EMU and France

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This article examines the loss of sovereignty entailed for France the transition to the European monetary Union. In the first part, it reviews several episodes of the French monetary history, and illustrates the constraints that today limit the margin of maneuver of France in terms of economic policy. France retains only a very limited and purely formal margin of maneuver, both in terms of monetary policy and the use of the exchange rate. A second section examines the interactions between different exchange rate regimes - flexible rates, stable but adjustable rates, fixed rates - and the markets for goods, labor and capital. The next section examines adjustment within an Economic and Monetary Union. The article concludes with an examination of the options open to France in the nineties. It shows that a devaluation policy would be extremely costly, and that maintaining the option to devalue significantly reduces the room for maneuver of fiscal policy. To restore this margin of maneuver, France should, on the one hand, make the Bank of France independent and responsible for the stability of the value of the currency and, on the other hand, propose to Germany and other countries to the strong currency of the Community to set the exchange rate of their currencies definitively and without fluctuation, in order to further guarantee the financial stability required for the use of any instrument of economic policy. This solution would also have the advantage of accelerating the transition to EMU and showing the movement.

The monetary history of France is, until recently, marked by the exercise of sovereignty and the temptation of independence. However, since the creation of the European Monetary System in 1979, and especially since the economic adjustment program set up in 1983-1984, French monetary policy has been mainly devoted to defending the exchange rate. This choice has obviously largely undermined the room for maneuver that monetary policy could have in pursuing other objectives of economic policy (employment and growth in particular). The European Monetary System implies a formal (or institutional) abandonment of sovereignty for two reasons: central banks are committed to keeping exchange rates in bands of fluctuation around the central parity, which subordinates monetary policy to exchange rate objective; and, although adjustable, parities cannot be changed unilaterally. Any change in parity within the EMS must be the subject of collective bargaining, a humiliating step for countries seeking to devalue or are forced to do so, especially when their government has made it a point of honor to exclude it permanently! This partial institutional abandonment is doubled by an almost total loss of functional leeway: the asymmetrical operation of the EMS has indeed consecrated the hegemony of the

Bundesbank's monetary policy and, during the 1980s, system the characteristics of a mark area. The complete liberalization of capital movements in the main countries of the Community considerably accentuates this loss of autonomy (see Kirrane 1993)

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Therefore, the transition to the European monetary union would institutionalize an already well-established state of affairs. There is no longer an independent monetary policy in Europe (except perhaps in Germany). In fact, the issue of the European Monetary Union is less about monetary policy than about whether or not to fix exchange rates. The answer to this question depends mainly on the behavior of wages and prices and fiscal policy (Dornbusch, 1991).

However, the current system still relies heavily on the "self-restraint" imposed by central banks. The non-exercise of monetary independence is therefore still freely chosen. It results from an acute perception of the costs that this independence would entail, both in terms of inflation and the deterioration of the internal and external balances, as well as in terms of the loss of a credibility largely found. The institutionalization of this self-restraint within a monetary union where there is only one central bank and one single currency represents an irrevocable loss of sovereignty (Kirrane 1993). The choice of such a system is in itself a sovereign decision, but it excludes the subsequent exercise of sovereignty. It is therefore a serious decision that engages the national interest and needs to be thoroughly analyzed and widely debated. Voluntarily giving up the short-term exercise of monetary autonomy is one thing. The renunciation of long-term monetary sovereignty implied by the abandonment of the national currency in favor of a single European currency is another.

This study is divided into four parts: the first examines some important episodes of France's monetary history, in order to draw some illustrations of the different roles played by the rate of exchange and exchange rate policy and their implications. The second, conceptual, studies in an open economy the interactions between exchange rate regime, markets of goods, labor, and capital. The third analyzes the adjustment within a monetary union, and discusses its implications for the independence of fiscal policies. The last evaluates the options open to France today. One conclusion specifies the counterparts to expect from the abandonment of sovereignty implied by the changeover to the single European currency. If "all things" were "equal", it would of course be preferable to keep additional room for maneuver. One of our objectives is precisely to show that "all things" are not "equal elsewhere" and that the maintenance of formal monetary autonomy (and the illusion of monetary sovereignty) has, for a country like France, a not insignificant cost, considering a questionable advantage.

Policies and exchange rate regimes throughout the monetary history of France

Rates and exchange rate regimes have over the course of the monetary history of France played several different roles. Sometimes, the exchange rate appears mainly as a constraint, preventing the implementation of expansion policies because of the risk of payment crisis and currency speculation, as was the case when radical policy changes were required in 1983-1984.

At other times, the exchange rate plays the role of an instrument: a strict rate target, supported by monetary policy, signals the determination to fight against inflation. Exchange rate policy then operates

thanks to its effects on expectations, but also directly through its consequences on price behavior and, through the improvement of competitiveness, on the level of employment. The eighties roughly provide an example of this use of exchange rate policy (Kirrane 1993).

The exchange rate may also be deliberately devalued in order to free monetary policy from its constraints and promote economic expansion, or at least avoid stagnation. The 1969 devaluation, decided after the events of 1968, provides a striking example of this role of the exchange rate.

These are the main directions open to economic exchange rate policy. It should be emphasized, however the traditional dilemma of economic policy: there are often fewer instruments than objectives. We can then think of resorting to exchange controls, or multiple exchange rate systems, to circumvent in part (and for a limited time) the rigor of the exchange constraint. The effectiveness of such instruments is questionable. But, in any case, the effective implementation of such measures requires a degree of intervention in private activity and interference with the business community which are now increasingly difficult to tolerate. Perhaps these instruments can be used in times of crisis; but the economic policy of one of the major industrialized countries cannot be based on such expedients. They are unacceptable in a context where greater freedom in cross-border transactions is essential to enable companies to take a stand in an increasingly competitive environment.

A second remark relates to the distinction between the management of the exchange rate by surprise and the exchange rate itself. Two characteristics describe the current economic environment: high capital mobility and the fact that economic agents anticipate both the possibility for governments to implement different options and the constraints that limit the room for maneuver of economic policy. . In such a context, there is necessarily a strong link between the regime governing economic policy and the interest rates on financial markets. Governments that reserve the option of devaluation will have to pay a premium that allows investors to protect themselves from the corresponding risk. The size of this premium will of course vary depending on the market sentiment as to the likelihood of a devaluation, its date and magnitude. But the existence of such a premium is perfectly clear in view of the behavior of interest rates in the EMS in the eighties.

French performances from 1960 to 1989

Even taking into account inflation and episodes of financial vulnerability, France's overall performance remains good. The real growth rate per capita is, in the long run, higher than the OECD average and inflation is more moderate than the average of the other industrialized countries of Europe.

During the last forty years, France has certainly been confronted several times with serious financial crises. Inflation has almost always been a problem. The late fifties and the time of oil shocks in the seventies appear as phases of great instability, while the early sixties and the second half of the eighties are periods of stabilization. France is today in a favorable and unique situation. Not only is inflation low compared to the past performance of the economy, but it is also one of the lowest in all industrialized countries experiencing significant fluctuations in the

short-medium term. But over the entire period 1972-1991, there is quasi-maintenance of the parity of bilateral purchasing power.

The events of 1968-1969

The events of the late sixties offer perhaps one of the most striking examples of successful discretionary exchange rate management. Disorders in the spring and summer of 1968 were followed by significant wage increases that immediately led to a deterioration of external competitiveness and increased inflation. Following the increase in wages linked to the events of 1968, the government set up three parallel measures in 1969: a devaluation of 11.1% in August (reinforced by the revaluation of the German mark of 9.3% in October), strict price controls and restrictive monetary and fiscal policies. The success of this program is striking, if we are to believe the results obtained:

- inflation has certainly increased durably, but has reached a new plateau without giving rise to acceleration;

- growth has not been sacrificed. In fact, unemployment increased very slightly from 2.5% in the fourth quarter of 1967 to 2.8% in the third quarter of 1968, and dropped to 2.7% in the fourth quarter of 1968, to 2.5% in the first quarter of 1969. , 2.2% in the 2nd quarter, 2.1% in the 3rd. It then rose to 2.5% in the second quarter of 1970 and 2.6% in the third quarter;

Real wage growth has continued at a slightly faster pace than before 1968;

- the external constraint was relaxed thanks to the devaluation. In fact, the country's external position has improved.

