creation of the ***European Monetary System*** in March 1979 highlights best the cooperation between France and Germany. The EMS not only provided exchange rate stability through the setting-up of formal fluctuation bands between currencies; it also organized a monetary solidarity between countries, by providing compulsory interventions and related financing facilities.

Although the very first years of the EMS were characterized by several currency realignments, due to insufficient nominal convergence between countries, the system progressively contributed to exchange rate stability. German monetary policy, based on stability and credibility, proved to be efficient. In this context, the French authorities fully endorsed the objectives and disciplines of the EMS and embarked on monetary and exchange rate stability.

The years that followed were characterized by increasing convergence between countries and fewer realignments. All countries, including new participants in the system, adopted similar strategies. Although satisfactory in theory, this stance was nevertheless difficult to follow for some economies still facing imbalances, and in particular a lack of competitiveness.

This explains partly the crises that occurred in 1992 and 1993. I cannot forget how efficient Franco-German cooperation was during this difficult period.

This concrete cooperation has also been made possible by the emergence of a ***conceptual convergence*** as regards monetary issues. Since 1987, the central rate of the French franc within the European exchange rate mechanism (ERM) has been unchanged, and a virtuous disinflation process has been taking place. This policy has allowed French short-term and long-term interest rates to decline steadily and to stand at similar levels to those reached by the best performers within the EMS. And a consensus has emerged in France that monetary policy should be shielded from short-term influences and short-termist strategies and placed in the framework of a medium and long-term strategy of credibility.

In this respect, a decisive step was the decision to grant independence to the Banque de France in late 1993. This reform was based on a new perception by the French populace of the role of a central bank in a developed country. The last three years have shown that independence was not merely a theoretical concept; the Banque de France has adopted its monetary policy and has made its own decisions, according to the law without any interference from the Government. The Banque de France has steadily increased its credibility among market participants and other observers.

The stability culture that has developed in France during the last decade is deeply rooted in French society itself. A strong consensus now exists in favour of a stable currency backed by an independent central bank and contributing to preserving the purchasing power of the currency, and thereby the purchasing power of citizens.

That is why Franco-German monetary cooperation made the case for European monetary union more obvious

Indeed it is clear that a single market is more efficient if it is backed by exchange-rate stability. Excessive exchange-rate volatility and misalignments are invisible barriers to trade, since they increase uncertainty and create inappropriate and erratic competitive fluctuations. Moreover, in an environment characterized by free capital movements, isolated monetary strategies are made more difficult. There is thus a need for monetary coordination, whose ultimate form is the creation of a monetary union and a single currency. France and Germany have had no difficulty in understanding this development and are deeply involved in the preparatory work for EMU.

The ***Maastricht Treaty*** contains clear and efficient monetary provisions by setting specific deadlines for the creation of a single currency and by organizing three separate stages for this process. These stages allow for a progressive but logical move to monetary union, which ensures that the single currency will rest on solid foundations.

Moreover, the independence of the European System of Central Banks, made up of the European Central Bank and national central banks which is fully warranted by the Treaty, will guarantee price stability and the credibility of the single currency.

Last, the Treaty allows for a balanced policy mix based on an independent monetary policy and appropriate fiscal discipline (in this respect, the stability and growth pact is a useful “user guide” to the provisions of the Treaty and not a new constraint coming from nowhere).

We are now in the implementation phase of the monetary provisions of the Maastricht Treaty. The concrete preparations of monetary union are the responsibility of the ***European Monetary Institute.*** The preparatory work is well on track and will allow the ESCB to perform its tasks right from the start of Stage Three in January 1999; moreover, the EMI is often consulted by other European authorities, who pay careful attention to the advice it provides; this was notably the case for the changeover scenario adopted by the Heads of State and of Government in Madrid in December 1995, and for the elaboration of draft regulations concerning the legal framework for the use of the euro. Here again, France and Germany are playing a very active role in these preparations, and as early as tomorrow I will meet President Tietmeyer in Frankfurt, together with our colleagues, to attend the monthly EMI Council meeting.

FRANCO-GERMAN MONETARY COOPERATION WILL ULTIMATELY BE CROWNED BY THE CREATION OF A EUROPEAN MONETARY UNION IN 1999

I am personally convinced that the creation of monetary union in 1999 is the logical consequence of economic, monetary and financial developments that have been taking place during the past years. The increasing integration of the European economies - and in particular those of France and Germany - called for a single monetary policy and a single currency.

