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The Political Economy of French Economic Policy and the Transition to EMU

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RESUME

Depuis vingt ans au moins, la France a joué un rôle central dans le processus d'intégration monétaire européenne. Cette orientation a été poursuivie par des gouvernements successifs de différentes couleurs politiques, et elle a profondément marqué la politique économique du pays. Des réorientations fortes et des réformes de grande ampleur ont été entreprises en son nom, et lorsque des conflits de priorité sont apparus, les objectifs européens ont à deux reprises au moins prévalu sur les objectifs internes. Curieusement, cependant, peu de recherches ont été consacrées à l'influence de l'intégration européenne sur la politique économique française, et moins encore à l'économie politique de l'intégration monétaire européenne en France. L'objectif de cet article est de contribuer à combler ce vide.

La première partie rappelle les grands moments de la politique macro-économique et des réformes de structure depuis les années soixante-dix, puis analyse les conditions et les effets de la désinflation entreprise à partir de 1982-83 dans le cadre du SME. Elle met en évidence les succès de la désinflation, en particulier en ce qui concerne la gestion du taux de change réel, et son coût, dont il n'apparaît pas qu'il ait été significativement réduit par l'appartenance à un système de changes fixes. Elle montre aussi que la désinflation s'est accompagnée d'une déformation du partage du revenu au profit des entreprises. Elle examine enfin les relations entre politique monétaire et politique budgétaire, en particulier au début des années quatre-vingt-dix, où la politique budgétaire a dans une certaine mesure fait office de substitut de la politique monétaire.

La seconde partie porte sur la logique de la politique économique. Les économistes font souvent de l'appartenance à un système de changes fixes l'instrument qui permet de donner crédibilité à un programme de désinflation. Nous soutenons que dans le cas français, la stabilité des changes a été un objectif en soi et pas seulement un instrument, et ceci pour deux raisons : l'une politique -la nécessité pour la France d'afficher des performances macro-économiques à la hauteur de ses ambitions internationales- et l'autre économique -la préférence française pour la stabilité des changes, nourrie d'une méfiance tenace à l'égard de la capacité des changes flottants à assurer la stabilité monétaire internationale. Nous montrons que dans ce contexte, la désinflation s'est imposée comme une nécessité dérivée de l'objectif de change, et qu'une fois celle-ci en bonne voie, l'union économique et monétaire a été conçue comme un couronnement de l'effort accompli.

La troisième partie est consacrée aux attitudes des agents privés par rapport à la désinflation et à l'union monétaire. La difficulté d'une telle analyse est que l'intégration monétaire met en jeu plusieurs canaux d'influence sur le bien-être relatif des différentes catégories d'agents, dont plusieurs sont entachés d'incertitude. Cela peut conduire à un biais de statu quo. L'analyse des débats autour du référendum sur le traité de Maastricht conduit à souligner une division verticale de l'opinion par niveau de revenu ou d'éducation, ainsi qu'en référence au degré d'optimisme des anticipations individuelles. On ne dispose pas d'information systématique sur les attitudes des entreprises, mais l'analyse des données économiques met en évidence une intégration européenne croissante. Ceci devrait les conduire à souhaiter l'union monétaire, mais leur attitude dépend aussi (a) de la composition d'un futur noyau monétaire, et (b) de leur perception des effets de l'union monétaire sur les conditions du crédit, compte-tenu du fait que les entreprises françaises sont plus exposées aux variations des taux à court terme que les entreprises allemandes.

Enfin les banques sont en général favorables à l'union monétaire, mais attentives aux conditions de la transition vers la monnaie unique.

Au total, l'intégration européenne a été pour l'économie française un puissant vecteur de modernisation. Bien qu'initiée « par le haut », la dynamique d'intégration s'entretenait elle-même jusqu'au début des années quatre-vingt dix, parce que les coûts qu'elle impliquait étaient compensés par des gains qui renforçaient le soutien dont elle bénéficiait. La récession et le débat sur le traité de Maastricht ont enrayé cette mécanique, et ont révélé que le processus d'intégration faisait aussi des perdants. Mais il ne l'ont pas remplacée.

SUMMARY

For at least two decades, France has been playing a key role in the European monetary integration process. This goal has been pursued by successive governments of different political affiliation, and has very significantly shaped the country's economic policy. Major policy shifts as well as large-scale reforms were undertaken in the name of this objective, and when conflicts of priority arose, European objectives at least twice prevailed over domestic objectives. However, there is curiously few research available on the influence of European integration over French economic policy, and even less on the political economy of European monetary integration in France. This paper aims at contributing to a better understanding of these issues.

Part 1 first surveys the major periods of French macroeconomic and structural reform policies since the 1970s, and then analyses the conditions and effects of the disinflation undertaken from 1982-83 on within the context of the ERM. It highlights the successes of disinflation, including as regards the management of the exchange rate, as well as its cost, which was apparently not reduced through France's membership in a fixed exchange rate system. It also shows that disinflation was accompanied by a shift in the distribution of income in favour of the business sector. Part 1 finally examines the policy-mix, and emphasises that in the early 1990s, fiscal policy has to some extent been used as a substitute for monetary policy.

Part 2 is devoted to an analysis of the logic of French economic policy. Economists frequently consider that membership in a fixed exchange rate system is a commitment technology whose aim is to give credibility to a disinflation programme. We argue that in the French case, exchange rate stability was an objective in its own right, and not only an instrument. We see two reasons for it : a political one and an economic one. The political reason is the French leadership's desire to achieve a macro-economic performance that is consistent with its international ambitions. The economic one arises from a French long-standing preference for fixed exchange rates, which is rooted in a widespread and solid defiance vis-à-vis the ability of floating exchange rates to deliver international monetary stability. We show that in this context, disinflation was logically implied by the exchange rate objective. Once it was on track, economic and monetary union soon became seen as the crowning of the disinflation effort.

Part 3 deals with the private agents' attitude vis-à-vis disinflation and monetary union. The difficulty of such an analysis is that monetary integration involves several channels of influence upon the various categories of agents' relative welfare, of which several are marred with uncertainty. This may give rise to a status quo bias. An analysis of the debates around the Maastricht referendum of 1992 leads to emphasise a vertical split in public opinion by income class or education level, as well as by the degree of optimism of individual expectations. There are no systematic data available on the enterprises' attitudes, but economic data show that the French companies' integration in the European economy has grown significantly. This should lead companies to support monetary union, but their attitude will also depend on (i) the composition of the future monetary core, and (ii) their perceptions of the effects of monetary union upon the availability and cost of credit, knowing that French companies rely more on short-term credit than their German

counterparts. Finally, banks are generally favourable to monetary union, but they care about the conditions of the transition to the single currency.

European integration has been for the French economy a engine of modernisation. Although it was initiated ‘from above’, the dynamic of integration was self-sustained until the early 1990s, because the costs it implied were compensated by gains which reinforced support for integration. The recession of the 1990s and the debate around the Maastricht treaty represented stumbling blocks for this dynamic, and have made clear that there are also losers in the European integration process. But they have not led to replace it as an engine of modernisation.

THE POLITICAL ECONOMY OF FRENCH ECONOMIC POLICY AND THE TRANSITION TO EMU

Christian de Boissieu(*) *and Jean Pisani-Ferry*(**)

INTRODUCTION

For nearly two decades, from the creation of the European Monetary System to the Maastricht treaty and the discussions over its implementation, France has been a driving force behind European monetary integration. This goal has been consistently pursued by several governments of different political affiliations, and domestic economic priorities have been set accordingly. When a conflict arose between domestic and European objectives, like in 1982-83 or 1992-93, priority was given to the European commitment.

The extent to which the pursuance of this objective has shaped French economic policy can hardly be overestimated. For a large part, the major changes in the framework of economic policy that have taken place in the 1980s and the 1990s can be attributed to it. Having committed itself to exchange rate stability and being aware of the conditions the country had to meet in order to be eligible to a shared leadership of European monetary affairs, French governments from both left and right undertook sustained efforts in order to adapt the country and to redefine the implicit or explicit rules of economic policy: during the 1980s, disinflation was consistently pursued in spite of its short run macroeconomic costs; in the mid-1980s, credit markets were liberalized and the traditional *modus operandi* of monetary policy through credit ceilings was abandoned; capital controls were progressively lifted from 1986 to 1990; in 1993, the institutional framework of economic policy itself was rewritten with the granting of independence to the central bank (actually, this reform required a constitutional amendment). France therefore offers the rare example of a medium-size, non-hegemonic country whose domestic policy choices seem to have been shaped by an external agenda.