The success of the 1968 devaluation must be interpreted as follows. Without the gain of external competitiveness, it would have been necessary to choose between internal and external balances. The expansion would have led to problems with payments and perhaps a crisis. The external balance, however, would have implied more unemployment and lower growth. The devaluation policy (and the welcome appreciation of the mark) has opened a third way, with a modest increase in inflation, to get out of the dilemma and to obtain satisfactory results on all fronts. This experience serves as a reference for those who argue that when the political situation is tense, it is sometimes impossible to resist upward pressure on wages and that growth should not be penalized. In such circumstances, the option to devalue allows you to have "butter and bucks", all the more so as the inflationary impact will be moderate. If both devaluation and price control are possible, there is indeed a real option. It can, however, go through a contraction of profits, harmful to the growth of investment in the medium term.

The experience of Great Britain is very different. From 1964, the devaluation of the pound sterling appeared as an option, but was continually postponed. Finally, the pound was devalued in 1968. But, unlike France, the results were disappointing: growth hardly progressed, but inflation rose, exceeding 9% in 1971. The country has not controlled inflationary and wage pressures.

The early eighties

Following the second oil shock of 1978-1979, inflation and unemployment increased sharply in France. The competitiveness of the French economy deteriorated relative to German competitiveness at the turn of the 1970s. In the early eighties, with the exception of the impact of the sharp rise in the dollar, France did not have the breath of fresh air that would have allowed a real depreciation of the currency. In particular, the relative wage rate between France and Germany deteriorated by more than 10% between 1979 and 1982.

The introduction of a restrictive fiscal policy in 1980 and the increase in real interest rates led to a marked slowdown in demand in 1981. Unemployment increases, but does not relieve inflationary pressures. In 1981-82, fiscal policy changed drastically towards expansion: the budget deficit grew rapidly and the growth of domestic demand was strongly stimulated. Growth is starting again, but the counterpart is an explosion of the external deficit. With an interest rate level that is not enough in relation to German rates, a currency that does not hold up against the mark and depreciates rapidly against the dollar, speculative attacks are developed against the franc. In 1983, the French policy of rider alone must stop and give way to a total reversal.

The extent of the attack on the franc and the ability of capital controls to isolate the French capital market from the international market. It shows the differential between the Eurofranc rate, namely the rate of 1-month deposits denominated in francs on the Euromarket in London, and the money market rate in Paris. Even using the monthly averages, it is clear that in the early eighties, the "free" investor had to be offered a very substantial risk premium compared to the rate paid on the captive market in France. In fact, the monthly differential reached 32% (annualized rate) in October 1982, illustrating the anticipation of a sharp devaluation in the near term. This episode suggests that, in the absence of capital controls, it would have been extremely difficult to burden the national economy with the interest rates that the markets considered adequate to offset the probability of devaluation (Kirrane 1993).

It is this aspect of the implications of the choice of economic policy made in 1981-1982 that demonstrated the impossibility of continuing in the same direction. In fact, we can assume experience has been rather beneficial effects, apart from its inability to reduce unemployment: in itself, the recovery in 1981 will not deteriorate competitiveness, does not lead to higher inflation, allows an acceleration of GDP growth, and is accompanied by a budget deficit and current account deficit, the magnitude of which remains in principle perfectly bearable by a country like France. What is missing then is confidence in the financial markets.

It is not therefore the content of the economic policy of 1981 that is in question, nor even the fact that France is going it alone; it is more the structural and cyclical foundations of the economic situation of France in the early eighties. In a way, the stimulus policy was "premature". On the financial markets, France was still too vulnerable to choose an isolated stimulus, to support large deficits and to finance them at interest rates that do not include a high risk of foreign exchange risk.

The experience of the early eighties, marked by the risk of collapse of the currency on the foreign exchange markets, is firmly anchored in the memory of both governments and market participants. We will argue below that the situation in France has fundamentally changed and

that the country can now benefit from increased budgetary room for maneuver without forgetting the lessons of the 1981-1982 experience.

The integration of capital markets

France in the second half of the eighties (from the reversal of economic policy in 1983) is characterized by a strategy of "competitiveness through disinflation" (International Economic Policy Group). OFCE, 1992) whose success is still uncertain.

In the eighties, France has continued to promote the opening of its capital markets. This effort has, in particular, been felt in two directions. In domestic markets, the "financial repression" implied by credit rationing and quantitative controls has been replaced by a mode of indirect transmission of credit policy, acting on the relative supply of financial assets through interest rates (de Boissieu and Duprat, 1989).

With regard to the outside world, the phased elimination of capital controls has strengthened the opening of the French financial markets and the links between the remuneration of financial assets in France and abroad. In open markets, the remuneration of securities denominated in francs is made up of three terms: the first is the foreign interest rate (in particular the rate of bonds in marks); the second is the premium to be paid to compensate for the anticipation of the devaluation of the franc against the mark (or the bonus which could on the contrary result from an anticipation of appreciation); the third consists of a political risk premium, which mainly reflects investors' perceived risk of the French government resorting to exchange controls which endanger the mobility of capital and imply a greater loss than the anticipated devaluation. We therefore have the following relationship:

French nominal interest rate = global rate + foreign exchange premium + political risk premium

The exchange premium is, for its part, well measured by the differential between the euromarket rates of deposits of the same maturity denominated in francs and marks. Once again, we observe that the episode of the early eighties led to very strong expectations of devaluation. But the chart also highlights the marked decline in these expectations until they are canceled under current conditions.

Once we accept the free movement of capital and the domestic markets have been substantially deregulated - which has largely happened and is going to happen continue under the auspices of the 1992 European project - the room for maneuver for an independent interest rate policy disappears completely (Kirrane 1993). Investors consider the currencies highly substitutable once the devaluation expectation, measured by the product of the estimated probability of readjustment and the expected devaluation rate, is taken into account.

Throughout the experience of the last fifteen years, the independence of the interest rate policy has disappeared in stages. In the 1970s, the correlation between German and French interest rates was moderate. In the first half of the eighties, it already increases substantially. But by the end of the eighties, the correlation becomes almost perfect. Independence no longer exists.

It follows that interest rates in France cannot be lowered below German rates unless the franc is close to its floor in the fluctuation band of the EMS and can only appreciate (if we

exclude an adjustment of the parities). Beyond this narrow margin of maneuver, the autonomy of monetary policy is limited by the policy of the central banks of the "hardest" currencies, or by that of the leader. We will come back to this point in the last section of this report, arguing that France does not take full advantage of the hard-won status of strong-currency countries by failing to make the extra step of tightening the mark and closer cooperation with Germany.

France and the experience of the SME

Following the fiscal expansion episode of 1981-1982, France adopted a stabilization policy based on the maintenance of the exchange rate. Despite multiple temptations, France remained in the exchange rate mechanism of the European Monetary System and used exchange rate fixity, supplemented by a very efficient income policy, to reduce the inflation rate by almost 12% in 1982 to less than 3 in 1991.

It is interesting to note that the disinflation in France since 1985 has been characterized by a fall in unemployment and a gain in competitiveness within France. EMS. The current macroeconomic situation is problematic (see next section), but the improvement has occurred, and the fixed exchange rate mechanism (with proof to the contrary) of the EMS is not an obvious suspect to explain the deterioration. .

How has the French commitment within the EMS contributed to disinflation? For some, the mere fact of membership and abdication of monetary sovereignty reinforces the credibility of the policy of disinflation. This credibility automatically translates into significantly lower inflation. The formation of wages and prices, in view of the commitment to defend the exchange rate, incorporates lower inflationary expectations and a moderation of upward pressures.