I am also convinced that monetary union will successfully go through, right from 1999 since:

- it is a credible process;
- it will create an environment of stability.

EMU is a credible process

Indeed, the case for a European monetary union is based on solid economic grounds, and it will be implemented in a realistic way.

EMU is not just some abstract concept dreamed up by a few people. It is based on ***solid economic grounds***. When the exchange rate stability provided by the Bretton Woods system and by the barriers between national financial markets disappeared in the 1970s, a number of European governments became progressively convinced of the need for a single currency. The Maastricht Treaty is indeed the result of past major initiatives, such as the Werner Report in 1970 and the Delors report in 1989.

The removal of all tariff and non-tariff barriers to trade has made Europe the largest market in the world. The EU accounts for 21% of total world trade, against 17% for the US and 10% for Japan. The benefits of the sheer size of the Single Market are plain to see. The allocation of savings and investments is more efficient, competition is stronger, and the greater liquidity of financial markets makes more capital available at lower cost to finance profitable ventures.

No doubt the European Monetary System and its Exchange Rate Mechanism have helped curb exchange rate instability and eradicate the inflation culture that prevailed in some countries; yet the current level of economic and business integration calls for the Europeans to take a further step towards monetary integration, for the benefit of all European economic agents and citizens.

The benefits of the single currency are clear. It will reduce uncertainty and facilitate production and investment decisions. It will make price comparisons across Europe more transparent and reduce transaction costs. In addition, the single currency area will enjoy price stability and sound public finances, which will lead to a high level of confidence and to low market interest rates. Last but not least, the euro will be a major international currency and this will facilitate international monetary cooperation.

EMU is not only based on solid economic grounds. It is also a ***realistic economic process***. EMU is based on *convergence criteria* which have to be met on a sustainable basis. The fulfilment of the convergence criteria is not only a legal condition for participating in EMU but, of course, corresponds to the sound policy management which is in the interest of all Member States.

I am convinced that EMU will create an environment of stability

I know how important the *concept of stability* is to the German people. This culture of stability, which explains to a large extent the economic success of your country, is shared by many Governments, central banks and citizens all over Europe, not least in France.

I know that the German people have expressed some qualms about the disappearance of the Deutschemark and its replacement by the euro. But I will try to convince you that the euro will be as stable as the Deutschemark, as stable as the French franc today, for the sake of European economic prosperity and growth. Indeed, EMU will contribute to reinforcing stability in Europe. EMU will bring legal, fiscal and monetary stability.

EMU requires a sound ***legal basis*** to foster the credibility of the changeover to the single currency. The Madrid European Council asked the Commission to prepare a draft Council regulation on the legal framework for the use of the euro.

This regulation is of the utmost importance. Market participants need legal certainty, not only as regards the new instruments in euro, but also as regard the continuity of instruments denominated in the former national currencies or in ECU. Besides financial markets, legal certainty is also important for citizens, as the emergence of a new currency is inevitably, at the first stage, a source of uncertainties.

In this respect, technical preparatory work on the legal framework for the use of the euro is almost achieved. The European regulations that have been drafted and should be endorsed by the European Council in Amsterdam clearly state that the euro will be the currency of the European monetary union as from the 1.1.1999 . As a consequence, the national currencies, in particular notes and coins, will continue to circulate during a transitional period, as subdivisions of the euro. Two other key elements are that the changeover will ensure the continuity of existing contracts denominated either in national currencies or in ECU and that the ECU will become the euro at a rate of 1 to 1.

Besides legal security, EMU will reinforce ***monetary stability*** in Europe.

The Maastricht Treaty provides for a monetary framework very similar to that prevailing in Germany and in France. The primary objective of the *European System of Central Banks* (made up of the European Central Bank and national central banks) will be *price stability.* The ECB Council of Governors (only those of countries participating in monetary union) will decide independently the level of official interest rates. Representatives of the European Council may attend the ECB Council meetings, but they will not participate in the voting procedure.

Monetary union will be characterized by a single monetary policy and national fiscal policies. In this context, the issue of ***fiscal discipline and coordination*** is crucial. Sound fiscal policies will help the ESCB to maintain price stability. Coordinated fiscal policies will contribute to a balanced policy mix in Europe. Fiscal discipline will prevent free-rider strategies by countries running large deficits and raising funds at low interest rates, thanks to the credibility and stability of other countries.

