

Monetary Policy in France: Monetarism or Darwinism?

1. Introduction

Over the last five years monetary policy in France has undergone sharp changes. Operating procedures have been deeply affected in January 1985 when the long familiar quantitative controls have been abandoned in favour of market-based procedures. Earlier on, since about 1982, policy objectives assigned to the monetary instrument have been redefined. While the relative stability of interest rates had long been the central preoccupation of the Banque de France, priority has shifted to fighting inflation. This shift is intimately related to the creation of the European Monetary System (EMS) and, consequently, to the constraint imposed by the need to keep the exchange rate within the agreed upon margins of fluctuations.

This article is divided in three main parts and a conclusion. Section 2 shows how the process of money supply control has evolved and led to a momentous transformation of financial markets. Section 3 explains the evolution of monetary policy in response to the need to come to grips with double-digit inflation. A central theme is that monetary policy has never played a key role. This is explained by the fact that France has almost always operated under a fixed exchange rate system, which implies very limited monetary policy independence. The attention therefore shifts to the nature of the constraints imposed by the EMS, the main issue of Section 4. This section considers how and why the EMS has evolved to a Deutsch Mark zone. This situation is now being questioned and raises the issue of a reform of the EMS, which includes an early evolution towards a monetary union.

In the concluding section, I provide an interpretation of the evolution of monetary policy.

Drawing upon the analysis presented in the text, the conclusion argues that the loss of monetary independence has left the French monetary authorities with no other choice than abandoning the many peculiarities which have long distinguished their action from what was being done in other developed economies. Briefly stated, France could not maintain its position in an increasingly integrated European Community without evolving to a market-based system of monetary control. The evolution was dictated by necessity, not necessarily by conviction.

It is useful to keep in mind, at the outset, that the French central bank, the Banque de France, is not a very independent institution. Its Governor is appointed by the government and reports to the Minister of Economics and Finance. He can be dismissed at will. In practice, the Banque de France operates under close supervision from the Treasury. This situation has undoubtedly helped in speeding up the transformation of the French monetary landscape. Interestingly enough, the new system has enhanced the status, if not the independence, of the Banque de France.

2. Changing Operating Procedures

2.1. Brief Overview of the Previous System¹

For most of the postwar period, and permanently from 1972 to 1985, monetary control has been mainly exercised through quantitative restrictions. These restrictions have evolved over time, both because the banking system was continuously refining strategies to evade the controls and in response to changing economic conditions. The general principle has been to

assign each bank each year a maximum growth rate – the so-called ceiling – for its stock of credit outstanding. Capping the growth rate of bank credit obviously allows to put a lid on total money supply growth. Two particular features of the system are worth noticing. First, the maximum allowed growth rate was typically inversely related to the size of the bank, a feature designed in principle to foster competition in the credit market – of course, this resulted in mixing up competition policy and monetary control, an unholy approach. Second, some forms of credit, deemed important for ‘structural’ reasons – and often subsidised – were either excluded from ceilings or else entered into the total amount of credit outstanding with a coefficient less than 100%. This was the case, for example, of export credits or mortgages on private housing – another unholy mix-up, this time between monetary control and industrial policy. This latter feature naturally led some banks to ‘dress up’ credits so as to include as much as possible of their lending in the category (partially) free of ceiling (‘crédits déplafonnés’).

To be effective the system had to generate a situation of permanent excess of demand in the credit market. Thus potential borrowers were constantly rationed. One solution, of course, could have been to let interest rates rise to the point where demand would come down to the level of the authorised supply, but the main objective of the whole apparatus was precisely to separate out the control of the money supply from interest rate policy. Indeed, the monetary authorities regarded their task as two-sided: keeping the rate of money growth within specified targets on the one hand, controlling interest rates, preferably keeping them low so as to sustain investment spending, on the other hand.

From this summary description of the system, a number of remarks naturally emerge. First, rationed borrowers would be inclined to raise funds elsewhere, while savers might try to get better returns on their assets than what the ‘market’ was offering. This could be done abroad, so that capital movements had to be restricted: credit controls and capital controls were jointly needed if the system was to function. It could also have been done outside the banking system, on financial markets. Consistency was achieved by the many restrictions which reduced the size and effectiveness of the bond market, effectively reducing it to a marginal

source of financing for firms². Thus credit controls and a tightly regulated financial market appeared to be intimately linked. As a result of both features, the large majority of corporate borrowing needs was channeled through banks.

Second, for rationing to be effective, interest rates had to be prevented from moving so as to clear markets. Consequently, a broad array of interest rates were regulated by the monetary authorities, naturally kept below market clearing level.

Third, the quasi-fixity of interest rates, or rather the non-responsiveness of interest rates to market conditions, meant that the Banque de France was forced to refinance banks without limit on the money market. While the ceiling ensured that the money supply could not grow without bounds, the limitless ability to borrow led banks to be constantly indebted to the Central Bank. This situation was matched by the indebtedness of the corporate sector vis-à-vis commercial banks, their main source of financing³. Thus existed an unhealthy chain of vested interests running from individual firms to the monetary authorities, not entirely different from the current interlocking between sovereign borrowers and banks which characterize the LDC debt problem.