We do not deny such an effect. But we do not think that it is simply a disinflation generated by the EMS and are not aware of analyzes that would prove it. It goes without saying that the anticipation mechanism plays an important role. But would it have worked in the same way without a revenue policy? Perhaps even the income policy plays the essential role? In our opinion, during the 1985-1991 transition phase, the income policy and the commitment to defend the franc define a joint approach, the two elements of which are mutually reinforcing. Each of them played a vital role. In fact, the visible difference in the results of France is perhaps due to the success of its income policy. Another element seems to have to be highlighted: the increased confidence in the currency has gradually led to a reduction in interest rates which, in turn, has contributed to lower costs for businesses and well strengthened the disinflationary movement. Of course, it would be wrong to think that the commitment within the SME and the income policy are actions independent of each other: without the EMS, employees would have less easily bent to the discipline of politics income (in particular ex ante indexation). Without a revenue policy, the commitment to defend the franc would have been much more difficult to maintain. The decline in the interest rate differential would also have been much slower. Although the experience of the EMS can be interpreted as a "corset" useful for disinflation, the system shows, in its present form and the current context, all its limits. The gains in competitiveness are now limited, the disinflation is complete. The central problem is healthy growth that creates jobs. As we will emphasize, it is not a question of turning one's back on the stabilization experience of a decade and devaluing the franc. Nor can it be a massive fiscal expansion that puts the franc at

risk. But it is essential to capitalize on the gains made in terms of financial stability and to extrapolate the experience of the EMS through new institutional mechanisms that provide a more resilient framework within which the flexibility of fiscal policy can be used. .

Current situation

The economic situation of France in 1991 provides a case study to study the role and merits of exchange rate flexibility. Should we devalue the franc today? In our opinion, this option would have few advantages and many disadvantages. On the other hand, we will develop in the last section of this report the idea that the current situation offers a unique opportunity to rehabilitate the fiscal instrument through a strengthening of monetary integration with Germany.

The time when France was suffering from financial instability is over: the government is exercising strict control over public finances, and, according to its reputation and interest rate differentials, the franc has become a hard currency. This is the remarkable performance of the past eight years. Inflation today is moderate. The country is not really in the zone of zero inflation (between 0 and 2%), but the result is virtually equivalent. Inflation performance is particularly striking in relative terms, especially in relation to Germany's benchmark. In fact, with French inflation being the lowest of all OECD countries, maintaining fixed exchange rates implies that cost competitiveness is improving, albeit at a very slow pace. The major problem today is unemployment. A determined incomes policy and the credibility gained through financial consolidation have certainly played a central role in creating a climate of disinflation. But high unemployment has also been one of the elements. It remains high even as financial consolidation and disinflation have been completed. Unemployment should be the main concern of macroeconomic policy in France today. The key question in terms of economic policy is how to improve growth and employment without at the same time boosting inflation, deteriorating financial stability and weakening the franc.

The question is all the more important as the forecasts for 1992 may prove optimistic: the wage pressures in Germany are such that the German disinflation strategy will continue to rely on interest rates close to 10%. Growth will slow down. It is likely that this slowdown will bring France back to double-digit unemployment rates. High real interest rates in Germany force other central banks to follow: they can lower their rates to the German level, but do not have much room for further decline. France, where inflation is now lower than in Germany and which does not benefit from the fiscal stimulus that Germany has implemented to finance the unification, cannot therefore compensate for the effects of interest rates.

When will the monetary restriction stop in Germany? Most likely too late, as far as France and other European countries are concerned. The prospect of a recession does not worry much Germany; the economy is turning into a high level of employment and inflation is a much bigger concern than unemployment.

Exchange rate and economic adjustment

If prices and wages were totally flexible and information perfect, the exchange rate would be indifferent from a strictly macroeconomic point of view (as would be the policy monetary policy). Rates of the effects changes depending on a point of the variability allows sometimes

microeconomic view, to increase nominal prices utility on domestic, can in the currency of the national currency. It may be thought that this one with flexibility to protect is in external price shocks by exchange rate adjustments (Ishiyama, 1976) of fixed exchange and floating rate would be equivalent. The choice of the exchange rate regime is particularly important when there are price and wage rigidities in particular: the nominal exchange rate then becomes one of the determinants of the real exchange rate, ie the competitiveness of the economy. of the country compared to its competitors. This is the value of the exchange rate instrument: nominal changes can only contribute to economic adjustment if they have an impact on the real exchange rate.

The history of the devaluations of the French franc shows that this was not always the case: in January 1987, for example, the devaluation (in fact) of 2% of the franc in the EMS was more than offset by the increase of 2%. , 4% of the export prices of French companies to the countries of the European Community. The breath of fresh air given to companies in terms of external competition offered them an opportunity to improve their financial situation. Conversely, Japanese firms were able to mitigate the impact of the appreciation of the yen in 1985-1987 by a sharp decline in their export margins. More generally, inflation following the many devaluations of the franc has often canceled out the competitive advantage that the devaluation was supposed to provide. These examples confirm that the effectiveness of the use of the exchange rate instrument is closely linked to the behavior of prices and costs.

Choice of regimes

It is useful to classify the various possible exchange rate regimes by decreasing flexibility, corresponding, moreover, to an increasing loss of monetary sovereignty: we will consider in this order a regime of perfectly floating exchange rates, interest rate regimes stable but adjustable currencies, characterized by target areas with wide and narrow fluctuation margins, an irrevocably fixed exchange rate regime and the single currency. There are of course other exchange rate regimes, for example the multiple exchange rates applied to different types of transactions, in particular the dual exchange rate regimes separating current and capital transactions. We do not examine these regimes here because we assume that the European Economic Community has for a long time opted for complete freedom of capital movements and deregulation of foreign exchange markets.

The evaluation of the "best regime" can be carried out according to two main approaches, responding to compatible but different logic. The first is that developed by the economic literature on the optimal exchange rate regime. The latter is defined as best protecting the national economy against external shocks. This approach, however, does not allow us to draw precise and prescriptive indications on the choice of the best exchange rate regime. It depends on the random environment and the nature of the shocks, real or monetary, of the economy in question, the objectives of economic policythat, from the structure of the economy, the credibility of the government (Flood and Marion, 1991). The second approach is the cost-benefit analysis found in work on optimal currency areas. The empirical foundations of exchange rate regime analysis do not allow us to use this work to determine whether or not Europe is an optimal currency area in which a single currency should flow. But it illustrates, for a country or a region (4), the balance of costs and benefits related to the flexibility of rates and the abandonment of this flexibility. It is in this context that our analysis is located.

One of the main arguments for exchange rate flexibility is that it facilitates macroeconomic adjustment to the various shocks that the economy can sustain by increasing the flexibility of relative prices and real wages. However, we will come back to this notion, related to the degree of indexation of wages and the existence or not of monetary illusion. The corresponding advantage, however, depends on the nature of the shocks to which the studied economy is subject. In view of this profit, and beyond the transaction costs implied by the existence of different currencies and a system of inefficient payments (Dornbusch, 1991), exchange rate flexibility introduces a microeconomic cost, resulting from the uncertainty it implies: money plays less well its function of unit of account (and also of value reserve). The optimal currency area approach is tantamount to comparing the macroeconomic advantage and the microeconomic cost of flexibility to determine the "optimal" geographical area within which a single currency must move. One of the weaknesses of this approach is that it is intended more to develop arguments for monetary integration than to prescribe the disintegration of existing monetary areas, whose political symbol is too important for the question to be even posed (Krugman, 1991). It is therefore used in an asymmetrical way, which suggests that it is not able to take into account all the relevant arguments to judge monetary unification. In particular, and this is an argument that France has continued to develop in the debate on the European Monetary Union, monetary integration can have the effect of reinforcing economic convergence and of developing, a posteriori , the qualities necessary for the existence of an optimal monetary zone. Optimality is therefore not an operational concept ex ante.

Costs and benefits of the different exchange rate regimes

There is a wealth of literature on the comparison of the different exchange rate regimes and the adjustment methods they imply to the external or internal shocks to which an economy is confronted. Our purpose is not to summarize this literature, it actually rarely leads to prescriptions of economic policy or optimal choice of regime, as the results of the analysis depend on the models used and the random structure of the shocks studied. Moreover, the empirical estimation of the costs and benefits of the different exchange rate regimes is particularly delicate, not only because of the difficulties of estimation, but also because the costs and benefits are closely interdependent and cannot therefore be the subject of a separate measure (Ishiyama, 1976). We will instead seek to focus on the factors that we consider most important to consider for a country like France, to inform decision-making leading or not to the European Economic and Monetary Union. Rather than successively listing the costs and benefits, we will review the different markets: markets for goods and services, labor and finance, and study the implications on these markets, and their interactions, of the different exchange rate regimes evoked above.