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From 1982-83, when the debate around *l'autre politique* was first settled, until 1992-93, when it arose again, this policy was fairly consensual, although a consistent minority within both the right and left opposed it. Controversies began to re-emerge in the early 1990s when the economic costs of maintaining a fixed link to the D-mark in spite of German unification became visible. Public discontent vis-à-vis the process of European integration expressed himself strongly in the 1992 referendum on the ratification of the Maastricht treaty, and again in the elections for the European parliament of 1994. This was widely interpreted as the emergence of a new divide in French politics, but a divide which arose within each political party. Europe was not prominent in the presidential election debate of 1995, at least between the three major candidates, but to a large extent the victory of Jacques Chirac was built upon his criticism of orthodox economic thinking (which he dubbed *La pensée unique*) and his call for a reversal of the order of priorities of economic policy. As the costs of mass unemployment become more and more visible and as there is little perspective that it will abate spontaneously, the debate both in the society at large and in policy circles is intensifying. Although supported by all mainstream parties, EMU is implicitly central in all economic policy discussion, because the commitment to the single currency shapes major policy choices.

In spite of the importance of what is at stake, there is very little available research on the political economy of monetary integration in France. This was understandable as long as the goals of achieving exchange rate stability and of building a monetary union were pursued by the government with the (mostly silent) consent of a majority. Yet as public controversies have emerged, and after the referendum on the treaty of Maastricht revealed how limited public support for the project was, it is urgent to clarify the politics of monetary unification.

This paper is an attempt to analyse these issues. It consists of four parts. Part 2 presents an overview of French economic policy since the late 1970s and a short assessment of its results Part 3 discusses the political and the economic logic of the policy choices, from the point of view of policymakers. Part 4 analyses the positions of the various categories of private agents vis-à-vis EMU. The conclusions are drawn in part five.

1. FRENCH ECONOMIC POLICY SINCE THE 1970S

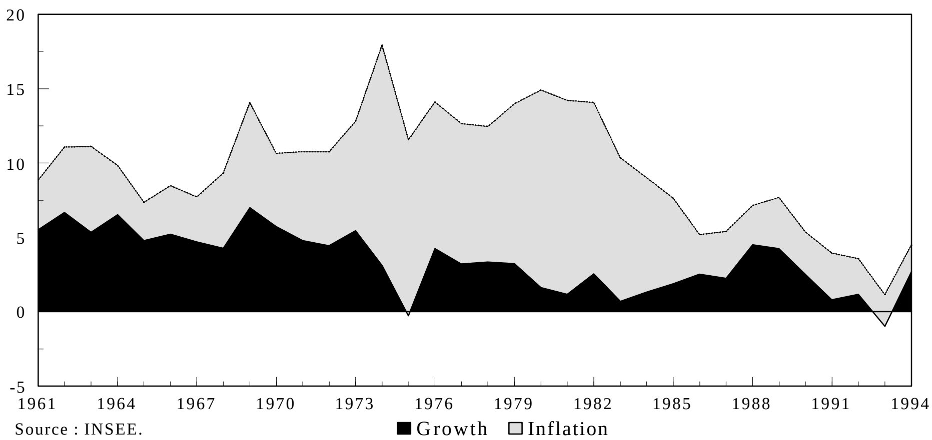
1.1. Major macroeconomic developments

The major turning point of French economic policy occurred in 1982-1983, when after an initial attempt at reflation the government of president Mitterrand clearly made the choice to aim at disinflation and nominal exchange rate stability. This turning point had been prepared by the Plan Barre (1976) and the creation of the European Monetary System (1978-1979).

Reflation and adjustment, 1974-80

The first oil shock abruptly brought to an end the continuous expansion that the French economy had been experiencing since the 1950s In 1975, the growth of real GDP was negative (- 0.3 per cent) for the first time since World War II Prime minister Chirac decided in September to boost the economy by implementing an expansionary monetary-fiscal mix Very soon, however, the ineffectiveness of the reflation became evident, as consumers increased their precautionary cash balances while inflation did not abate (Figure 1).

Figure 1: French Growth and Inflation, 1961-94



Source : INSEE.

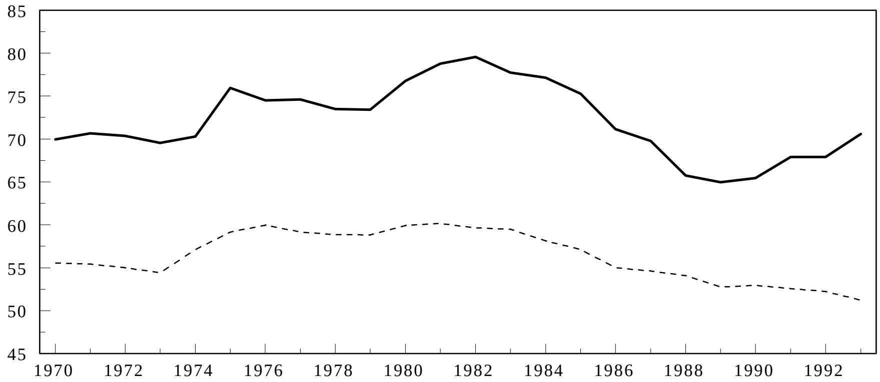
France thus reacted to a supply shock by giving preference to reflation over inflation control and accommodated it through an increase in the wage share in national income (Figure 2). It was only a few years later that the negative consequences of this collective choice became obvious. The government of Raymond Barre attempted to reverse the hierarchy of economic objectives through giving priority to disinflation, the external balance and nominal exchange rate stability - a goal he eventually reached with the creation of the EMS in 1979. His objective was to escape the vicious inflation-depreciation circle that France faced during the period 1973-1976. This early attempt met with opposition from the unions and was not supported by the employers, because in the mind of many entrepreneurs, the memory of the successful devaluations of 1958 and 1969 was still present, and it was widely accepted that changes in the nominal exchange rate would, *ex post*, offset any inflation differential vis-à-vis the main trade partners[1].

This experiment was significant but unsuccessful. On the one hand, the Plan Barre was crucial in the evolution of French economic policy thinking, because it had set new goals and created new instruments for economic policy and because it prepared the field for the 1982-1983 turning point. On the other hand, when looking at the records, it was not successful. Inflation was still 9% in 1978, and it increased dramatically with the second oil

[1] A process of economic and financial liberalization was also started under Barre. In 1977, the Competition Council (Conseil de la Concurrence) was created, with large disciplinary powers. An ambitious price liberalization programme was implemented during the period 1978-1981, after the initial price freeze of 1976. And the Monory Act (1978) introduced large tax incentives in order to boost the development of the French stock market. It was the starting point of the financial innovation process in France, which reached its peak in the mid-80's.

shock. Unemployment grew continuously. There was also a significant gap between the appeal to wage moderation and the constant drop in the profit share in total value added (Figure 2). The disinflation effort was not only limited, it was probably also unsustainable because it relied on an excessive reduction in the profit share.

Figure 2: Share of Wages in Total Value Added, 1970-93



Source : CEPII-OFCE. —— Manufacturing ---- Business Sector

"Relance" and "rigueur", 1981-1983

The initial reaction to the second oil shock was roughly similar to the one of 1974-75. At the beginning of the first Mitterrand presidency, the Mauroy government launched a keynesian program intended to boost global demand (and thereby to reduce unemployment). The implications of the Mauroy reflation on growth and employment were deceptive. But its consequences for inflation, the current account and the external debt were clearly negative. Inflation reached 14%, and the current account deficit exceeded 2% of GDP, a level which was considered excessive. Furthermore, this policy was at odds with that of France's main trading partners, who were implementing a restrictive monetary-fiscal mix in order to limit the inflationary consequences of the second oil shock[2].