In summary, it is fair to say that the system was not ideal. On the positive side, the Banque de France was able to set separately its target money growth rate and its target interest rate. Table 1 presents the money growth targets since they were instituted in 1977 and the out-turns. While far from perfect, the performance is

Table 1: Money Growth: Targets and Out-Turns

	Aggregate	Target	Out-turn
1977	M ₂	12.5	13.9
1978	M ₂	12.0	12.2
1979	M ₂	11.0	14.4
1980	M ₂	11.0	9.8
1981	M ₂	10.0–12.0	11.4
1982	M ₂	12.5–13.5	11.5
1983	M ₂	9.0–10.0	10.2
1984	M ₂ R	5.5– 6.5	7.6
1985	M ₂ R	4.0– 6.0	6.9
1986	M ₃	3.0– 5.0	4.2
1987	M ₂	4.0– 6.0	4.2
	M ₃	3.0– 5.0	9.9
1988	M ₂	4.0– 6.0	

Source: Banque de France

nevertheless quite good. The major weakness, of course, was the a priori inefficient allocation of resources. Another important problem was that below-market interest rates provided a disincentive to save, or an incentive to place savings in non-financial instruments (housing, artwork, etc.). In particular, there was a strong incentive to invest – often illegally – abroad, so that balance of payment crises were always lurking in the background and the French Franc was an endemically weak currency.

2.2. The Reform

By 1983, these shortcomings came to be widely recognized. International pressure came from within the EMS, a conjunction of the difficulties associated with a weak currency status, of partners' (in particular Germany) insistence that no further progress towards European unification could be achieved without the removal of capital controls, and of the worldwide increasing sophistication of financial engineering which was bypassing France. While the project of wholly integrated markets within the European Community – the Single Act due to take effect by the end of 1992 – took shape somewhat later, ever since it has provided a strong impetus to carry out the ambitious programme of reforms initiated in 1983.

Given the logical and practical links between the various restrictions emphasized in the preceding section, the reform had to advance on a broad front. For monetary control to break away from the ceiling, interest rates had to be allowed to clear the market. This, in turn, required well functioning and sufficiently 'deep' markets, allowing participants to access to risk-hedging instruments, and apt to compete with foreign financial markets once exchange controls would be removed.

As far as the conduct of monetary policy is concerned, the key decision was to abandon credit controls and evolve towards an open market mode of regulation. Credit controls were formally abandoned in January 1985. In a first step, during calendar years 1985 and 1986, the ceiling system was replaced by a system of progressive required reserves: banks were under the obligation of constituting reserves (i.e. deposits with the Central Bank) at a rate increasing more than proportionally with the growth rate of credit⁴. This system was in-

tended as a safeguard during the transition to full freedom which took place in January 1987. Since then, required reserves are simply proportional to bank deposits, not credit outstanding⁵.

Central Bank interventions are typically conducted on the interbank market. The former interbank market has been split into a leaner market⁶ accessible only to banking institutions, and a new broader and truly open bond market. The major changes actually concern this market. While it used to be seriously restricted in terms of participants and types of assets, it now is open to all agents and trades assets of maturities ranging from 10 days to 7 years. This is part of what has been called 'décloisonnement' or decompartmentalisation, i.e. the removals of regulations which maintained separate a number of sub-bond markets according to maturities and allowed agents, in effect reducing the scope for arbitrage along the yield curve. Finally, an interest futures market has been created in February 1986, accompanied by a parallel OTC market and followed by a currency futures market.

As a result of these momentous changes, Paris is gradually emerging as a 'normal' financial center. The process has been facilitated by the development of mutual funds. Helped by substantial fiscal advantages dating back to 1978, these mutual funds have drained a major share of savings (see Table 2), effectively bringing to the financial markets whole segments of the population. Similarly, the possibility now more widely open for firms to borrow directly on financial markets has started to significantly reduce the quasi-monopoly of banking institutions in the distribution of credit (see Table 3).

Table 2: Share of Mutual Funds (percentage of L – M₂)

1979	1982	1984	1986	1987*
8.5	19.9	51.7	90.1	80.8

* September Source: Banque de France

Table 3: Short-term Financing of Firms (percentage of direct bond financing)

1984	1985	1986	1987*
0.0	0.6	5.5	9.0

* September Source: Banque de France

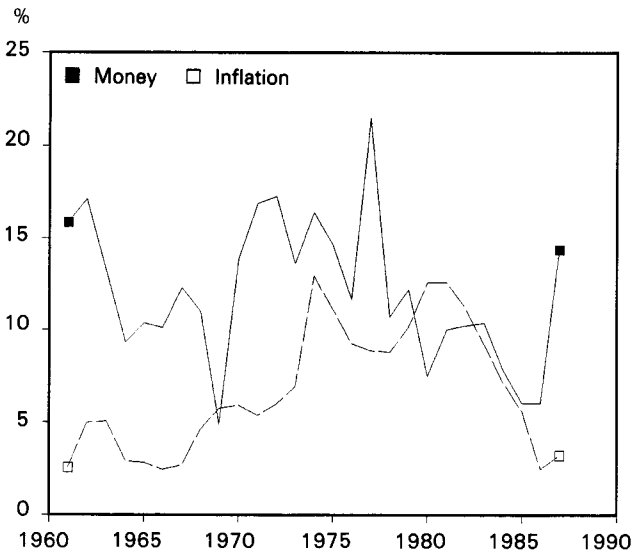


Figure 1: Money and inflation: annual growth rates.