This question of European fiscal discipline is important in the context of the **main criticisms** which are presently enumerated, particularly from outside Europe, in the analysis of the concept of EMU. Without being exhaustive in this listing, I personally see four major criticisms:

First, it is sometimes argued that EMU will lead to *greater rigidity*, in diverting attention from the necessary structural reforms and inducing an inward-looking posture over Europe at the very moment when global competition is of the essence.

Secondly, the difficulty of delivering an appropriate *"policy-mix"*, the monetary policy being by definition concentrated in the hands of the ECB and the ESCB when, at the same time, the absence of a federal government and therefore of a federal budget leaves the fiscal policy of the Union in the hands of 15 different governments.

Thirdly, the difficulty of *absorbing "shocks"* in a particular member economy, whether this shock is of a domestic or an external nature. This difficulty stems in particular from the absence of the automatic stabilizers of fiscal transfers because there is no federal budget.

Fourthly, it is stressed that there are *important costs* associated with the transition towards EMU, namely the necessity to reduce overall fiscal deficits in the run-up to the single currency in accordance with the Maastricht fiscal criteria and the necessity to embark on an excessively tough monetary policy after the creation of the single currency to ensure the global credibility of the ECB, which in this view will start from scratch.

Let me respond to these criticisms and try to demonstrate that the Europeans have embarked upon a coherent economic and monetary strategy, responding as accurately as possible to the various questions I have just listed and paying due attention to the special nature of the European endeavour.

As regards the *first criticism*, which I call the *"diverting from structural reform" argument*, I really think that it rests on a misunderstanding of the very nature of the Monetary Union: the essence of EMU is the completion of the single market, which has been one of the boldest structural reforms ever launched in industrialized countries. On top of the common market which was the initial concept of the Treaty of Rome, the single market is marshalling the elimination of all non-tariff barriers, of all those barriers that are of a structural nature and are hampering the smooth circulation of goods, services and capital throughout the European Union. In order to meet the single market targets, workshops have been set up everywhere in Europe in all sectors of the economy and in all capitals to embark on the modernization and harmonization of regulations of all kinds. It is a major medium-term endeavour and an indispensable economic impetus to foster competition, economic growth and job creation throughout the single market.

In this perspective, the single currency appears as the last decisive messier for the completion of the single market, eliminating the last barriers that still exist within the European Union: no more additional costs for transactions, no more exchange risks, either justifiable or not amenable to appropriate hedging, and no more costs associated with these hedging mechanisms. Throughout the single market, there will be the same visibility of all prices, thus permitting immediate price comparisons, cost comparisons and therefore fostering competition in all markets.

My conclusion on this point is that the single currency will not prevent Europe from embarking on eliminating economic rigidities, inducing market flexibilities and generating measures to cope efficiently and successfully with global competition. On the contrary, the single currency endeavour will help foster the structural reforms that are needed in Europe to improve growth prospects and job creation and counter unemployment.

The *second and third criticisms* are based upon the argument that the Europeans will not set up an *optimum currency area* like the US because of the absence of a federal government and a federal budget and therefore that there is no possibility of ensuring an appropriate consolidated fiscal policy and ensuring shock absorption through automatic stabilizing transfers.

In my eyes, the Maastricht Treaty gives a pertinent response to these pertinent questions. The thrust of the spirit and of the letter of the Treaty is that everything is done to construct the euro area as an optimum currency area.

First by ensuring that it incorporates *economies that have already proved being convergent* in the fiscal field as well as in the monetary and financial fields. This is why the so-called five Maastricht criteria are important. Not only can one expect that a particular economy meeting the five criteria is clearly eligible to belong to a currency area composed of other economies with the same fiscal, monetary and financial features but one can also expect that the business cycles in these economies are likely to be largely synchronized.

Convergence from the very beginning of the single currency is a necessary condition to create an optimum currency area. But convergence is *not only necessary at the moment of the selection* of member economies. It is *also necessary afterwards* in what we could call the permanent regime of the euro. And then the stability and growth pact is of the essence. It calls for each country to remain in a sound position as regards its fiscal behaviour.