The franc was devalued three times in 1981, 1982 and 1983. This led to a large debate within the government and to a major rethinking of policy. Mr. Delors, then Minister of Finance, and several high officials were instrumental in formulating the new policy framework:

(i) disinflation was officially recognized as an absolute precondition for strong growth; the full indexation of nominal wages on prices was abandoned as according to the "Delors rule" for the public sector *-de facto* extended to most of the private sector given the leading role of the public sector- nominal wages became indexed on a target rate of inflation, much below the actual rate of inflation;

2 For a detailed account of this period, see Fonteneau and Muet (1985).

(ii) a fiscal retrenchment was undertaken;

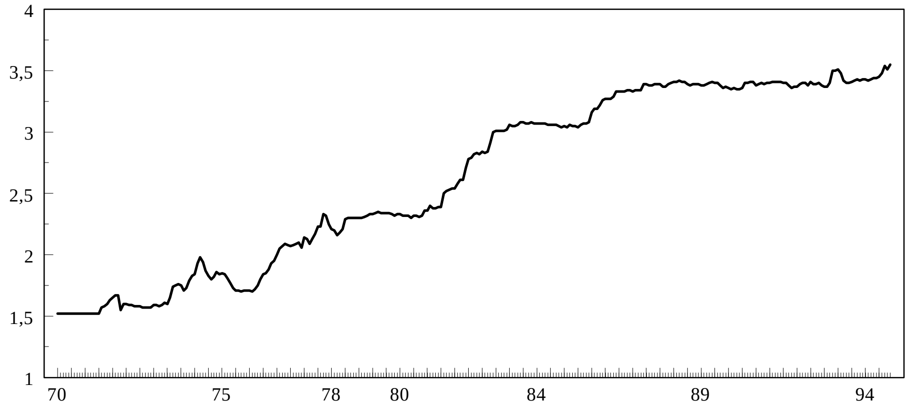
(iii) the pegging of the French franc to the mark was reasserted and the goal of external balance was set.

This restrictive economic policy was presented as a necessary response to the « external constraint ». The meaning of this expression, which had become prominent in the economic policy debate under Raymond Barre, was not entirely clear (Cooper, 1983). Literally, it was referring to the current account balance, a policy target that played a major role in the 1980s, especially as the oil shocks deteriorated the trade balance and the capital account had not been liberalised. More widely, it was a reference to the need for French policymakers and private agents to open up to the external environment. The « external constraint » was widely accepted as such because of its merely accounting character. It was later replaced by a reference to the constraints arising from European integration.

Successful disinflation, 1984-92

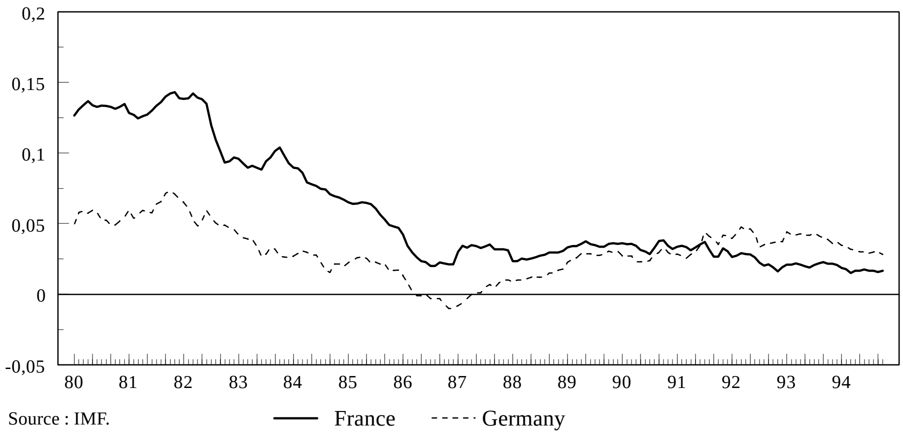
This policy philosophy was continuously followed in the 1980s and the early 1990s. The French franc was not devalued until the two realignments within the ERM in 1986 and 1987 (Figure 3). From January 1987 (date of the last global realignment for the narrow band ERM) until September 1992, the nominal exchange rate vis-à-vis the DM remained stable. For most of this period, exchange rate policy was decided upon by Pierre Bérégovoy, who was successively minister of Finance and Prime minister, and throughout the period remained totally commited to exchange rate stability. Disinflation was achieved by 1986-87, and price inflation remained low thereafter as shown in Figure 4. As several other ERM members were less successful in their disinflation effort, the French real exchange rate vis-à-vis the rest of the EC appreciated only slightly in 1983-86 and began to depreciate again in 1987. Disinflation therefore was being translated into real competitiveness gains. When the German economy began to experience the reunification shock in 1990, the French-German inflation gap narrowed and turned negative in 1991. This increased again the real benefits from disinflation.

Figure 3: The franc-mark exchange rate, 1970-94



Source : IMF.

Figure 4: Year-On-Year Price Inflation in France and Germany, 1980-94



Source : IMF.

Starting in September 1992, however, the ERM was subject to speculative attacks. In September 1992, the franc was not the main target of speculation, which was concentrated on the lira, the pounds Sterling and the peseta. In July-August 1993, however, the franc became the target of speculative attacks. This was not due to an overvaluation of the currency vis-à-vis the mark, which would have been hard to diagnose (see Figure 6 below), but to the fact that, for many international market participants, the economic policy was perceived as unsustainable in the long run given the rate of unemployment. The situation on the labor market was acknowledged as one of the dominant fundamentals, besides or instead traditional fundamentals as inflation and budget deficits.

The move to a large-band ERM (±15%) in August 1993 helped to ease the tensions. The central bank attempted to maintain the franc in the neighborhood of this central rate vis-à-vis the mark, but without trying to stick to the former narrow band of ± 2.25%. Monetary policy basically followed that of the *Bundesbank* until early March 1995, when short term rates where raised by 300 basis points in order to defend the exchange rate as renewed tensions arose in the run-up to the presidential elections.

The recession of 1991-93 was both long and severe. In spite of the slowdown in real activity and the rise of the unemployment rate (OECD definition) from 8.9% in 1989 to 12.5% in 1994, monetary policy remained essentially devoted to the exchange rate target. Fiscal policy, however, turned clearly expansionary as the general government deficit increased from 1.2% of GDP in 1989 to 6% of GDP in 1994. This was an extraordinary development in a country whose deficit had only reached 3.2% of GDP in 1983, after the reflation of the early 1980s. As the 1997 deadline for monetary union was getting closer, France was facing the prospect of not being able to meet the Maastricht deficit criterion of 3% of GDP. One of the first initiatives of the Chirac administration was therefore to propose to postpone the beginning of Stage III of EMU until 1999. This proposal was endorsed by the European council in June 1995.

1.2. Structural Changes

During the last two decades, the French economy has gone through sweeping structural changes that have been, at least in part, the result of policy initiatives.

Financial reforms

Financial innovation started at the end of the 1970s, but the process gained momentum in the mid-80's, with the introduction of new instruments on the money market and the creation of the financial futures market (MATIF). The active promotion of capital markets and financial innovation led to structural changes in the financing of the French economy and in bank activities.

In the financial innovation process, there were winners and losers even if it was not a zero-sum game. In contrast with the experience of Anglo-saxon countries, the Ministry of Finance played the main role as regards the timing and the content of the financial innovation process. This process was rather centralized and the Treasury was the main beneficiary of the dramatic growth of French capital markets. Table 1 illustrates the huge share of the State in these capital markets. It has declined somewhat for the money market (this is the natural consequence of the opening of this market to enterprises) but has continuously increased for the bond market. Treasury intervention in capital markets is thus more an idiosyncrasy than a paradox of financial liberalization in France.

Table 1: Share of the State in Overall Market Financing of Nonfinancial Agents (year-end)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Financing on the money market 1/ total financing (FF billions) 2/ Treasury financing (percent)	311 100	339 99	398 94	474 91	510 88	645 81	702 78	709 78	886 81	924 83
Financing on the bond market 1/total financing (FF billions) 2/ Treasury financing (percent)	531 56	652 59	812 63	911 65	1017 66	1109 67	1232 68	1367 68	1515 71	1830 75

Source: Banque de France.

The major change introduced in the 1990s was the independence of the Banque de France. Required by the Maastricht treaty during Stage II, it was implemented in January 1994 at the very beginning of this stage. The *Conseil de la politique monétaire* is the token of the independent Banque de France. Due to the fact that France is a unitary state (and not a federal state) and that the independence of the central bank is a break with the tradition, the new institutional setup is both akin to the German system as regards the goal of monetary policy (namely, price stability) and different from it as far as procedures, and checks and balances are concerned.

Industrial structure and industrial policy

Industrial policy has always had a particular role in the French system of economic policy due to the indicative planning and the role of the public sector, but also to the emphasis on manufacturing development during the Pompidou presidency (1969-1974). The main goals of industrial policy have been: (i) to foster the modernization of the French economy, and (ii) to improve its competitiveness through specialization and thereby somewhat loosen the external constraint.