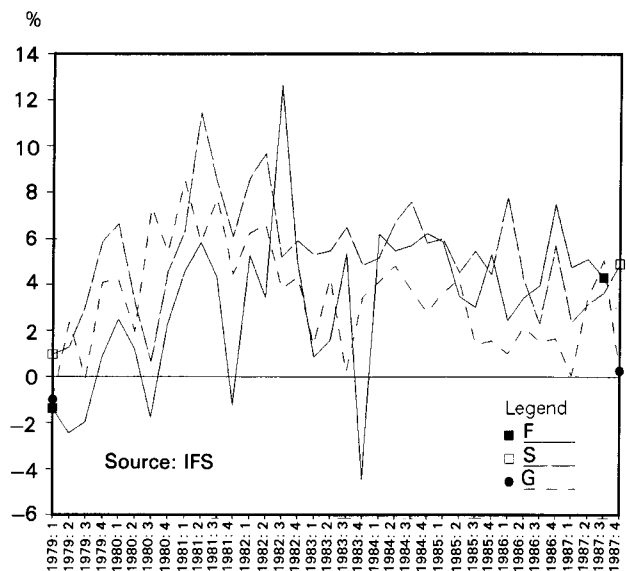


Figure 2: Short-term interest rates.

3. Eradicating Inflation

3.1. The Legacy of the Seventies

In the mid-seventies, France emerged as a high-inflation country (see Figure 1). This is not the place to review in detail how it happened⁷. However, it is instructive to review briefly the thinking about inflation which prevailed at the time.

The link between money growth and inflation was not considered as an established fact. The debate between 'demand-pull' and 'cost-push' leaned towards the 'cost-push' view. Econometric evidence on the wage-price spiral was strong, and taken as supporting the cost-push view. Of course, it was well realized that additional hypotheses were required to reach such a conclusion⁸. Two of them were strongly defended. First, wage settlements were seen as largely exogenous. The Phillips curve never was popular. The wage shock of 1968, the oil shocks, systematic wage indexation, the strong influence of the government (via the minimum wage which was being continuously upgraded in real terms and via the public sector which employs about half of the salaried labour force) and the politization of the major trade unions were all taken as evidence in favour of this assumption. Second, money growth was seen as endogenous. As explained above in 2.1, this was true *given* the fixity of the interest target and in

the absence of credit ceilings. But there was a feeling that the stability of interest rates should not be jeopardized and that credit ceilings were not really binding⁹. Finally, evidence of the type shown on Figure 2 was used to dispell any second thoughts about the issue.

Accordingly, the responsibility for fighting inflation was largely thrown upon price controls. Here again, since World War II, price controls were the rule rather than the exception. The controls were alternatively relaxed and tightened up, but it has never been the case that producers and sellers were free to set prices. Ex-ante or ex-post agreements with the administration were always required.

The upshot is that monetary policy, both money growth and interest rates, were seen as affecting primarily the external sector: the balance of payments and exchange rates. Any tightening up therefore would follow from a need to deal with external financial imbalances. Inflation was seen only as a complicating factor of secondary importance for the conduct of monetary policy (which could, in any case, be supplemented by exchange controls). Because of the overriding concern with export performance and competitiveness, it was unconceivable that inflation differentials would not be matched by generous exchange rate depreciations. The irony is that these views are those which led to a very successful disinflation.

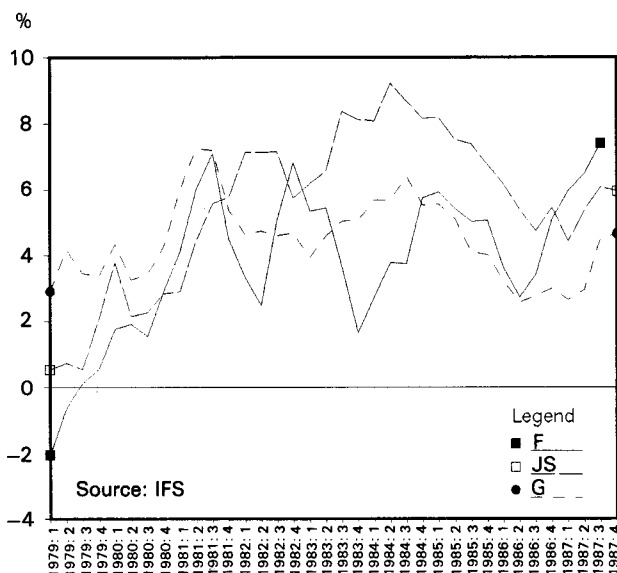


Figure 3: Long-term interest rates.

3.2. Disinflation: Early Attempts

3.2.1. Inflation was first identified unambiguously as a major policy issue by prime Minister Barre when he took office in 1976. Concern with monetary policy surfaced in the setting of money growth targets starting in 1977, but these targets were not particularly signalling a tightening up. Rather the concern centered on the budget deficit which was back to equilibrium in 1980. During this period, early deregulation moves were aimed at the financial markets and at prices.

When the 1979 oil shock struck, it was met with continuing fiscal restraint. The acceleration of inflation was not translated into lower money growth targets (see Table 1). The overshooting of the target for 1979 should not be interpreted either as a sign of relaxation. Over 1979–80, monetary policy can be described as merely accommodating. For further reference, though, we note on Figures 2 and 3 that the real interest rates rose, yet simply in line with their evolution in other countries, an early experience with the constraint imposed by the EMS which started to function in March 1979.