There is a paradox enshrined in the stability and growth pact: implementing the Maastricht Treaty provisions, including sanctions vis-à-vis past behaviour, it places more power in the hands of the „centre“, which is in that case the Council, say Brussels, vis-à-vis member states than is the case, for example, for the US government vis-à-vis Texas or California.

The absence of a significant federal budget and the absence of a federal government have driven the Europeans to embark upon a *direct coordination of their national fiscal postures*, through direct peer pressures and decisions within the Council of Ministers.

This very bold construction, which has no worldwide equivalent in the world, will simultaneously permit through the decision-making process that has been decided in Dublin:

- to ensure that we have a sound consolidated fiscal policy at the level of the euro area even without a federal budget,

- and to ensure that each particular economy reloads the fiscal cannon in order to be able to cope with domestic or external shocks even without the automatic stabilizers of the transfers built into a federal budget.

Ensuring a sound consolidated fiscal policy at the level of the Union and reloading the fiscal cannon at the level of national economies are the two major goals of the stability and growth pact monitored by the Stability Council and decided, in accordance with the Treaty, by the Council itself.

As regards the *costs* associated with the transition towards the euro, which were the *fourth major criticism,* I will confine myself to two main remarks relating to the fiscal side as well as to the monetary side.

From a European perspective, the *strategies of fiscal retrenchment* that have been decided within the European Union are *to be implemented in any event,* whether the Maastricht Treaty existed or not. There is no doubt that even in a pure, selfish, domestic approach in each of the European countries, meeting the fiscal criteria would be welcome for the sake of the economy, for the sake of the appropriate financing of the competitive sector, for the sake of the credibility of the signature of the State, for the sake of the confidence in the currency and therefore for the sake of growth, job creation and the fight against unemployment. All European governments are saying that Maastricht or no Maastricht, they would pursue their sound fiscal policies and strategies.

In the case of France, the proof is even easier. For it was in June 1982 that France adopted the 3 % rule, on the basis of a multipartisan consensus and for domestic reasons, ten years before the ratification of the Maastricht Treaty.

As regards the *monetary side of the coin,* shall I also say that we in the Banque de France would pursue exactly the same kind of monetary policy based on low inflation, exchange rate stability, a high level of credibility and confidence, and therefore a low level of long-term interest rates. Implementing what our law says, namely price stability, through exchange rate stability and the monitoring of our domestic monetary aggregates, the *French independent central bank* would meet spontaneously on pure domestic considerations the three Maastricht criteria that are in our monetary and financial domain, namely a low level of inflation, a low level of long-term market rates and exchange rate stability.

For these reasons, I see *no extra cost associated with the fiscal and monetary policies* that are consistent with progress towards monetary union.

The question of the costs associated with the launching of the ECB and the ESCB is also important. The question arises only to the extent that the ECB is supposed to start from scratch and has to build credibility on its own. But it is certainly not the spirit nor the letter of the Maastricht Treaty; it is certainly not the very nature of the monetary concept of the single currency.

The single currency is neither supposed to start from scratch, nor to result from the averaging of the various currencies that exist within the European Union. It must clearly and it will according to the convergence concept, have the legacy of the most credible and solid currencies participating in the ERM mechanism. The euro, in any case, must be as solid and credible as are the most credible currencies in Europe.

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In conclusion, I would like to make three points

- Firstly, it is not only monetary union that we are preparing actively, but also economic union, i.e. political union in the economic field. We should not forget that the Treaty itself provides for a higher degree of political union than is usually acknowledged, with the concept of coordination of economic policies and the provisions for fiscal discipline and sanctions. The stability and growth pact grants important powers to the Council - i.e. the Council of national Governments which is the equivalent in Europe of a federal government in a political federation.

- Secondly, one should not underestimate the degree of monetary stability already achieved by European countries. Monetary stability is not only a project for the future, it is already a major achievement in many European countries. For example, seven countries have been participating in the ERM without any change in their central parities for more than ten years.

- Thirdly, it is a false perception to view the necessary fiscal consolidation and monetary stability as constraints imposed by the Maastricht Treaty against the very interests of European countries. We would be implementing the same economic policies if there were no Maastricht Treaty, since they are based on some principles of sound economic management which are necessary to create jobs and tackle the problem of unemployment.

Finally, economic and monetary union and the creation of the euro will crown economic and monetary cooperation between European countries, notably France and Germany which are the two pillars of it, and will foster prosperity, stability and peace in the European Union.