The amount of various transfers (direct subsidies, "fiscal expenditures", etc.) from the State to the industrial sectors is a relevant indicator of government intervention in the production process. According to data collected by Dutailly (1984), for 1981, overall transfers amounted to FF 129 billion (4.8 per cent of GDP). In 1982, the ratio dropped slightly (4.4 per cent of GDP) but remained high during the first half of the 1980's. During the period 1980-1985, the bulk of the transfers went to a few sectors: the farm industry, coal, steel, transportation, aeronautics, housing, etc. Some of them represented, and still represent today, a high proportion of French exports.

Detailed analyses of production structures (Freudenberg and Ünal-Kesenci, 1995) indicate that the French industry was very significantly transformed during the last two decades. Productivity gains exceeded those observed in Germany, leading to a near-equalization of French and German productivity levels[3]. However, French manufacturing growth slowed down significantly after 1982 in comparison to Germany, and the process of deindustrialization was much more pronounced than on the other side of the Rhine.

By definition it is difficult to measure whether industrial policy was instrumental in fostering changes. However, it is worth mentioning that the external constraint was not significantly alleviated through it. For instance, Holcblat and Tavernier (1989) have underlined the negative evolution of the international specialization of the French economy during the period 1979-1986. French exporters lost market shares in the most buoyant sectors (electronics, automotive industry, several mechanical industries, etc...).

Since the mid-80's, the concept of industrial policy has disappeared from the economic policy debate, except for its horizontal dimension (competition and anti-trust rules, incentives in favour of research and development, etc.).

[3] Actually, according to Freudenberg and Ünal-Kesenci (1995), French labour productivity in manufacturing might even exceed that of Germany.

Nationalization and Privatization

In the 1980s, France went through a nationalisation-privatization cycle, with wide-ranging implications for the structure of property and control and the links between finance and industry. The 1982 nationalization of five industrial groups and most of the banks was justified by the socialist government on three grounds: (i) the wish to socialize profits and, in some cases, losses; (ii) the desire to resort to nationalized firms as the main lever for an active industrial policy; (iii) as far as banks are concerned, the desire to use money and credit as another lever for industrial policy. At the end of 1982, nationalized firms amounted to 24 per cent of overall turnover of French industry and 20 per cent of the total number of employees in industry.

The 1986-1988 Chirac government initiated an ambitious privatization programme, that was somewhat interrupted by the October 1987 crash. During the period 1986-1988, twelve firms were privatized (industrial firms and banks), with 530.000 employees. The process was then stopped when president Mitterrand was reelected. In 1993, before the second phase of the privatization programme, nationalized firms still represented 18 per cent of total turnover of industry and 13 per cent of employees. Since the 1993 general elections, the privatization process has resumed. However, the French government has also shown concern vis-à-vis ailing state firms like Air France or Crédit Lyonnais. Both have received large subsidies.

1.3. Assessing the results

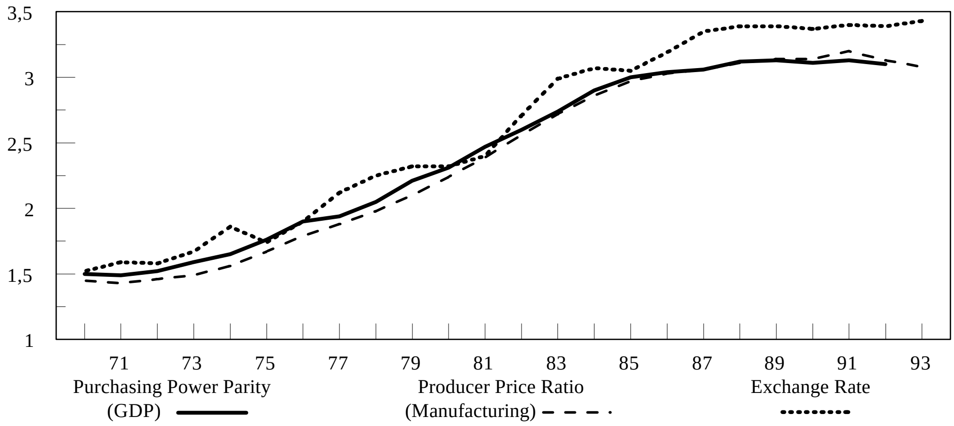
A successful disinflation under fixed exchange rates

France is one of the few countries which successfully achieved disinflation under a fixed exchange rate regime. This experience contrasts sharply with that of other ERM members or shadow members like Italy, Spain or Sweden. As developed by Alberto Giovannini (1995), putting economic policy on an automatic pilot via an exchange rate commitment generally failed to produce sustainable disinflation. Eventually, the real exchange rate became overvalued, markets became skeptical of the sustainability of the exchange rate commitment, and an exchange crisis occurred.

Why was France successful? A first factor was that although the commitment to exchange rate stability was instrumental in ensuring price discipline, the profitability of the tradable goods sector did not suffer excessively from it: as shown in Figure 5, the FF/DM exchange rate constantly remained above its PPP level[4], and the share of profits in total value added actually increased during the disinflation period. After the initial sharp devaluations of 1981, 1982 and 1983, this was obtained through a combination of small realignments and an incomes policy. Ironically, the concept of incomes policy had almost disappeared from the policy agenda, but it became reality in the early 1980s as disindexation contributed to speeding up disinflation and ensuring an increase in the share of profits in valued added after its drop in the early 1980s. Econometric estimates confirm that incomes policy was briefly, but decisively effective in 1982-83.

[4] This obviously depends on the measurement of PPP exchange rates, which are open to criticism.

Figure 5: Market and PPP FF/DM Exchange Rates

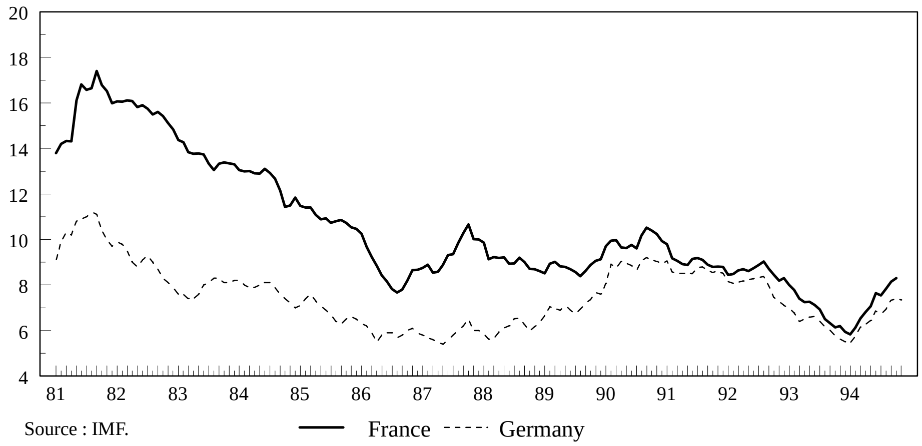


Sources: M. Freudenberg et D. Ünal-Kesenci, 1995.

A second factor behind the success of disinflation was fiscal policy. Throughout the disinflation period, fiscal policy remained tightly under control, and the structural deficit moved from 3.2% of GDP in 1982 to 0.7% in 1987 (it increased again thereafter, see below). Thus, unlike Italy the French economy was not subject to contradictory macro policy impulses.

Finally, the timing of disinflation was especially appropriate (partially by luck). It began while the recovery in Europe was under way, benefited from the effects of the drop in oil prices of 1986-87, and translated into real exchange rate depreciation via-à-vis the less successful European partners early on (and eventually also vis-à-vis Germany). Thanks to the widespread confidence market participants had in the 'new ERM' of the late 1980s, credibility also was achieved in the early 1990s, as indicated by the sharp narrowing of the FF-DM bond rates spread (Figure 6), and was not severely affected by the currency crises of 1992-1995.

Figure 6: Long Term Interest Rates in France and Germany, 1980-94



Source : IMF.

The costs of disinflation

Careful evaluations of this strategy (Blanchard and Muet, 1993) have however indicated that in spite of the credibility gains that were expected from the country's participation in the ERM, it was not successful in reducing the unemployment cost of disinflation. After controlling for the effects of the 1983-1984 wage policy, standard wage equations exhibit stability over the 1970-1990 period, i.e. credibility effects are not empirically discernible[5]. Furthermore, Blanchard and Muet have pointed out that competitiveness through disinflation is a slow process: starting from an initial situation of high inflation, the pegging of the exchange rate eventually succeeds in bringing inflation down, but at the cost of an increase in the unemployment rate that may last for several years. There is therefore little wonder that rough comparisons of the sacrifice ratio (de Grauwe, 1989) exhibit a high disinflation cost in France in comparison to non-ERM OECD countries.