3.2.2. The election of Mitterrand in May 1981 led to a turnaround of policy setting yet, curiously, the pre-Barre views remained largely unchallenged and Barre's legacy survived via the EMS. The turnaround was predicated upon a shift in priorities, now set on unemployment and income distribution. The budget was

pushed back into deficit (to 3% of GDP by 1983) and various measures raised labour costs (increased minimum wage, fully compensated reductions of working time, restrictions on layoffs, etc.). As for monetary policy, while growth targets were raised, actual supply increased moderately. The increase was entirely motivated by the need to finance the budget deficit. Its moderation followed from EMS membership. Within weeks, if not days, of the election, interest rates soared. For example, the one-month money market rate, which stood at 10.9% in February 1981, reached 16.0% in May and 19.9% in June. This was but a consequence of the decision not to devalue, which could only be postponed until October. The conjunction of increases of both the interest rate and the money supply reflected inflationary expectations but was also made possible by the ceiling mechanism. It also made apparent the expectation of an exchange depreciation¹⁰.

The conclusion is that monetary policy was barely accommodating over 1981–82. The reason for this moderation is not concerned with inflation but EMS pressure. Inflation was meant to be contained by the price controls quickly reinstated in 1981 by the new government.

3.3. Disinflation: How it Worked

Three devaluations later and with unemployment still rising, by early 1983 it became obvious that the policies adopted in 1981 were leading nowhere. The last devaluation of March 1983 and the concomitant balance of payment crisis clearly established the limits of policy independence for a medium-sized open economy part of a fixed exchange rate system. The two main measures taken were the following:

- A pledge to stabilize first, then reduce the budget deficit.
- A complete freeze of prices *and* wages for 6 months, followed by a complex procedure of controlled increases.

One is hard-pressed to detect much immediate action on the monetary front. Certainly the money target was reduced from 10% to 9% for 1983, only to end up at 10.2%. Figures 2 and 3, which show short term and long term interest rates, do not indicate a major tightening either.

Inflation fell rapidly. There was a marked slowdown in real output growth and a rise in unemployment. This general feature, though, is shared by most European countries, and calculations shown in SACHS and WYPLOSZ (1986) indicate that the unemployment costs of disinflation were rather moderate in France¹¹.

Since 1984, inflation has stabilized at 2.5–3.5% and, under current forecasts, seems to be set durably in this range which is below the average of the sixties (4.4%). Money growth has declined (see Table 1) along with inflation. Importantly, however, real interest rates do not seem to be returning to earlier lower levels¹² and remain significantly above Germany's real interest rates, a reversal of the pattern of the 1960s and 1970s. This is testimony to the central concern of monetary policy, namely the exchange rate policy and the functioning of the EMS.

4. Monetary Policy and the EMS

4.1. The EMS Constraint

The European Monetary System links its member countries (the Benelux countries, Denmark, France, Germany, Ireland and Italy) in a fixed exchange rate system. A complicating factor is that these currencies jointly float vis-à-vis the other currencies. From any member country's point of view, however, the obligation to maintain a given parity in terms of the others implies that it essentially operates under a fixed exchange rate regime¹³. Another important consideration to keep in mind is that realignments are explicitly allowed and indeed have occurred quite frequently (11 times over the first 9 years).

As is well known, under a fixed exchange rate system, monetary policy independence is lost. The obligation to intervene on exchange markets whenever the exchange rate is about to cross its limit means that foreign exchange reserves are entirely committed to this objective. Of course, it is possible to sterilize, i.e. to intervene on the domestic money market so as to shield the monetary base – and hence the domestic money supply – from the effect of exchange market intervention. The room for manoeuvre however is very limited, at least if capital is mobile. Indeed, any injection (absorption) of liquidity via money market intervention

puts a downward (upward) pressure on the domestic interest rate which prompts an outflow (inflow) of capital thus requiring a new intervention. Sterilization fails when domestic and foreign assets are perfectly substitutable and capital mobility is complete. Perfect substitutability has been extensively tested¹⁴ and is usually found to be a close description of reality. Capital mobility may be reduced by exchange controls, an issue to be taken up below where I shall argue that it provides little room for policy independence.

The conclusion therefore is that the EMS seriously constrains the conduct of monetary policy in France¹⁵. The overwhelming importance of the exchange rate objective readily provides an interpretation for the apparent lack of responsiveness of monetary policy to major policy shifts, as documented in Section 3. The puzzle would seem to be the decisive move against inflation after 1982, and particularly the still lasting marked increase in real interest rates, even though the disinflation process is more or less completed. The following section attempts to resolve this puzzle.

4.2. Strong and Weak Currency Policies

The EMS constraint – or, for that matter, any fixed exchange rate regime constraint – varies depending on the time horizon. In the short run, the exchange rate is only allowed to move within the margins of fluctuations ($\pm 2.25\%$, except for Italy $\pm 6\%$). This is the extent of monetary policy independence, and it is virtually non-existent. In the longer run though, things differ significantly. The possibility of occasional realignment signifies that divergences in *trend* inflation are possible: all that is required is that differences in prices and costs be corrected when cumulated to the point of affecting competitiveness. The implication is that long run monetary policy independence is not lost, at least if one is willing to accept the view that, in the long run, money is neutral and only affects trend inflation, so that long run independence means the ability to choose trend inflation.