We place ourselves in a framework of perfect mobility of capital: this hypothesis is justified by the movement of integration of the markets for goods and services and the factors at work in the Community with the 1992 project. Since 1 July 1990 (and even before for most countries including France) capital is perfectly mobile in the Community.

Goods Market

This is often the one that receives the most attention because it is the place to observe the problems of competitiveness and current payments. Here we focus on price competitiveness, not to mention that there are other equally important dimensions of competitiveness that are beyond the scope of this report. First and foremost, price competitiveness has the component not only of the exchange rate, but also of the inflation differential with foreign countries. This is the interaction with the labor market and the financial markets, as we will see later.

On the other hand, devaluation cannot be considered as a "weapon" of competitiveness: other countries also have it. The competitive devaluations of the 1930s showed the limits of the process. The option of changing parities can therefore only be considered as a "defensive" option, an instrument of adjustment to a deterioration in competitiveness, the use of which is subject to certain conditions on the part of trading partners, including on the nature of this adjustment. In the context of the EMS, parity realignments have generally only partially offset, and with delay, inequalities in competitiveness, forcing weak-money countries to implement and continue their economic adjustment efforts.

In floating exchange rates, the lack of competitiveness of national production does not in principle result in a constraint of external payments, because the level of the exchange rate is determined by the equality between the financing needs of the country. But then attention must be focused on inflation. The continual depreciation of the currency, besides the fact that it leads to a cumulative impoverishment, is not a solution to a chronic insufficiency of competitiveness. It is inflationary and thus contributes to strengthening the problem it is supposed to correct. Sooner or later, we must break the vicious depreciation-inflation-depreciation cycle, which requires restrictive fiscal and monetary policies, accompanied by income policies that will result in a decrease in employment and growth, and aim at containing cost growth. Even floating, the behavior of the exchange rate can leave governments indifferent (Kirrane 1993).

The essential advantage of fixed exchange rates in the goods market is microeconomic in nature. It expresses itself in terms of increased competition, encouraging companies to make the necessary competitive effort themselves without relying on the exchange rate policy to replace it. In a diversified economy like the French economy, and in a context of low inflation (and even, in October 1991, lower than in any other industrialized country), there is no reason to fear exposure to this competition: companies are in a macroeconomic environment that allows them to take advantage of it. The German experience has shown that a strong currency is not incompatible with highly competitive companies. Concretely, the intensification of competition results from the improvement of information and the disappearance of the uncertainty linked to the possibility of changes in parities. This advantage comes with the irrevocable fixing of parities; in the case of stable but adjustable systems, such as the EMS, the possibility of adjusting the parities remains, and with it the political debate and the lobbying of the producers. Moreover, as long as the possibility of devaluation exists, the incentive to pursue a policy of autonomous competitiveness is less strong: there is a form of "moral hazard", since the possibility of devaluation can be interpreted by companies as periodic flood insurance, whose disincentive impact should not be overlooked.

On the other hand, with the increased integration of goods and services markets in the European Economic Community, particularly with the completion of the Single Market, it is likely that prices are now more determined by competition in the European market than by national cost. As a result, devaluation becomes an ineffective means of adjusting relative competitiveness.

There are two important interactions with other markets: on the one hand, we will argue further that the irrevocable fixity of exchange rates, or more exactly the single currency, increases the degree of financial integration in the monetary zone and contributes (" all things being equal ") to reduce the interest rate it frees exchange risk premium. Productive capital movements are thus facilitated, which is favorable to the financing of the investment.

On the other hand, the constraint of competition reflects on the organization of relations between employers and employees, and is thus able to modify negotiations and wage demands (Kirrane 1994). While it is often assumed that exchange rate flexibility allows for real wages, it is possible to argue otherwise: the credible fixity of foreign exchange exercises more effective discipline over the behavior of nominal and real wages, and can thus promote their flexibility. The French example since 1983 seems to validate - it is true after a long adjustment - this interpretation. The recent decision by employees in Finland to accept a nominal wage cut of more than 7% seemed to go in the same direction. This hypothesis would therefore suggest that wage behavior is indeed dependent on the exchange rate regime (Flood and Marion, 1991). We will come back later.

Labor market

Exchange rate flexibility is often interpreted as a substitute for real wages. In the event of an adverse balance-of-payments shock, for example due to changes in consumer tastes, the adjustment requires either a direct change in the relative price vis-à-vis the foreigner, or a contraction of the demand, production and employment (which then brings about the correction of relative prices needed). In the absence of downward price and cost flexibility, only the devaluation of the exchange rate is likely to bring about the decline in the relative price of domestic goods needed for adjustment.

This argument is essentially based on the existence of a monetary illusion (Ingram, 1973): the devaluation of the currency causes, concealed, the decline in the real wage that employees refuse to accept by other means. In the end, this is what happens: the devaluation, in a context of full employment, leads to a fall in imports and an increase in exports, thus limiting national absorption, that is to say the quantity of goods and services available to the population. In the presence of unemployment, there is another relationship, namely that between wage demands and the level of employment. To what extent are employees tempted to moderate their wage demands in the presence of unemployment?

Several reasons can explain the existence of monetary illusion. First, it can come from a lack of understanding on the part of unions and consumers. The effect of a devaluation on real income is indirect, while the effect of moderation in nominal wages is immediate. It may also be mentioned that the determinants of inflation, which have been the subject of endless debate among economists, do not seem sufficiently clear to the general public that the prospect of a devaluation necessarily results in inflationary

expectations; these arguments are not convincing, however, because in an open economy exposed to external competition, the learning of the relationship between the exchange rate and the rise in consumer prices must necessarily occur. Moreover, the monetary illusion of this type should disappear rather quickly after several devaluations (Kirrane 1994).

Monetary illusion may also be rational (Tower and Willett, 1976, Fellner, 1973): if employees are more sensitive to relative real wages, they will be less concerned about the impact of the devaluation on real wages, as this impact will not change the relative structure of real wages. But the monetary illusion at the global level can also come from the harmful nature of the lack of cooperation: if employees in a certain sector think that others will act as if they were victims of monetary illusion, it is in their interest to do the same. In this case, it is not strictly speaking a monetary illusion: it is absent at the individual level, but because of this problem of coordination, society as a whole reacts as if it were the victim of monetary illusion. . This is an example where decentralized rationality does not lead to collective rationality. This type of argument can illustrate the value of comprehensive wage bargaining, as in Sweden or Spain, rather than branch bargaining.

The fact that wage earners accept devaluation more easily than moderation in nominal wages may also be due to another form of monetary illusion. Indeed, after the devaluation they retain the possibility of negotiating further wage increases. So they have a way, perhaps with a certain lag, to protect themselves against the inflationary effects of the devaluation. It seems that the reaction of inflation and nominal and real wages after the devaluation of the franc in August 1969 (11.1%) confirms this last interpretation. It is indeed a manifestation of monetary illusion: this behavior of wages leads sooner or later to a new devaluation and contributes to the establishment of the dynamic devaluation-inflation-loss of competitiveness-devaluation whose exit requires restrictive policies. Here we find the idea that devaluation is an inefficient means of adjustment if it is not accompanied by other policies, notably an income policy.

From the moment when the employees are convinced that the control of the evolution of the real wages is a central objective of the economic policy, the phenomenon of monetary illusion related to the use of the exchange rate becomes less probable in an economy largely opened.

Employees have the choice between accepting the risk of increased unemployment or accept more flexibility in real wages. Economic studies of wage behavior show that the relationship between unemployment and the level of real wages does exist, but generally after a certain period of time. The cost in terms of employment can be very important. If we remove the monetary illusion, we must reverse the argumentation and recognize that, when a government is likely to resort to devaluation, employees incorporate in their expectations a probability of devaluation and inflation that will affect their claims for nominal wages. Hence the link between exchange rate regimes and wage behavior. The credibility gains are then important. The commitment of the French government not to devalue has become, since 1987, more and more credible. This credibility has made it possible to move from a system where wages were indexed ex post (validating inflation) to an ex ante indexation policy (allowing the disinflation objectives to be anchored in wage behavior).