Exchange rate discipline was instrumental in fostering adjustment in manufacturing industry. Plant closures and massive layoffs accelerated significantly after 1982-83. This was intended, as French industrial restructuring had been lagging behind, but although exchange rate overvaluation was avoided, the process was painful. French manufacturing output declined from some 62% of that of Germany in the early 1980s to 56% in 1992 (Freudenberg and Ünal-Kesenci 1995). Even taking into account the effects of German unification, this was a significant drop.

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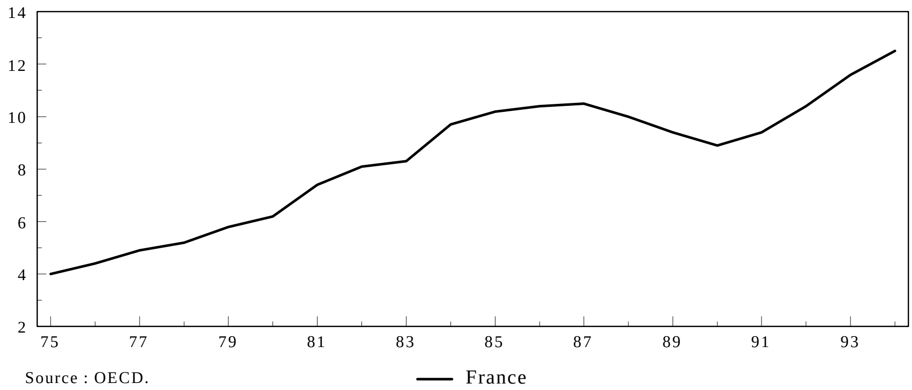
[5] When assessed in terms of gaps between monetary targets and the actual growth of monetary aggregates, monetary targeting in France has been globally successful. Nevertheless, since 1993, the growth of M3 (the announced target) has been disturbed by a number of factors: substitution effects (between financial assets) generated by the bullish bond market (1993) and (since February 1994) by its crisis; and discretionary measures, like the launching of the *Emprunt Balladur* in 1993. But the gaps between the targets and the actual growth provide piecemeal information. Other dimensions have to be considered, including the announcement effect on private agents created by monetary targeting. Contrary to Germany, announcement effects on social partners produced by the targeting procedure have been negligible since the beginning (1976). This could be explained in considering several factors: the limited knowledge of the layman about monetary policy, the lack of information and transparency concerning this policy, the absence of consensus among the social partners, and obviously the co-existence of domestic and external targets.

In distributional terms, it is apparent that the costs of disinflation where overwhelmingly borne by the wage-earners. Between 1983 and 1990, a period in which growth was buoyant in the EC, the unemployment rate (OECD definition) constantly remained above 9% (Figure 7), while the share of profits in total value added rose continuously (see above Figure 2).

Figure 7: Unemployment Rate, 1980-94

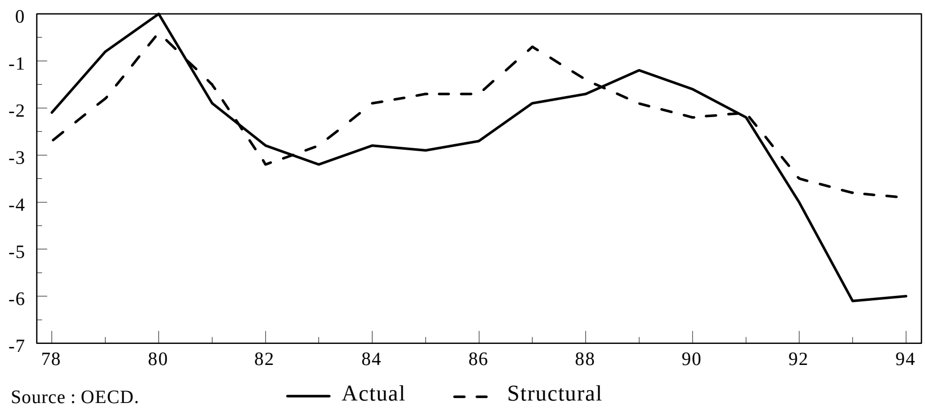


Another setback was that interest rates remained historically high in real terms. Until the mid-1980s, real *ex post* long term interest rates had been low, and were even negative in the 1970s. In the second half of the 1980s, the combination of financial liberalization and the fixed exchange rate policy was accompanied by a jump in the level of real bond rates. Furthermore, real bond rates rose again with the German unification shock: in 1990-1992, they reached 7% a year on an *ex post* basis.

A closer look at fiscal policy

Post-war France has a tradition of fiscal discipline, and from 1974 until the early 1990s the general government deficit exceeded 3% of GDP only in 1983, when it reached 3.2%. From the standpoint of fiscal rectitude, this was the best performance among the G7 countries. Fiscal policy went through successive periods of expansion (1974-75, 1981-82) and retrenchment (1976-80, 1983-87), but both the structural and the actual general government deficits remained within relatively narrow margins. The deterioration in the situation of public finances that occurred in the early 1990's departed significatly from this record (Figure 8).

Figure 8: Actual and Structural General Government Deficits, 1978-94



Looking at the structural deficits calculated by the OECD, it is clear that the willingness to implement a more restrictive fiscal policy coincided with the 1982-1983 turning point and that it was somewhat thwarted by the economic circumstances. Conversely, according to the same indicator, a more expansionary fiscal policy started in 1988. At the time France was beginning to experience the positive effects from the drop in world oil prices. The structural deficit deteriorated further in 1988-90 in the context of buoyant growth[6], and the deterioration in the actual deficit resumed with the slowdown in growth that started in 1991[7].

Figure 8 suggests that in the early 1990s, a loose fiscal policy was to a certain extent used as a substitute for monetary policy, because the latter was assigned to the targeting of the exchange rate and could not be used for dealing with the recession. The successive governments of Bérégovoy and Balladur chose to smooth out the recession through the action of automatic stabilizers and a limited discretionary reflation. The policy mix was therefore characterized by a very tight monetary policy and a relatively lax fiscal policy. The result was that the deficit reached unprecedented levels. Furthermore, fiscal adjustment was delayed in France until 1995, while in most European countries it started in 1993 or 1994.

The legacy of this period is therefore a fiscal problem of unprecedented magnitude (at least by French standards). This is both a problem in its own right, because French public deficits and debt are not sustainable in the medium run and have to be corrected anyway, and a very significant hurdle on the road to EMU[8]. To a large extent, French policymakers succeeded in reducing the short-term macroeconomic costs arising from the choice to stick to the DM exchange rate target through fiscal policy. But this cost was merely postponed, as fiscal adjustment has to be undertaken. This is bound to affect the perceived cost of the transition to EMU.

2. THE LOGIC BEHIND THE POLICY

2.1. The political case for disinflation

In order to understand the logic of the policy choices, one has to go back to their origins. In Post-WWII Europe, economic policy priorities were largely shaped by the diagnosis of the pre-war failures. The main economic lesson that the French elite drew from the interwar period was that growth, and therefore modernization, had to be given the absolute priority if France wanted to regain some of his pre-war status. *Modernisation ou décadence* was the motto. As documented by Stanley Hoffman (1963) and Richard Kuisel (1984), the primary motive of this effort was the search for international prestige and power.

[6] This was to a certain extent due to the fact that the acceleration of growth that arose in the late 1980s was perceived as more permanent than it turned out to be. Therefore, policymakers considered that fiscal policy was on track as long as the actual deficit was being reduced.

[7] These conclusions have to be taken with precaution, since the calculation of structural deficits remains open to discussion.

[8] This has to be linked to the permanence of a critical gap between the real interest rates and real growth, which has prevailed since the early 1980's.

In this context, monetary stability *per se* was not considered an overriding objective. In contrast with Germany, the focus was much more on low interest rates (actually negative in real terms) and on a competitive real exchange rate[9]. Until the late 1970s, a policy of monetary stringency had therefore little support within French society and even within the ruling elite[10]. Yet as the Bretton-Woods system broke down and Europeans began to envisage monetary arrangements of their own, French policymakers became more conscious of the need to achieve price stability.