For any member country, therefore, the EMS means that the long run rate of inflation can be set quite freely – with some restrictions which are discussed below. Simplifying somewhat, there are two sorts of currencies within the

EMS: 1) strong currencies, with a lower than average trend inflation rate, which are regularly revalued; 2) weak currencies, with a larger than average trend inflation rate, which are regularly devalued. In the shorter run – i.e. in between realignments – monetary policy must be entirely committed to maintaining the parity within the allowed margins of fluctuations. For a strong currency, this implies a relatively low interest rate so as to discourage capital inflows. For a weak currency, of course, higher interest rates are required to avoid capital outflows.

The problem with such an arrangement is that monetary policy is commonly believed to have, if any, relatively short term effects on the real sphere of the economy (output growth, investment, saving, unemployment, etc.). Long run independence is then of little help. Furthermore, if disinflation requires some contractionary pressure – because, say, agents' expectations are not entirely based on monetary targets and need to be 'softened' – monetary restraint will not be enough¹⁶.

4.3. France under the EMS since 1983

The foregoing analysis readily explains the turnaround of 1982–83. The fact that the use of the monetary policy instrument has been severely limited – this state of affairs largely predates the EMS as it also concerns the Bretton Woods and the snake periods – has led the French authorities to seek other instruments. Of course, fiscal policy has been the normal stabilization instrument. But other tools have been developed, such as price controls, industrial policy, credit ceilings, and exchange controls.

As noted above, one aspect which distinguishes the EMS from the Bretton Woods system is the dedramatisation of realignments. Consequently, the EMS apparently can easily accommodate trend inflation differentials. This is true, but up to a point. Large inflation differentials would indeed have either of two consequences: frequent realignments or significant changes in relative competitiveness within the system¹⁷. The French experience of 1981–82 exactly matches this situation. During this period, Germany was making significant progress in reducing its inflation rate. The rebound of inflation in France thus opened up an increasing inflation differential between the two countries and led to both frequent realign-

ments (three between October 1981 and March 1983) and competitiveness swings in the interim periods separating out realignments. The choice for France amounted then to either slow down inflation, or ask for wider margins of fluctuations, or else to suspend membership in the EMS. The second option was never considered (and would probably have been turned down by France's partners), the third one was hotly debated and finally rejected, leaving inflation as a main policy objective since 1983.

While exchange controls were expected to insulate domestic interest rates, it had become obvious by then that they do not operate that way. (This issue is discussed in some detail in Section 4.5.1.) Consequently, since 1981 interest rates had risen markedly, reflecting both the concern with inflation in France and the worldwide increases initiated by the United States (see Figures 2 and 3). Thus credit ceilings became less and less binding. The monetary policy shift, therefore, consisted in accepting high real interest rates, and consequently in tightening up the credit ceilings to make them effective once again¹⁸. Over 1986–87, as monetary control procedures have changed, the policy stance has remained the same.

The essential conclusion is that, since March 1983, monetary policy has been directed at the exchange rate. The objective has been to bring the French Franc into the league of strong currencies. This objective has been pursued by accepting historically high real interest rates, despite rising record unemployment rates and a marked slowdown in investment spending. Disinflation is part and parcel of the strong currency policy.

4.4. Power Sharing Within the EMS

So far, the EMS has worked as a disciplinary device providing incentives for the monetary authorities to pursue anti-inflation policies. It has had similar effects on other countries as well. Indeed, there is a view that most EMS member countries have 'borrowed' the Bundesbank's credibility and thus achieved disinflation more efficiently than would have been the case under a free float¹⁹. In return, Germany exerts de facto leadership on the EMS, sometimes referred to as a greater Deutsch Mark area²⁰. According to this view, the EMS offers a quid pro quo favourable to all its member

countries (a Pareto-superior form of coordination).

While this view is widely shared within EMS member countries, frustrations have emerged over the recent past about the German leadership, with complaints that it exerts a contractionary bias and hampers the resumption of adequate growth after the dark years of disinflation. Put differently, the question arises whether a German leadership is the natural implication of any fixed exchange rate arrangement in Europe, or whether it is a consequence of particular rules of the game, or else whether it is related to particular circumstances and may well evaporate in the future or lead to a breakdown of the system.

As it turns out, all three conclusions have an element of truth. What is not true, and yet widely believed, is that the EMS provides the conditions for *automatic* coordination of monetary policies. The point however is simple and well-known. When N countries decide to join in a fixed exchange rate system, de facto they jointly give up $N-1$ degrees of freedom regarding the conduct of monetary policy. In that sense, there is automatic coordination. This leaves entirely open, though, the question of how is to be managed the remaining N th degree of freedom. Under the Bretton Woods system, there was a natural hegemony exerted by the United States, entrusted with the N th degree of freedom. Within the EMS, there is no natural hegemony based on historical or size arguments. The assignment of the last degree of freedom remains an open issue, and this issue is what creates frustrations.

In principle, the N th degree of freedom can be assigned to one country, or jointly shared by a number of them through specific rules. The interesting question is why it turns out that Germany may have been assigned this degree of freedom within a system which was originally conceived as a fully symmetric one, since intervention rules were explicitly designed to promote full symmetry.