Capital market

The key element for this market is the role of expectations in the determination of interest rates. Perfect mobility of capital does not imply the perfect substitutability of assets: this will depend both on the risk perceived by investors regarding the solvency of the security issuer and the currency risk. The formation of exchange rate expectations thus largely influences interest rates. It is again on this idea that French policy has been based since 1983: the gradual decline in the exchange risk premium penalizing the French franc through the modification of expectations on the foreign exchange markets. The slowness of the process, which requires restoring the credibility of monetary policy and exchange rate policy, can not be surprising. It has been successful in France, but this success remains fragile: the test of the credibility found again intervenes in the periods of acute difficulties.

Implications

It is not surprising that the question of the optimal exchange rate regime has not been theoretically agreed in spite of the abundant literature devoted to it. The answer will depend on countries and times, objectives and structures. In the light of the foregoing analyzes, the following observations can be made:

- The options open to France are also open to other countries. Thus, the devaluation option for France cannot be considered in isolation; given the trade integration between European countries, the other states would devalue at the same time as France. Therefore, the option is that of a devaluation of a block of countries against the mark. A much larger devaluation (around 20 or 30%) is needed to achieve significant competitiveness gains.

- Exchange flexibility is not a real alternative to wages and prices; wage bargaining, and hence wage and price behavior, depend on the exchange rate regime, the reputation of the government and its credibility in complying with the regime's constraints.

- Exchange rate regimes that preserve the devaluation option are accompanied on the financial markets by devaluation premiums that involve interest rate differentials. Maintaining a devaluation option that one would never exercise is the worst of all situations, since it provides no benefit and has a significant cost. This cost is for France today in the order of 1.5% of the total long-term public debt. It would be very expensive to want to surprise the markets by exercising the option to devalue while we did everything to convince them that it would never be used. It is difficult to see how a "surprise" of this type can remain compatible with the maintenance of credibility. The surprise policy would therefore increase the risk premium imposed by the financial markets. - Devaluation seems more appropriate for developing countries, where the structure of production is more homogeneous and where a strategy of low labor costs allows the development of activities with higher added value. In industrialized countries, other aspects of competitiveness are essential: labor costs often represent only a small proportion of the total costs of production and marketing. A true competitiveness policy, or "industrial policy", must address these other aspects of competitiveness: technology, distribution, marketing, organization of social relations, training in the company, management, motivation of the workforce, etc. One can of course wonder why the United States practices competitive depreciation when they need it (Kirrane 1994). On the one hand, the notion of industrial policy is practically absent from economic policy thinking and the main focus is on labor costs to the detriment of the management of the economy. labor market, on the other hand, that the

debate on the European Monetary Union, of course, opens the possibility of making changes in parities (depreciations or devaluations depending on the exchange rate regime) between Europe, the Member States and United States and Japan.

- When comparing the different exchange rate regimes, it is observed that preserving a limited margin of flexibility for exchange rates (fluctuation margin like that of the target zones) appears of very little use: it does not change the competitive position significantly, while it strengthens the role of expectations in the foreign exchange markets and thus results in a significant cost as interest rate premium than in terms of the actual loss of room for maneuver in economic policy choices.

Regional Adjustment in a Monetary Union

The Example of the United States

The United States offers a number of lessons on how economic adjustment is achieved within an integrated monetary area, but same heterogeneous time (Canada could also serve as an example).

Two main institutions play a role in the adjustment mechanism: the common currency and monetary policy on the one hand, and the federal component of the fiscal and budgetary system on the other. It is useful to review them.

Money and credit

The common currency has been managed since 1913 by the Federal Reserve System. The Federal Reserve is responsible for banking regulation and supervision (for the only banks in the system, however), and the money and credit markets. In the latter area, the Federal Reserve is entirely independent of the Administration. The link with Congress, however, is more ambiguous, since the Federal Reserve is a creation of the latter. More specifically, while the FED plays an important role as fiscal agent of the government, it is under no obligation to defend an interest rate target. Since the "agreement" between the Treasury and the EDF in 1953, there is no agreement on interest rates or the monetary financing of deficits. This does not, however, prevent the administration from urging the Fed as soon as a monetary easing would bring a political advantage.

The main body in charge of monetary policy is the Federal Reserve Open Market Committee (FOMC). The members of this committee are, on the one hand, ex officio, the members of the Board of Directors of the Federal Reserve, and on the other hand, in turn, several of the presidents of the twelve regional reserve banks. The FOMC meets regularly or as needed, and gives instructions to the "office" of the Open Market, located at the Federal Reserve Bank of New York and charged with implementing monetary policy decisions.

The Fed has no direct responsibility in managing the exchange rate. Of course, its monetary policy, geared to controlling interest rates, can be used to affect the exchange rate and this channel of influence of monetary policy on the economy is well recognized. But when it comes to intervening on the foreign exchange markets, the FED acts as agent of the Treasury. There is

potential for conflict between the Treasury's and the Federal Reserve's exchange rate objectives in terms of interest rates and growth in the volume of monetary aggregates.

The twelve Federal Reserve Banks have today mainly a regulatory role. Their influence on monetary policy comes exclusively from the influence their president and analysts have within the system. This influence acts directly on the FOMC and of course indirectly during informal discussions on the FED policy. The Federal Reserve Banks are in fact primarily the eyes and ears of the Federal Reserve.

Recently, following the "Volcker recession", the independence of the Fed was questioned. A proposal, championed by Congressman Neal, aimed at imposing a zero inflation target on the Fed. Other proposals went in the opposite direction and envisaged giving the Treasury Secretary a seat on the FOMC to improve coordination between fiscal and monetary policies. This discussion does not put the FED statutes in jeopardy at the moment.

Fiscal Policy

The federal structure of the budget system leaves States and local authorities responsible in the functional areas (education, roads, etc.) and allows states to raise their own funding as soon as they wish. Part of the resources of state and local governments take the form of transfers under various federal programs.

The federal government is financed mainly by the income tax, the profit tax and the receipts of the social security tax. States and local governments may use income taxes, property taxes, and sales taxes.

Debt financing is not capped and states cannot be sued for bankruptcy. State-level or local-level defaults can occur: New York City's debt crisis is remembered, as is the flaw of the 1930s. Credit markets routinely assess the degree of risk of debt issued by governments. Recent research (Goldstein and Woglom, 1991) shows that a risk premium clearly penalizes over-indebted states. Thus, compared to a benchmark state like New Jersey (Aaa rating), Wisconsin, rated A1, pays a premium of 0.17 percentage points, while Massachusetts, rated Baa1, pays an additional premium of 0, 62 point. It can be concluded that credit markets are pushing unbalanced public finances to more discipline.

The issue of fiscal federalism continues to be debated, but there is currently no clear conclusion, particularly on the following questions:

- To what extent do revenue-sharing operations and federal spending allow to stabilize regional economies in recession?

- To what extent are there specific mechanisms to facilitate economic recovery in recessionary regions through budget instruments?

This question of fiscal federalism arises in these terms because many shocks that adversely affect one of the regions will also have a favorable impact on another region; in such a situation, a fiscal and fiscal system that relies on a significant redistribution of income and expenditure movements triggered by specific shocks seems best able to stabilize production and employment. For example, if oil prices go up, Texas is experiencing an economic boom, but New England is

suffering. If the share of federal revenues from Texas increased while that of New England declined, the tax system would facilitate stabilization in each of the two regions.

The structure of taxation, in particular the progressive structure of the income tax and the capital gains tax, is in line with a redistribution of income between regions. The Sala-i-Martin and Sachs study (1991: 20) concludes that "a $ 1 reduction in per capita income in a region results in a reduction in federal taxes close to 34 cents and a rise in federal transfers of about 6 cents ... between one-third and one-half of the original $ 1 shock is absorbed by the federal government. " The facts and studies available are less convincing with regard to expenses.

Adjustment process

The United States is the scene of marked regional divergences in economic performance. Asymmetric shocks, particularly in agriculture, oil and manufacturing, are the sources. In addition, there are adjustment trends associated with the migration of production factors - firms and labor - between jurisdictions, particularly from the "rustbelt" to the "sunbelt".

To what extent does the absence of an inter-regional exchange rate facilitate or, on the contrary, hinder the adjustment process? It is clear that a sufficient degree of wage and price flexibility can substitute for changes in the exchange rate. Moreover, we observe such flexibility. But it would be wrong to think that this process works enough to largely offset the regional effects of shocks. The reason, however, is not so much for price and wage flexibility (or real exchange rates) as for the financial impact of large shocks. In particular, capital gains or losses on real estate play a major role.