There were two main rationales for this, one political and one economic. The political logic was that only a low-inflation, stable-currency France could pretend to some form of leadership in Europe. In the same way that after the War, industrial growth had been considered essential to maintaining the country's rank, macroeconomic discipline (or r*igueur*, as it was termed in the early 1980s), was a precondition for maintaining France's status within the EC and within the so-called French-German couple. Only on the basis of such a policy record could France expect to participate in European monetary decision-making and so, to be the co-leader of the EC and one of its agenda-shapers. There was a reward at the end of *rigueur*: power.

This link between France's ambitions within the EC and its macroeconomic performance has been repeatedly stated by numerous policymakers. Reflecting on his experience as Prime minister in 1976-81, Raymond Barre for example emphasized that "France had to be able to play an eminent role in the EC and in international affairs. She could not fulfil it without an economy able to sustain competition and without a solid and stable currency"[11]. It may be surprising, especially in reference to the U.S. case, that foreign policy considerations could be given such a priority over domestic economic ones. It should be remembered that in the institutional structure of the French government, the Prime minister, who is in charge of economic policy, reports to the President, who has a prominent role in foreign policy. This institutional structure therefore gives a disproportionate weight to foreign policy.

President Mitterrand's successive policy priorities over his two seven-years terms perfectly conformed to the logic of the country's political institutions. His initial 1981 priorities were essentially domestic, and mostly economic. Yet after he made the choice of giving priority to France's European commitments over his own initial economic program in 1983, European integration constantly gained weight in the policy agenda until it became the number one objective of his 1988-1995 term. In the same vein, EMU was primarily endorsed on political grounds[12]. It is not an exaggeration to say that economic and

[9] It is significant that in 1945, the French government had to make a choice between a monetary reform in order to eliminate the monetary overhang (as advocated by the socialist Pierre Mendès-France) and the acceptance of a price surge in response to the lifting of consumption rationing (as advocated by the centrist René Pleven). The latter thesis prevailed, and Mendès resigned from the government.

[10] This is documented in several studies of French post-WWII economic history. See for example Kuisel (1984) and Zysman(1983). A first-hand account of this period is also given in Bloch-Lainé and Bouvier (1986).

[11] Interview with François Furet, in *Le débat*, September 1983, p. 21.

[12] There was almost no French *ex-ante* evaluation of the effects of EMU and the professional discussion among economists did not really begin until the referendum on the ratification of the Maastricht treaty.

monetary policies became instruments serving the political goal of creating an integrated Europe of which France could be the co-leader.

2.2. The economic case for disinflation

There can be different economic rationales for disinflation, which link domestic and international aspects in opposite ways. Low inflation can be aimed at because private agents express a preference for stable prices, as in Germany, or because policymakers realize that price stability is conducive to allocative efficiency or even higher growth, as Robert Barro (1995) recently attempted to demonstrate. Preferences may change over time, either because agents and policymakers learn from their experience, or under the influence of exogenous factors, e.g. changes in the size and structure of public debt, or in the distribution of wealth and the asset composition of private portfolios.

In such cases, disinflation is essentially domestically grounded. External exchange rate stability arrangements only play the role of a « commitment technology », a way for the government to surmount the time inconsistency problem and to "tie its hands" as well as those of its successors (Giavazzi and Pagano, 1988). This view is consistent with the standard approach to the ERM as an instrument to borrow credibility from the *Bundesbank*. According to this view, exchange rate stability within the ERM was only an intermediate objective, while price stability was from the outset the final objective.

There is however an alternative view of the logic of disinflation, which takes the exchange rate stability commitment seriously. If governments do have a preference for exchange rate stability *per se*, and come to realize that it is incompatible with having a higher inflation than that of the partner countries, then exchange rate stability becomes the final objective, and disinflation the intermediate objective.

We consider that this second approach to disinflation deserves a serious discussion in the French case. France had for a long time expressed strong preferences for exchange rate stability. In the early 1970s, French governments attempted to resist the move to floating exchange rates. Since then, they have taken every occasion to emphasize the link between trade liberalization and international monetary reform and to advocate a return to some form of international monetary order (Landau, 1994). This consistent emphasis on exchange rate stability is specific to France among the G7 countries, and it has been a major objective of French international economic diplomacy, both at the regional and at the global level. Actually, French insistence encountered some success at both levels, with the creation of the European Monetary System in 1979 and the G7 Louvre agreement of 1987.

It is not obvious why France has been giving such a priority to nominal exchange rate stability. One explanation is that, in accordance with de Gaulle's criticism of the U.S. attitude during the Bretton-Woods era (Jeanneney, 1994), the establishment of international rules of the game was seen as a way to put constraints on the policies of the global and regional hegemons, the U.S. and Germany. More generally, it was seen as necessary to foster cooperation: as several other Europeans, post-war French policymakers remembered the sad experience of the 1920s and the 1930s, when beggar-thy-neighbour exchange rate policies contributed to the deterioration of international relations. A second explanation is that because of its intellectual background, the French elite was much less inclined to a *laisser-faire* attitude than that of the U.S., and has always been doubtful of the ability of floating exchange rates to deliver stability around ‘fair’ equilibrium real exchange rates. Support for floating exchange rates has always been very weak in France, both within academic circles and in the enterprise sector. Hence, the constant advocacy of fixed nominal exchange rates as a way to achieve real exchange rate stability. Finally, the choice of a fixed exchange rate system at the European level was consistent with the operation of the Common Agricultural Policy and the EC budget (Giavazzi and Giovannini, 1989). Whatever the reason, it is clear that the return to a fixed exchange rate regime logically implied the adoption of price stability as a major domestic policy objective.

This is not to say that the alternative logic has not been at work, too. Policymakers who considered that low inflation was a goal in its own right knew that companies, labor unions and the general public could only be convinced of the merits of disinflation to the extent that it was conducive to the attainment of "real" objectives. Therefore, disinflation was essentially presented as a policy whose benefits would show up in the form of improved competitiveness, employment, growth, and the achievement of external balance[13]. In the eyes of the public, it was a derived objective. Germany was admired not because of its success in mastering inflation, but because stable prices appeared to be a key component of its industrial and foreign trade successes.

There is however little evidence that the view of exchange rate arrangements as pure commitment technologies was widespread among policymakers, while from the aftermath of the first oil shock until the 1990s, the alternative reasoning is apparent in a very large body of policy papers, including the successive medium-term plans as shown in Table 2[14]. In virtually all official literature, as well as in background reports, the inflation objective was (i) formulated in comparison to the other countries' performance, rather than in an absolute manner, and (ii) directly related to the growth perspectives via price competitiveness vis-à-vis the other European countries[15]. The implicit framework was therefore a neo-keynesian model under fixed exchange rates, in which disinflation automatically translates into real exchange rate depreciation, gains in market shares, and growth. As illustrated in Table 2, the objective was initially formulated in a rather "soft" manner: until the late 1980s, there was a debate between those who argued that France should aim at an inflation rate close to the OECD or EC average performance, and those who favored the more ambitious objective of converging to the German level.

13 One might be surprised that the external balance is mentioned among the "real objectives". Yet external balance played a disproportionate role in the French policy debates of the 1970s and 1980s. As France began to experience moderate current account deficits, policymakers made major (and successful) efforts in order to convince public opinion that these deficits had to be eliminated. The external balance was thus taken as a benchmark for the observance of the open economy's constraints. Richard Cooper (1983) has argued convincingly that the stringency of this constraint may have been overestimated.

14 In the early 1980s, the importance of planning had already diminished very significantly with the oil shocks. Nevertheless, medium-term plans still represented official policy targets as well as collective preferences.

15 Note that in the 1970s and the early 1980s, economic policy evaluations relied heavily on policy simulations with macroeconomic models. As all French models were run under fixed exchange rates, disinflation automatically yielded benefits in the form of improved competitiveness.

Table 2: Medium Term Inflation and Exchange Rate Targets, 1981-93

Period	Reference	Inflation Target
1981-1985	Report for the VIIIth Plan (**)	"inflation rate [at least] below the [OECD] partners' average"
1981-1985	VIIIth Plan (*)	"continue disinflation"
1981-1983	Two-Years Plan (*)	"a progressive decrease in the inflation rate"
1984-1988	IXth Plan (*)	"stabilise inflation at the level of the [OECD] competitors"
1989-1992	Report for the Xth Plan (**)	"convergence of French inflation towards the EMS average"
1989-1992	Xth Plan (*)	"best European performance"
1993-1997	Report for the XIth Plan (**)	"maintain one of the best inflation performances among EC members"

Source: Commissariat général du Plan.
(*): officia.l policy document of the government;
(**): macroeconomic experts' group's report.