A first answer is that circumstances have put Germany in a particular position: because its Central Bank has a comparative advantage as inflation fighter, assigning the N th degree of freedom to Germany was a way for the other Central Banks to signal unambiguously their determination to disinflate. This is the borrowed credibility argument presented above.

There are two problems with this argument however. First, it is not necessarily the case that a complete leadership is the (Pareto) optimal solution: other intermediate rules for sharing power are conceivable²¹. Second, this is only true if inflation fighting is the main policy objective. The implication would be, then, that Germany's leadership may be due to the large inherited inflation rates prevalent in the late seventies, that even though it was not the optimal solution then, it is likely to be a clearly inferior solution now that inflation cannot remain at the top of policy agendas in most EMS member countries.

A second consideration concerns the functioning of a system of fixed *but adjustable* parities when realignments are expected to occur to restore competitiveness altered by inflation differentials. This is approximately how the EMS has functioned. The problem is that realignments are expected and therefore generate balance of payment crises. The theory of crises²² predicts that such crises must destroy the fixed exchange rate regime. Despite repeated crises, the EMS has not collapsed. In WYPLOSZ (1986) I show that exchange controls provide the necessary tool to go over repeated and anticipated realignments. An implication is that exchange controls play a key role in the existence of the EMS.

Another implication is that an asymmetry will inevitably emerge between low inflation-appreciating countries and high inflation-depreciating countries. The reason is a simple and well-known feature of fixed exchange rate regimes. The issue is linked to the process of interventions on exchange markets. Strong currency countries which intervene accumulate foreign exchange reserves and, typically, attempt to keep the monetary base unchanged by conducting sterilizing operations. Conversely, weak currency countries run down reserves and sterilize by increasing loans from the central bank. There are limits to this process of intervention-cum-sterilization. For the weak currency countries, the limit is the available foreign exchange (which can include borrowing from other central banks). For the strong currency countries, the limit is the volume of central bank credit to the economy. In practice, there is a wide difference between these limits, hence a key asymmetry: weak currency countries hit their limit much faster than strong cur-

rency countries. This being well known in advance, the bargaining power (over who should manage the Nth degree of freedom) of weak currency countries is not a match for the bargaining power of strong currency countries. Hence, it is the country with the lowest trend rate of inflation which is likely to emerge as the custodian of the Nth degree of freedom. This outcome is predictable in the absence of other fundamental asymmetries such as size, history, political power, etc. It fits the experience of the EMS and provides an explanation to Germany's dominance, even if the other member countries did not wish to borrow the Bundesbank credibility. Consequently, it predicts a continuation of German dominance, even if policy priority is assigned away from inflation. In that case, however, it means that monetary policy in France will have to continue to be targeted at inflation even though the monetary authorities would like to relax somewhat their stance. Frustrations along these lines have recently surfaced. Addressing these frustrations, however, requires dealing with the deep logic of the system and raises the question of reform and redistribution of power.

4.5. Reforms of the EMS

The previous section can be summarized as follows. Particular historical circumstances (the high levels of inflation inherited from the seventies) have made it beneficial for all EMS member countries to accept, indeed to seek, a German leadership in the area of monetary policy. This rationale is now evaporating as disinflation has been more or less achieved everywhere. On the other side, it is a permanent feature of a fixed exchange rate system to introduce an asymmetric bargaining power favouring the lowest inflation country. Consequently, a country like France must eventually bring its trend inflation rate to Germany's level, and keep it there. France may ask Germany to aim at a somewhat higher level but, given the fundamental asymmetry, should harbour few illusions of being satisfied. If France wishes to retain the power of influencing its own long term rate of inflation, the only alternative is to seek a reform of the EMS which corrects for the fundamental asymmetry. This has recently become a central issue and is briefly explained in this section.

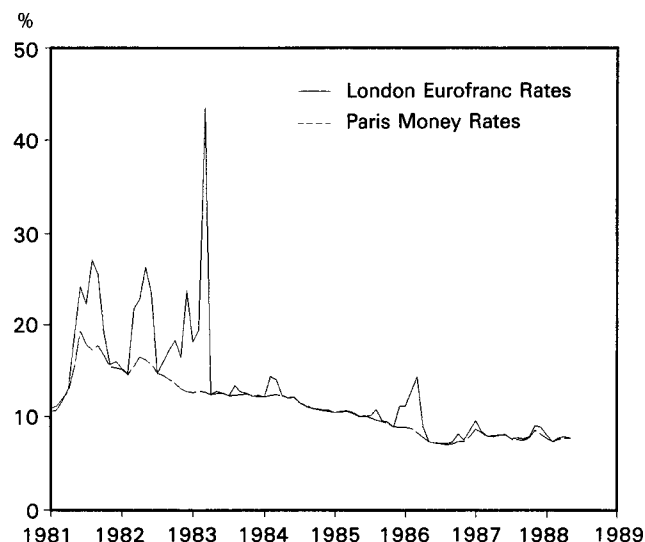


Figure 4: One-month interest rates: Paris and London.

4.5.1. Exchange controls. A first possibility has in fact been used extensively. The existence of exchange controls allow some degree of independence. In essence, they slow down, sometimes markedly, the decumulation of foreign exchange reserves at the time of a crisis. In so doing, they reduce the disadvantage of the weak currency country. But the gains are limited, for two reasons.