Before examining these latter aspects, it is useful to return to migration. The theory of optimal currency areas suggests that within such an area, factors of production are mobile and that changes in exchange rates are not essential. The study of migratory phenomena in the United States makes it possible to identify four characteristics:

- First, the mobility of the labor force is substantially dependent on unemployment. The labor force is moving away from unemployment to regions where labor markets are tight;

- second, labor moves from regions with low per capita income to those where it is high. These movements, however, seem to be mainly concerned with skilled labor.

- thirdly, regional tax rates have an impact on migration;

- finally, the migratory phenomenon also takes into account the costs of housing.

These results help to understand long-term trends towards convergence between states and regions. But even in this respect they are only part of the adjustment mechanism. In addition, they have no influence on the short-term adjustment mechanism.

What is striking reading this last painting is the magnitude of the differences in income per capita and unemployment. Adjustment is lagging behind, and shocks like the soaring and collapsing oil prices in Texas have a marked local effect. Of course, they cause migration and wage adjustments, but not enough to offset their effects.

What use would an exchange rate adjustment be? In the first analysis, a devaluation in Texas after the fall in oil prices would have served as shock absorber. The traded goods sector would

have become more competitive and could have expanded, offsetting the sharp decline in demand for non-traded goods. But, of course, assuming that exchange rates have fulfilled this adjustment function, nothing says that wages and prices would have done the same. There is no guarantee that reallocation of resources would have occurred much faster. Above all, there is the question of the behavior of capital. Texas being dependent on oil, currency crises and speculative attacks would not only affect banks (as is the case today), but also all nominal assets. There would be less financial stability (but a reallocation of the capital factor probably faster).

Texas or Massachusetts also illustrate an important aspect of the adjustment process for non-traded assets, including real estate. Real estate prices fluctuate widely with the good or bad fortunes of a region and then trigger booms or recessions in both the construction sector and the financial sector. Adjustable exchange rates would do little to eliminate this problem, and even to mitigate it. In fact, they could aggravate this difficulty. Debts that allow small states to finance themselves may have to be denominated in the currency of states in a strong financial position. The devaluation would then add to the possible reasons for a bankruptcy the deterioration of the balance sheets of the borrowers that would result.

Adjustment mechanisms

It is important to distinguish the different types of shock that may affect a country or region within a monetary union: temporary or persistent shocks, common or specific shocks). Reactions in terms of economic policy will have to take into account such characteristics. What reactions does monetary union allow?

Let us note beforehand that the instrument of the exchange rate seems the most qualified to deal with a specific persistent shock: it is in the case of such a shock that one needs a modification of the real exchange rate. . In the presence of price rigidities and if it is not possible to modify the exchange rate, the adjustment is done by a variant of the distinction often made between symmetrical shocks "and" asymmetrical "contraction of demand, growth and employment. If the labor force is not sufficiently mobile, there is an increase in unemployment. It is therefore in the case of shocks of this type that the question of adjustment arises most acutely. We return to it below.

Temporary shocks and common shocks

The simplest case is that of temporary shocks: they do not necessarily require adjustment because they are not sustainable and can therefore be financed without debt. In the context of increasingly deregulated and integrated financial markets, however, the financing option can sometimes be tricky, especially if the markets do not interpret the shock as temporary. The problem of credibility can then resurface.

The case of common and persistent shocks is, in principle, well managed in the context of a monetary union: all member countries being affected in a comparable way, there is no reason, in the first analysis, to change the rate of change. change between them. The shock does not affect their relative competitiveness. However, there may be different strategies for adjusting to such shocks (Snider, 1967) and each country may wish to determine its own choice between these various strategies. These will have different effects on the economic adjustment trajectory and

savings during the transition. When countries hit by the same shock external to their economies wish to implement different adjustment strategies, real exchange rate movements may be needed during the adjustment period. These strategies can also give rise to the appearance of a permanent specific shock. The oil shock of 1973-1974 provides an example of marked differences in the responses of the various industrialized countries to a largely symmetrical shock. It also illustrates another difficulty: how to know if a shock is temporary or permanent? Interpretations are likely to diverge on this subject.

This suggests that some convergence of economic philosophies is desirable before entering a monetary union. In the case of the European Economic Community, this convergence has indeed occurred, quite remarkably, at least between a group of countries which now share with Germany the privilege of low inflation.

Specific persistent shocks The likelihood of such shocks may be expected to decrease as European economic integration and trade, financial and cultural interdependence develop among the member countries of the Community. The case of the reunification of Germany is interesting: it can be interpreted as the combination of a temporary monetary shock and a permanent real shock. The first, characterized by high interest rates reflecting the anti-inflationary objective of the Bundesbank in a context of uncontrolled budgetary expansion, tends to push the mark up. The second, on the other hand, is a double shock on supply and demand, whose medium to long-term implications suggest a weakening of the mark.

The problem of adjusting to a persistent specific shock brings attention to the real aspects, while a change in exchange rate parities is a nominal and monetary approach (Ingram, 1973). This suggests that fiscal policy must have a role to play. But it should not be limited to the financing of the shock, that is to say the maintenance of the level of income and consumption. It must incorporate a structural policy aimed at developing productivity investments, to enable the affected region or country to maintain productive activity and the level of real wages (Kirrane 1994). The concept of regional transfer can be misleading. The transfer principle is more about financing consumption than productive investment. This is one of the reasons why the prospect of increasing inter-regional transfers within a European monetary union does not garner unanimous agreement. It requires solidarity with which some countries prefer the alternative of economic convergence. When convergence is sufficient, there is less need for interregional transfers.

If the payments system is effective (we return to this later), private capital markets are likely to play part of the role of financing productive investments. However, markets can not be relied on to make the bulk of the adjustment. The attractiveness of a region and the volume of investment that occurs, there seems to respond to a drive dynamic rather than an automatic stabilization scheme.

Budgetary action is therefore necessary. The monetary union loosens the funding constraint for regions and governments that can borrow on the union's capital markets at the interest rate prevailing in these markets. The resources thus available should be used to finance structural measures to promote productivity investments on the one hand and to obtain more flexibility on real wages on the other. In this latter context, the implementation of profit sharing programs supported by tax incentives could be considered.

Monetary Union and Fiscal Discipline

Public finances largely escape the otherwise remarkable process of economic convergence that was observed in the 1980s among the member countries of the European system. Budget deficits and public debts present significant contrasts. Can monetary union work well with such divergences? The fears expressed in the Delors report and repeated in many theoretical works are based on two types of arguments. First, that of the "externality" that present national budgetary policies: all budgetary choice decentralized may influence the rate of common interest to the whole monetary union to bring about capital movements between the Union and the rest of the world that have a potential impact on the exchange rate of the European currency vis-à-vis the outside world and on the competitiveness of the Union as a whole. This is one of the manifestations of budgetary interdependence, which justifies the establishment of procedures for consultation and even coordination. But it must also be recognized that this interdependence is already present, as demonstrated by the impact of German unification on interest rates in the EMS and its possible exchange rate implications.

The second argument is more worrying. It relates to the potential insolvency risk of one of the member countries of the union: in the absence of fiscal discipline, there may be a leap forward in indebtedness to a point where the debt becomes impossible. Both the debt crisis of developing countries in the eighties, and the financial crisis of New York City in the seventies, show that the risk is real.

Such a situation would necessarily weaken the monetary union: it would be necessary either to organize the rescue of the offender, by transfers from other member countries or the monetary financing of its debt by the European Central Bank, or to accept that the defaulting country should leave the union, to have the freedom to finance itself by creating money and devalue its currency.

Faced with this risk, the Delors report - in which central banks played an important role - recommended the introduction of strict rules on budget deficits and public debt. This solution can certainly help undisciplined countries to put their public finances in order. But it is difficult to see what kind of rules could combine both an effective constraint on the States' fiscal space and the flexibility needed to take into account the variety of possible shocks (eg German unification) and the differences between them. in the savings capacities of the member countries. On the other hand, the implementation of such rules and the verification of their respect face considerable obstacles. Finally, it is enough to observe how the Gramm-Rudman agreement works in the United States (various skins, ad hoc forecasts, off-budget expenses ...), and especially the budgetary blocking that it entails on any new expense even justified , to be skeptical about the desirability of such rules. The European Commission, for its part, seems to favor the establishment of a "multilateral surveillance", certainly more flexible, but not necessarily effective.