The logic of disinflation under fixed exchange rates was probably first pushed to its ultimate conclusions in an article by Jean-Baptiste de Foucauld (a former aide to Finance minister Delors who later became the head of Planning), who in 1986 coined the expression *désinflation compétitive* and proposed to adopt zero inflation as a policy target[16]. Interestingly, his article makes only briefly references to the standard micro benefits of stable prices, but argues that zero inflation would improve French competitiveness vis-à-vis Germany, and be conducive to maintaining the country's rank as a great power. Later, in 1992, this objective was theorized as official policy philosophy by Jean-Claude Trichet (then director of the Treasury), who in 1993 became governor of the central bank in a widely quoted paper (Trichet, 1992), which argues that "*if competitive devaluation is not considered acceptable* [in a fixed exchange rate regime], the only remaining competitiveness strategy at the disposal of economic policymakers is competitive disinflation" (emphasis added)[17].

However, the non-cooperative character of this doctrine, whose gains mainly arise at the expense of trade partners, was not seriously discussed until the early 1990s. It became obvious when some of the trade partners stopped playing the game and left the ERM (or

16 See Jean-Baptiste de Foucauld, "Une occasion à saisir : l'inflation zéro", *Le Monde*, 8 April 1986.

17 This logic was perceived early on by Herbert Giersch, who already in 1979 envisaged that "a disguised form of support for real growth in West Germany [might] arise from the EMS [...] if German labor unions accept a major responsibility for price level stability [...] and exchange rate adjustments within the EMS are delayed so that unit labor costs in Germany are artificially reduced most of the time, making locations in Germany again more attractive..." (Giersch, 1979).

devalued their currency). French policy thinking lost one of its pillars, and public support for low inflation weakened somewhat.

2.3. EMU as a coronation

From the outset, EMU was conceived as a coronation of the disinflation effort. Accordingly, the (somewhat subjective) ranking of its potential benefits in the view of French policymakers was probably different from that of their counterparts in other European countries. The chief benefits expected from the creation of a single currency were (i) equal participation in the monetary decision, (ii) a softening of the current account constraint which had been perceived as a major obstacle to growth[18], (iii) the emergence of the ecu as a world currency that could challenge the dominance of the U.S. dollar, (iv) the elimination of the expected depreciation and risk premia affecting French interest rates, and (v) further competitiveness gains through the continuation of the *désinflation compétitive*.

As it was conducive to the achievement of long-standing diplomatic as well as economic objectives, France accepted to build its institutions on the model of those of Germany: the adoption of the German model of monetary policy making was not considered as a benefit in its own right, but rather as the price to pay for the achievement of France's goals[19]. A significant illustration of this attitude was provided by the way in which central bank independence was legislated. As this independence necessitated a constitutional amendment (because the constitution states that the government « determines and conducts the policy of the Nation »), the choice was made to draft this amendment in such a way that the bank's new status was explicitly linked to the building of EMU. In fact, as the parliament passed the law granting independence to the central bank in 1993, before the ratification of the Maastricht treaty had been completed by all the Twelve, the constitutional court ruled that the law could only enter into force after the completion of the ratification process[20].

Summing up, we argue that external political and economic motives have very significantly influenced the domestic economic agenda in the period of disinflation. This does not mean necessarily that economic policy has been detrimental to the achievement of domestic objectives, but rather than a major driving force behind the policy choices has been external.

3. INTEREST GROUPS, MONETARY POLICY AND EMU

3.1. Agents' views on European monetary integration

[18] As explained above, the external constraint played a major role in the formulation of economic policy in the 1970's and the 1980's. It is hardly relevant in 1995, as France exhibits a current account surplus, but it was important when the EMU project was launched.

[19] For example, P. Duquesne (1994), a high-level Treasury official, considers that « The European Central Bank's independence is not primarily the result of as efficiency constraint (some 'dependent' central banks, such as that of Japan, are at least as efficient as the independent central banks). Its independence results from an institutional choice. In general, the independent central banks have been put together by 'federal' or 'confederal' types of States [...]. This is naturally the construction chosen for the European framework.»

[20] Décision du Conseil constitutionnel du 3 août 1993.

In Section 3, we emphasized the role of the elites in changing France's macroeconomic policy and in leading it to adopt EMU as a major policy objective. However, an agenda dominated by external commitments can only be pursued as long as it does not conflict with domestic priorities arising from the private agents' preferences. As already mentioned, from 1992 on a conflict of priorities arose between domestic concerns and the external agenda. Disinflation *cum* European integration stopped being a consensual objective. It is therefore important to investigate the attitudes of the private sector and the society at large.

An obvious difficulty in studying the political economy of European monetary integration is that it involves different channels of influence on the relative welfare of interest groups. Among the most significant channels are:

(i) *central bank independence and low inflation*;
(ii) *the loss of interest rate autonomy*;
(iii) *the loss of the exchange rate as a policy instrument;*
(iv) *the end of nominal exchange rate uncertainty and transaction costs*;
(v) *European integration at large*.

Furthermore, additional channels have to be considered in relation with the costs and benefits of the transition to EMU. These are:

(vi) *costs of budgetary convergence towards the Maastricht objectives*;
(vii) *transition costs in the introduction of a single currency*

Analytically, these channels are obviously not independent, but when turning to the political economy of monetary integration, there are two reasons to consider them separately. First, the relative significance of each channel varies over time, both depending on the overall economic situation and state of the transition to EMU. For example, the perceived gains from eliminating exchange rate uncertainty are not the same when comparing EMU to participation in the 'hard ERM' of the late 1980s, and when comparing it to the present state of monetary affairs in Europe. Second, the weighting of the channels depends on the agent's situation in the economy. It should therefore not be expected that various groupings (e.g. tradable vs. non-tradable sectors, banks vs. non-financial industries, small vs. large enterprises, wage-earners vs. business sector, etc..) line up in a stable fashion with respect to the distributional effects operating through these various channels. For example, exchange rate effects discriminate between enterprises depending on their position in product markets, i.e. by industry, while interest rate effects discriminate between them depending on their reliance on short- v.s. long-term borrowing. Constituencies for or against European monetary integration are therefore based upon linkage politics[21] and may not be stable over time. This may create room for manoeuvre for policymakers

Furthermore, EMU is a complex venture whose effects are not observable in advance, and are by nature uncertain. The economic profession is divided on the relative significance of its macro- and microeconomic effects, and in contrast to what happened when the Single

[21] For a discussion of linkage politics, see Eichengreen and Frieden (1994).

Market program was launched, no one has been able to provide an overall quantitative assessment of its consequences. As economic agents try to assess what costs and benefits EMU may have for themselves, two consequences can be expected.

The first one is a *status quo bias* in the spirit of Fernandez and Rodrik (1991), who have pointed out that uncertainty regarding the distribution of the costs and benefits of efficiency-enhancing reform may lead a majority to oppose it, even if the losers are expected to be a minority. This is because all those who face the risk of ending up as losers may expect the winners to be able to block a redistribution of the gains from the reform. This kind of effect should be especially relevant for a policy reform whose benefits are likely to be concentrated (among individuals and firms that are engaged in transactions with the rest of the EC), while costs, for example those arising from the loss of monetary autonomy in the presence of an asymmetric shock, are likely to be much more evenly distributed.

The second effect is that the agent's own weighting of the various channels can be expected to be also affected by uncertainty to a very considerable extent. This is bound to effect choices in favor or against EMU according to simple decision rules, for example on the basis of one's attitude towards European integration in general, towards the experience with the ERM and disinflation, or expectations of the short-term effects of the EMU process[22]. It can also be expected that agents will attach a great weight to any information that may signal what the real effects of EMU will be. Evidence of this kind of attitude was widespread when voters were asked to give their own opinion in the Maastricht referendum. People who were mostly ignorant about monetary affairs were desesperately looking for any piece of evidence that would allow them to make an ‘informed’ decision.

In what follows, we examine in turn the policy debate, and the attitude of the general public, the company sector, and the banks.