First, unless the controls are so tight as to amount to de facto non-convertibility, they only slow down capital movements, both out of the weak currency and into the strong currency. The fundamental asymmetry remains, it simply hits later. But as long as it is recognized, it still affects the respective bargaining powers: exchange controls cannot lead to a redistribution of influence on the Nth degree of freedom.

Second, because exchange controls are eventually circumvented, they only have temporary effects. Over the policy horizon (say, 6 to 12 months) they are ineffective. Exchange controls allow monetary authorities to retain some control over interest rates, but not long enough to have real effects on the economy. Figure 4 shows the yields on French denominated assets held in Paris and in London (Eurofrancs). Because exchange controls do not concern Euro-assets, the London rate shows what Paris rates would be in the absence of controls. Divergences do appear, and may be very large, but they are short-lived. The only degree of policy independence gained via exchange con-

trols is the choice of a *trend* inflation rate different from the leader of the EMS, via the ability to operate successful repeated realignments.

This has been indeed the practice for most EMS countries so far. Only Germany and the Netherlands are truly free of controls, and these are the countries with the lowest inflation rates! Pressure has built up to remove these controls so that they cannot be expected to provide more policy independence in the future.

4.5.2. Intervention Rules. The intervention rules adopted at the time of the creation of the EMS were meant to be fully symmetric. Under these rules, interventions must occur any time two currencies reach the limits ($\pm 2.25\%$ away from the central parity) of their bilateral exchange rate. Interventions are thus symmetric and must be bilateral. However, the main conclusion of Section 4.4 is that such symmetric interventions conceal a very asymmetric distribution of bargaining power. So the EMS is not symmetric after all!

True, divergence indicators exist. These indicators signal which currency mostly diverges from the average and could point towards the least inflationary country. Divergence, however, does not impose an obligation of intervention, only (in the diplomatic jargon) a presumption. It is well known that Germany has systematically avoided to intervene, except when compulsory²³. This is why France, among others, has sought a pledge of more active intervention by Germany at the September 1987 EMS summit in Nyborg.

It is interesting to note that when the EMS was created, another scheme had been envisaged²⁴. In this alternative, limits of fluctuations would have been set vis-à-vis the ECU, very much like the divergence indicator. This has been turned down partly on the ground that, since only one country would be under obligation to intervene, the outcome would be asymmetric! It is likely, on the contrary, that it would have singled out the extreme countries and would have favoured convergence towards the average, not towards the lowest inflation. The Nyborg resolution seems to point to a reform in this direction.

4.5.3. The European Monetary Union. With a complete removal of exchange controls, required to be achieved by 1992 if the Single Act goes through, the existence of the EMS will require a very intimate convergence of mone-

tary policies. The fundamental asymmetry, if not corrected by new rules of interventions, guarantees the continuation of the Bundesbank's leadership: convergence implies an effective alignment of all monetary policies on whatever Germany decides (unless of course the Bundesbank abandons its non-zero inflation target).

It is not surprising therefore that France has started to consider seriously the early creation of a monetary union. The precise form of such a union remains to be thought through (proposals are made in GROS and THYGESEN, 1988), but it is likely to be organised on a federal basis. As a result, France – along with the other central banks – would have one seat and therefore a say. Whatever the outcome of the decision making process, the Nth degree of freedom would be shared among all member countries. Conversely, the Bundesbank would relinquish its control of this degree of freedom. This may well explain the lack of enthusiasm of the Bundesbank and its likely efforts to slow down the process towards monetary unification²⁵. It is unclear how the Bundesbank may obtain full capital mobility – the irrevocable abandonment of exchange controls by France and Italy – without accepting some power sharing. Indeed, there is no general agreement that, under any circumstances, the Bundesbank leadership is the best solution for France's monetary policy.

5. Conclusion

Monetary policy in France has undergone profound changes over the last decade. These changes have concerned both the procedures of money control and the nature of policy making. The French financial system has evolved from a tightly controlled one, relying largely on non market-based mechanisms, to an increasingly sophisticated market, growing fast. The removal of barriers to foreign competition, called for by the European Single Act, will put further pressure on a banking system accustomed to operate as a sheltered industry with strong undertones of state-sponsored cartel-like behaviour.

The role of monetary policy has always been relatively limited. This was due to a number of factors: 1) the fact that the Banque de France has never been an independent institution; 2)

the long prevailing view that its main objective is to maintain moderate and stable interest rates and that inflation is not directly linked to money supply; 3) the fact that these views were based on operating procedures which emphasized administrative controls rather than market-based actions; 4) the fact that France has almost always operated under a fixed exchange rate system which, indeed, severely limits monetary policy independence.

As a result, monetary policy in France has long been very different from what was done in many other countries. That is not the case anymore and the depth of the structural changes enacted since 1983 guarantees that the evolution of French policy making towards what is done in most advanced countries will not be reversed.

The remaining question: why has it happened, and why then? One would be tempted to see this evolution as a success of monetarist ideas, including the recognition of the advantages of the market mechanism. It would be remarkable that such a 'revolution' occurred under a Socialist government elected on a pledge to 'break away from the iron fist of capitalism'. The truth is probably very different.