Faced with these centralizing approaches, one may wonder what role the financial markets could play. A recent study by the International Monetary Fund (10) shows that financial markets in the United States penalize states whose fiscal policies are considered imprudent by increasing the cost of their debt. The discipline they can contribute to promote will be the more effective

they will have in-depth information about borrowers (hence the need for independent ratings agencies), that funding monetary deficits will be excluded, and that the potential bailout of a bankrupt borrower will be deemed the least likely.

This debate is important. While the monetary instrument is no longer usable for pursuing growth and employment objectives, proposals for excessive centralization of fiscal policies need to be examined with the utmost attention. On the contrary, it is the goal of decentralization that should be promoted: in a monetary union, it is regional adjustment that needs attention. The disadvantaged regions will need transfers. But local fiscal policies, financed from the union's capital markets and aimed at financing productive activities, can play a significant role in regional adjustment. Budget discipline is not about limiting deficits, but about using public funds for productive purposes.

What options for France in the nineties?

The current situation of the French economy constitutes a particularly appropriate framework for the study of the only vestige of monetary independence that remains today: devaluation. This option exists, should it be exercised?

The initial conditions are characterized by financial stability and a high unemployment rate. Only two options are open to protect themselves from the constraint of German interest rates:

- devalue the currency and use the income policy to make this devaluation credible, creating the possibility of a reduction in interest rates counterpart of anticipations of appreciation;

- implement a fiscal expansion based on strengthening the credibility of the exchange rate regime.

Devaluation?

The arguments for a major devaluation (eg 15%) cannot be ruled out without consideration. In its history, especially after the events of 1968, France used devaluation as a means of circumventing the dilemma between the expansion objective and the external constraint. Is devaluation a plausible strategy today? If it is not, is there a great merit in keeping the exchange rate option at the price of an interest rate premium and a less complete financial integration?

An immediate objection to the devaluation, already noted above, is that France would not be the only one to devalue: why Italy, Great Britain, Spain, Portugal would not they? In this case, much of the gain in competitiveness would simply disappear. A nominal devaluation of 15% for the group would only lead to an improvement in the competitiveness of each of the order of perhaps 5%. The devaluation would be against Germany, not Europe as a whole. A significant devaluation would therefore only result in a modest gain in competitiveness.

Of course, a major devaluation affects the capital markets, where the growing confidence in a strong franc would be seriously undermined. The announcement that it would be the "last" devaluation would not deceive anyone: the previous one was too!

In the goods and services markets, a sharp devaluation raises the problem of inflation. If most trading partners within the EMS also devalue, then the inflationary impact is less, as is the gain in competitiveness. But inflation would certainly increase.

An income policy would be needed to limit the impact of inflation on the labor market. The income policy was certainly successful in the eighties. But is she not out of breath? During the period 1979-1989, real wages grew, but at a rate of less than 1% per year. This rate has improved over the past five years to 1.6% per year. Limiting the rise in real wages remains a possible strategy, but the gain in competitiveness and employment is unclear. In itself, a smaller rise in real wages affects incomes and thus aggregate spending and demand. In the short run, it brings with it some sacrifice in demand and growth. But, beyond this effect, the impact on competitiveness is not obvious; companies can be cautious and increase their profits rather than rely on a lasting improvement in their competitiveness. In addition, the long-term pursuit of such a policy may give rise to a situation of wage disputes and strikes, with all the negative consequences on productivity (Kirrane 1994). Such a development would run counter to the concern that ultimately characterizes industrial relations in Europe - and even more so in Japan - to build closer and co-operative social relations in the enterprise.

Moreover, any increase in inflation would call into question the possibility of lowering interest rates. Even if, due to the devaluation, the loosening of the external constraint gave more room for maneuver (which is not obvious), inflation fears would limit the possible fall in interest rates. It should not be forgotten that only expectations of franc appreciation would allow interest rates in France to be lower than German rates.

In total, the devaluation option has worked in the past and could be used again. But today there would be avery high price to pay in terms of loss of credibility on the capital markets. A significant devaluation would cause significant capital losses to holders of French debt securities. It would be difficult to persuade them, in the absence of a new and lasting exchange rate regime, that the same thing can not happen again at the first opportunity. In the goods and labor markets, it is better to seek competitiveness through industrial policy and tax incentives for wage moderation rather than through a labor-based growth strategy. cheap work.

Fiscal expansion

In the early 1980s, France sought to emerge from the spiral of the global recession by a decisive and unilateral fiscal expansion. The growth results were satisfactory. But they were very unfavorable in the financial field: the franc was besieged and it was necessary to set up an aggressive exchange control to pursue the policy. Even under these conditions, it had to be abandoned in 1983. What assurance do we have today that the holders of securities would consider a budget expansion as the expression of a financially sound and prudent growth strategy?

A first remark is that French inflation today is weak and has been weak for five years. In addition, this result is not due to temporary controls, but is interpreted as the expression of confidence in stability, reinforced by ex ante indexing. Of course, high unemployment plays a role that should not be neglected. The potential scope for fiscal expansion is severely limited by both the financial prudence constraint and the functioning of the labor market and the high level of the so-called "natural" unemployment rate.

At first sight, the state of public finances does not in itself differ markedly from 1981-1982. She was not then very unbalanced, she is not so today. The ratio of public debt to GDP was

moderate relative to other countries. The budget deficit remained acceptable, as it is today. The only difference is that today, financial deregulation facilitates the financing of deficits. But given their size (relatively for example in the United States or Germany), the financing of these deficits is not directly a problem.

The third observation, in the comparison between 1981 and today, is the link between inflation and confidence in the currency. In 1981, the inflation rate was 13%. Today it is 3%. Between 1978 and 1981, the Franc depreciated by 7% in nominal effective terms and its competitiveness vis-à-vis its European partners had nevertheless deteriorated. On the contrary, in 1991, it has been stable against the mark for more than three years and the measurement of relative unit labor costs does not indicate any loss of competitiveness. The franc has therefore become a really "serious" currency and does not have the past stability that characterizes the history of the German mark; but the performance of recent years is greater than that of the mark. In fact, the only shadow still present in this picture of financial stability has been the recurring debate about devaluation as a means to support growth (11).

In fact, proponents of a devaluation often think that it would have little effect, if not the elimination of the external constraint and the restoration of a sufficient margin of maneuver for the budgetary expansion. They therefore recommend, in fact, a mixed strategy of weakening the currency and increasing spending. We categorically reject the view that a strategy of fiscal expansion can be facilitated by devaluation. On the contrary, we believe that strengthening the link between the franc and the mark would be the most useful element in making a fiscal expansion a strategy for growth, reducing unemployment and reducing inflationary pressure. What matters is trust in the franc. The best way to contribute is not to devalue and promise that you will not do it anymore; it is rather to strengthen the fixity of the exchange rate.

It is not a question of recommending a very large budget expansion: it should be calibrated so that it only leads to a deterioration of the budget deficit of around 1% of GDP. Moreover, it should focus on supply - even if its effects are mainly on demand: it is about strengthening the competitiveness of the manufacturing sector. As suggested above, this short-term growth strategy should be based on a fundamental complementary measure.

Indeed, in order to strengthen the fiscal option, it is desirable and probably essential to build confidence and avoid fears of devaluation. The best way to achieve this result is to advance monetary integration with Germany. More specifically, France should propose an immediate tightening of the link between the franc and the mark, with the elimination of fluctuation margins. France would therefore invite Germany to form a de facto monetary union (n). The two countries would jointly elaborate in bilateral consultations the modalities for their cooperation. Once France has endowed its central bank with a status of independence and a mandate to defend price stability - France is one of the few countries among the most industrialized to have not yet crossed this stage - there would be no obstacle to such cooperation. We can also think that the announcement of the independence of the Bank of France would immediately allow a possibility of lowering interest rates by several tens of basis points.

A climate of cooperation exists of course already. But it is based on an untimely imbalance, namely the monetary supremacy of Germany. By insisting on maintaining the devaluation

option, France is actually choosing a strategy of "self-weakening" of the franc. Evacuating the arguments for loosening its own monetary policy, Germany naturally declares that France had the option of not following and devaluing its currency. Both countries are well aware that the option is not close to being exercised, but it stands in the way of greater cooperation. France is reduced to the role of "follower" that is desired by the rulers and politicians neither on one side nor the other, nor does it stem from the actual performance of the French economy or existing consensus in France to maintain macroeconomic and financial stability.

Summary and conclusion

The transition to the European Economic and Monetary Union (EMU) entails an institutional loss of sovereignty in the area of monetary and exchange rate policies. But France's room for maneuver in monetary policy today is purely formal. With the development of financial technologies and capital mobility, interest rates are no longer determined by internal monetary policy, but by foreign rates, foreign exchange expectations and the potential risk premium.

This constraint makes it possible to understand the direction followed by the French monetary policy: the deregulation of the capital markets and their opening on the outside made it possible to eliminate the risk premium which penalized the French capital markets. The anchoring within the EMS has meanwhile helped to stabilize exchange rate expectations: today, French interest rates have generally returned to German interest rates.

France, however, retains the formal leeway of making changes in parity of the franc. The interest in maintaining the devaluation option may seem justified in view of certain episodes of past monetary history. The 1969 devaluation, as a result of the events of May 1968, for example, was a real success: relaxation of the external constraint, gain of competitiveness, low cost of inflation, continued growth. It has allowed the smooth management of the implications of the salary increases previously granted. But the reasons for the success of this devaluation lie largely in accompanying policies: income policy, price, capital and exchange controls. These policies make it possible, on the one hand, to moderate the inflationary risks of devaluation and, on the other hand, to limit in the short term the financial costs, particularly as regards the loss of confidence of investors. Moreover, the success of a devaluation is partly based on a phenomenon of monetary illusion: the fall in the value of the exchange rate makes it possible to obtain a fall in the real wage, which is more difficult to achieve directly wage negotiations.

The economic environment in the goods, labor and capital markets has changed dramatically. Accompanying instruments aimed at restoring regulatory control, in terms of both price and capital movements, are now largely out of date. The income policy has been used successfully, but it wears out. His repeated job can focus social discontent. Finally, both European economic integration and the perception of economic interdependence have developed strongly, which makes it doubtful that we can still rely on a phenomenon of monetary illusion.

Monetary sovereignty exists only in the capacity to surprise; for this to work, it must also not happen again often, otherwise we no longer surprise, and that we have previously established a strong reputation, otherwise we do not surprise either ... The surprise can not hardly provide governments with a satisfactory mode of management of the economy. In addition, the handling of exchange rates in the European Community is not easy to surprise: the parity adjustments

must be negotiated. It is particularly difficult to keep the corresponding discussions secret. The alternative is to unilaterally decide to exit the EMS and return to exchange flexibility. But this is a real political crisis. Perhaps the behavior of other European countries can justify such a decision one day. But this simple evocation contradicts the premises of the construction of Europe. In the event of a serious political crisis, we can always get out of a monetary union.

It is on the financial markets that both the cost of devaluation and the devaluation option appear to be the highest. Devaluation damages investors and deteriorates confidence in the currency. The risk must therefore be offset by an interest rate differential. The monetary history of France in the eighties shows this phenomenon well. The option to devalue, even if it is not used, also represents a currency risk which results in an interest rate premium. To reduce this premium, we have no alternative but to try to convince the financial markets that the option will never be used. But, why keep it?

In fact, maintaining the devaluation option does not make it possible to take advantage of the considerable gain in credibility accumulated by France's economic policy since 1983-1984. Indeed, maintaining the option effectively blocks the room for maneuver of our economic policy both in monetary and budgetary matters. Even as the rigor of economic policy could or should be eased, the government cannot afford it, lest generate financial market perception of increased risk on exchange and financial instability.

The economic situation in France today, characterized by the persistence of high unemployment, very high real interest rates dictated by the outside world and poor growth prospects, nevertheless deserves concern about the response of appropriate economic policy. The experience of the eighties shows that the reduction of inflation and the stabilization of the exchange rate are necessary conditions for sustainable economic prosperity. But they are not enough. After having restored confidence in the financial field, it must be consolidated in the real economy. Two strategies are theoretically possible: devaluation or fiscal stimulus. We believe that devaluing would be a mistake: first, it would only give a margin of interest rate decline if the magnitude of the devaluation was such that it generates expectations of a rise in the franc on the foreign exchange markets. ; secondly, it would penalize investors who have put their faith in the franc and in economic policy, and who would have difficulty believing that this devaluation would be the last one again; finally, this strategy would probably not remain unilateral. Other partners from France in Europe would be tempted to follow us in the same direction, which would reduce the benefits that can be expected from the point of view of external competitiveness.

The situation of public finances as well as that of the budget and the public debt make it possible to envisage a moderate expansion (leading to an additional deficit of around 1% of GDP). This expansion should focus on supply and aim to strengthen the competitiveness of the manufacturing sector. It could include tax incentives to promote profit-sharing agreements. Sectoral or regional imbalances must be the subject of a search for original instruments designed to correct them. The fundamental question is about financial stability: how can fiscal expansion be interpreted as the expression of a financially sound and prudent growth strategy? We believe that the budget option would be considerably strengthened if it were accompanied by a firm commitment to the European monetary union. France should invite Germany and the other hard

currency countries of the European Community to form a de facto monetary union. It should propose an immediate tightening of the link between the franc and the mark, with the elimination of fluctuation margins. This would have the economic advantage of further anchoring financial stability and thus, in a way, restoring the room for maneuver in fiscal policy, as long as it finds its means of financing on the European capital markets and in Europe. prevailing interest rates on these markets. It would also have the political advantage of strengthening monetary cooperation with Germany, while today there is more convergence towards the Bundesbank's monetary policy than real cooperation. For such a proposal seems realistic, should that France acquires of an independent central bank responsible for ensuring price stability. Such a decision would immediately allow a substantial drop in interest rates.

Far from being in contradiction with the EMU treaty negotiated in Maastricht in December 1991, this approach would strengthen it and give it full meaning. The Maastricht agreements set up an institutional framework, a timetable and procedures. But only the political will of the member countries, including those who are deemed ready to join the Union, can really make the process "irreversible". All efforts must now focus on the transition. The latter can not be reduced to a simple calendar: the steps must be completed. This transition must start all the more sooner than the current system places the French economy in a certain way in the worst situation. We therefore insist on the urgency of implementing a strategy to speed up the process started.

The transition should also make it possible to learn the new economic policy instruments that will be needed for adjustment within the future monetary union. It is striking how little attention has been devoted to finding appropriate instruments to promote employment and to combat regional inequalities. We believe that these instruments will have to have more regional characteristics than national ones. Two elements seem to us essential for the proper functioning of a monetary union: a decentralized fiscal policy and an efficient payments system, designed to maintain a fixed rate system and to perfect the integration of the financial markets.

An adequate system of payments is based on three elements: firstly, agents in the group of countries that have decided to fix their exchange rates without fluctuation should be allowed to draw checks in any group currency; second, the group's banks would be required to honor all checks at face value (at no cost), regardless of origin or denomination currency; and central banks should organize centralized clearing for payments within the group.

In Europe today, the mechanism of cross-border payments is extremely underdeveloped. Progress towards the single currency has not been accompanied at all by a serious reflection on the mechanism of the payments likely to guarantee the fixity of the exchanges. Therefore, the introduction of par with cross-border transactions is an important element both to complement monetary integration and to strengthen the objectives of the single market. Only when one has the option to send a check payable at face value and without fees or delays can we really talk about integration of financial markets at the intermediate level. The current situation is far from it: the taxes collected on transactions of this type reach 6% and the deadline for the payment of checks is long and unpredictable. Because of these costs and difficulties, actual margins on exchange rates for operational retail tions are of course much higher than official limits.

The solution we advocate would have the advantage of facilitating the transition to the institutionalization of a monetary union, by preceding it with a real transition during which a pragmatic system of fixed exchange rates worthy of the name would work pragmatically. Is the best transition not to show the movement while walking?

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