There is no doubt that the failure of the 1981–83 attempt at an isolated expansion led to disenchantment with Keynesian economics²⁶. The contrast with Thatcherism, Reaganomics or Kohl-like policies pursued at the same time was too obvious to go unnoticed. Yet, it would be wrong to assert that France has become another stronghold of monetarism and supply-side economics. Necessity has forced changes and the 'new view' is largely opportunistic, or rather darwinian²⁷.

The main conclusion reached in 1983 was that France was too much integrated into the EEC to contemplate a return to any form of isolationism. This included EMS membership. From there, everything follows. Because EMS membership implies very limited monetary policy independence, the Banque de France had no choice but to accept the exchange rate as its primary target. Once this was accepted, there was no reason to stick to exchange controls which had proven to be of limited effectiveness. Without strict exchange controls, quantitative controls of the money supply – the ceiling – became inoperative and had to be abandoned. From there, it was clear that mar-

ket-based control of the money supply could not be conducted without well functioning financial markets. It was then necessary to free these markets. More in line with the French tradition of state intervention, the authorities took the leadership in creating and developing wide and efficient financial markets (with banks following reluctantly)²⁸.

The new breed of monetary policy represents a pragmatic recognition of France's increasingly limited ability to chart its own course of action if it wishes to remain influential in European affairs. It was not chosen but accepted. As such, it is not likely to be seriously challenged, yet attempts at re-regulation are not to be ruled out, especially if the German leadership is not somewhat curtailed.

Footnotes

¹ For a detailed description of the French financial system at the beginning of the eighties the reader is referred to the excellent article by MELITZ (1985).

² By keeping interest rates low on the bond market, the monetary authorities guaranteed a permanent situation of excess demand at a low level of supply. This, in turn, meant rationing and the need to establish queueing rules. These rules established priorities, the Treasury coming first, followed by the web of state-owned financial institutions and industrial corporations, then came financial institutions, leaving private corporations in the position of the marginal equilibrating borrower.

³ An analysis of the implications of this system is in BOUTILLIER and VILLA (1985).

⁴ The formula for 1985 was: $r = 0.2 t (t + 2)$, while in 1986 it changed to a less steep progressivity: $r = 0.2 t^2 + 0.2$, where r is the reserve ratio and t the percentage growth rate of credit outstanding.

⁵ The rate is 5% on demand deposits and 1% on term deposits.

⁶ The daily 'fixing' of the interest rate has been eliminated, allowing more flexibility and responsiveness.

⁷ An overview of this period is presented in OUDIZ and STERDYNIAK (1985).

⁸ For a critical review of this debate and econometric assessment, see FOURÇANS (1978).

⁹ See OUDIZ and STERDYNIAK (1985).

¹⁰ Actually the quoted numbers are an underestimate of market expectations due to exchange controls: the corresponding Eurofranc figures are 11.75% in February 1981, 22.5% in May and 26.0% in June.

¹¹ An interesting issue is whether price and wage controls have contributed to a relatively efficient disinflation process. Tentatively positive answers are given in SACHS and WYPLOSZ (1986) and ENCAOUA and MICHEL (1986).

¹² Over the period from 1955 to 1972, the real long term interest rate averaged 1%.

- ¹³ For an overview of the rules governing the EMS see J. VAN YPERSELE (1985).
- ¹⁴ The literature is fairly large. For a recent survey, see FRANKEL and MEESE (1987) and the references therein.
- ¹⁵ For a clear statement by Banque de France officials, see PATAT (1987).
- ¹⁶ This is the more so that under a fixed exchange rate regime, real exchange rate appreciation, one of the possible channels for disinflation through monetary contraction, is not available, at least in the short run.
- ¹⁷ This is why Italy, which joined the EMS with a sizeable inflation differential, was authorized to operate under larger margins of fluctuations.
- ¹⁸ The fact that credit ceilings had ceased to constrain money growth generated considerable anxiety. The reason is that the banking system started to accumulate rights (unused credit margins) to increase very significantly the supply credit. There emerged therefore the potential for a 'boom' in credit creation once demand would resume. The subsequent abandonment of credit ceilings owes at least as much to this circumstance as to a sudden conversion to the merits of freely functioning credit markets.
- ¹⁹ The argument is formally developed by MELITZ (1987) and GIAVAZZI and PAGANO (1988).
- ²⁰ See GIAVAZZI and GIOVANNINI (1988).
- ²¹ The argument is formally developed in BEGG and WYPLOSZ (1988).
- ²² See KRUGMAN (1979), FLOOD and GARBER (1984), OBSTFELD (1986).
- ²³ Evidence is provided by MASTROPASQUA et al. (1987).
- ²⁴ I owe this observation to FRANCESCO GIAVAZZI.
- ²⁵ The extreme reluctance of the Bundesbank against any move that would reduce its power also explains its long standing opposition to a widespread use of the ECU, inasmuch as the ECU might develop as a parallel currency eventually becoming the EMS currency. The 'Trojan horse' view of the ECU, supported by private agents, is mistaken however. The ECU will not dislodge the currencies of the large countries without the central banks' blessing.
- ²⁶ For an account of this period, see SACHS and WYPLOSZ (1986).
- ²⁷ A formal argument is given by COHEN (1988).
- ²⁸ The fact that the Banque de France is but one arm of the Treasury helps to understand that the shifts could take place swiftly. Similarly, the profound transformation of the financial markets was actually entirely masterminded at the Treasury.

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