3.2. The policy debate

France’s participation in the ERM was initially fairly consensual. But the exchange rate policy was thereafter the focus of two cathartic debates, which served to reveal preferences and to test support for it. The first debate took place in 1982-83, when the Mauroy government had to choose between leaving the ERM and undertaking disinflation. In technical terms, it was essentially a debate about the exchange rate regime, and the choice between nominal and real exchange rate stability (interest rates were not the focus of discussions because at that time, domestic interest rates were disconnected from offshore rates through capital controls). Politically, it was a debate between the supporters of *l'autre politique* -those within the ruling Socialist party who gave priority to the left's domestic agenda (fiscal reflation, growth and employment) and advocated therefore letting the exchange rate float- and those who refused to breakaway from the ERM, and considered that *l'autre politique* was an illusion. After the choice was made, disinflation was pursued

[22] To some extent, these issues resemble those that arise in the context of the transition from a planned to a market economy. As agents are unable to assess the costs and benefits of this transition for themselves in a forward-looking manner, the tend to rely on adaptive expectations. See Dewatripont and Roland (1992) on the argument in favor of gradualist transition strategies.

by five successive governments. Over time, its benefits began to show up as lower inflation translated into a real depreciation of the currency.

However, these benefits were put to question in the early 1990s as the inflationary consequences of German unification led to a monetary tightening by the Bundesbank. The cost of a fixed exchange rate regime manifested itself first in the form of high real interest rates, and later by the need to defend the exchange rate through monetary tightening. The breakdown of the ERM also meant that the 'virtuous' link between disinflation and competitiveness was broken. The second cathartic debate about monetary and exchange rate policy started in 1992-93, during the Maastricht referendum campaign and its aftermath. In technical terms, it was more a debate about interest rates than about the exchange rate, because there was no evidence of overvaluation of the French franc. But the essential difference with 1982-83 was that opponents to the *franc fort* policy could make a much more credible economic case for changing the course of monetary policy. This was because in the context of a recession, pursuing a tight interest rates policy was not warranted on domestic economic grounds, and could be pictured as obsessive (Fitoussi, 1995).

The discussion on the *franc fort* has been going on since 1992, but it has not led to any significant change in the macroeconomic strategy followed by the government and the central bank. Since mid-1994, the focus on interest rates has lost intensity (except for periods of money market rates hikes), but exchange rate issues have been the subject of increased controversies with the depreciation of the lira and the peseta. The presidential election of 1995 did not give rise to a debate about Europe nor about exchange rate policy, explicitly at least. However, the victory of Jacques Chirac was built upon his commitment to consider employment as the overriding objective of economic policy. Although he also expressed a strong commitment towards European integration and the building of monetary union, the presidential election emphasized domestic objectives and signalled they had to be given priority.

It is striking that despite the intensity of the debate (and the disarray in public opinion, see below), continuity in exchange rate policy seems to prevail: after the presidential election, the Banque de France did not significantly soften its attitude, and the successive governments of Messrs. Bérégovoy, Balladur and Juppé have basically made the same commitment to exchange rate stability. One explanation is obviously the independence of the central bank and its search for credibility, but the Banque de France is not in charge of defining the exchange rate policy. A deeper reason behind the continuity is that the economic policy debate is dominated by a wider issue: what is at stake is once again France's European strategy. Proponents of alternative policies have yet to define such a strategy, in the case that France would forsake EMU and therefore scale down ambitions as regards European integration. This is why even some of the staunchest critics of the *franc fort* policy (Fitoussi, 1995) claim full support for monetary union. Furthermore, for reasons mentioned earlier, the British alternative (i.e. the deliberate choice of a floating exchange rate regime and the adoption of a 'small open economy' strategy) does not appeal to French politicians.

3.3. The public debate

The referendum on Maastricht that took place in September 1992 came at a crucial juncture. Growth had been slowing down for more than a year but had not yet bottomed out in continental Europe. Unemployment was on the rise, but the recession was still expected to be mild. The EMS was in turmoil and Britain had had to exit the ERM a few days before, but the general public was not yet aware of the depth of this crisis. Yet the result of the referendum was unexpectedly close: the 'yes' vote won by a very narrow margin - 50.8 % against 49.2. It was surprise, because for years French voters had routinely expressed support for the single European currency in opinion polls[23], and because virtually the entire political establishment supported the Maastricht treaty. Only the fringes -the communists and the nationalistic right- and a few political figures were clearly opposed to it.

The campaign was a rare event in a democracy: citizens were in disarray because they were asked to settle an issue on which they had been hardly informed. The treaty became a national best-seller, and at the grassroots level European integration was for the first time the subject of many discussions. As the campaign developed, voters became increasingly skeptical of the virtues of the Maastricht treaty, and polls conducted afterwards indicated that the trend did not stop on 20 September. The *Eurobarometer* survey regularly conducted by the EC Commission shows that the margin between the proportion of Frenchmen considering that France has benefited from participation in the EU and those considering it has not has dropped from 30% in 1990 to 20% in 1992 and zero in 1994[24].

It is not clear to what extent the perspective of EMU was prominent among the voters' concerns. Opposition to the loss of monetary autonomy, to the independence of the central bank and to fiscal austerity were clearly expressed by the leaders of the 'No' camp (Séguin, 1992), but motives indicated by the voters in exit polls were rather general. 'Yes' voters mentioned peace (89%), the building of Europe (88%) and the need to be able to withstand competition with Japan and the US (83%). 'No' voters were not more specific, as they indicated sovereignty (75%), the Brussels technocrats (74%) and German dominance (61%) as the mains reasons for opposing the treaty[25]. The fear of austerity policies (69%) only ranked fifth in the voters' explicit concerns. Analyses of the determinants of the voters' choice reveals the interplay of several factors, including political affiliations and preferences, but overwhelmingly indicate that the main determinants were sociological. The referendum was the occasion of a divide between the rich and the poor, the educated and the non-educated, the winners and the losers (Table 3).

These results should obviously be read in the light of the observations previously made about the distributional effects of the disinflation effort. The Socialist governments under president Mitterrand relied on the support they could count on among wage-earners and labor unions to bring about the disinflation and the restoration of profits that the centre-right governments under president Giscard d'Estaing had not been able to achieve. Labor unions were generally critical of this policy, at least the CGT and FO confederations (the CFDT

23 For example, in May 1989 60% of the French voters were in favor of replacing the franc by a European currency (33% were opposed). Source : SOFRES poll, in SOFRES (1990).

24 Source : EC Commission, *Eurobarometer*, July 1994.

25 BVA Exit polls.

was more supportive), but did not oppose it in a frontal way. They were also critical of the process of European integration (the CFDT being here again more supportive), but did not attempt to organize opposition to it within the working class.

As disinflation was pursued in the name of Europe, the 'losers' in the process, i.e. the working class and the unemployed, naturally grew skeptical of the benefits of European integration. Their skepticism merged with that of other groups that had become reluctant to support European integration, either because of their experience with the implementation of the Single Market or, as in the case of farmers, because they had been affected by the unrelated, but quasi-simultaneous reform of the CAP.

Table 3 also provides striking evidence of the *status quo bias* effect, since the single most important factor that accounts for the voters' choice appears to be their opinion of their own future[26].

Maastricht was a shock, both in sociological and in political terms. The revelation of a split between the France of the winners and that of the losers contradicted the previously prominent view that class struggle was over and that France had been gently moving in the same direction than other industrial countries, namely towards the formation of a large middle class, with an elite above it and an underclass below. Mainstream political parties from both left and right were therefore competing for attracting the votes of the middle class. The Maastricht referendum, and the subsequent results of the elections to the European parliament of June 1994, in which mainstream parties favoring European integration attracted only 40% of the votes[27], gave rise to a new paradigm, that of the two Frances (Todd, 1994). According to this view, the split in public opinion vis-à-vis European integration revealed a deeper sociological divide. This analysis was reflected in the electoral campaign of candidate Chirac, who repeatedly mentioned the threat of a *fracture sociale* and the need to rebuild France's social fabric.

[26] To the extent that views on the working of democracy probably represent opinions on the ability of a democratic regime to ensure equity, they could be interpreted in the same way.

[27] Non-mainstream parties were not all opposed to European integration.

Table 3: Proportion of 'yes' votes in the referendum on Maastricht

Overall	51
Political preference (a)	
- Extreme-left	46
- Left	75
- Centre	51
- Right	43
- Extreme-right	7
Monthly income in U.S. dollars (a)	
- Less than 1000	43
- 1000 - 1500	46
- 1500 - 2000	49
- 2000 - 3000	52
- 3000 - 4000	62
- More than 4000	64
Age at end of education (b)	
- 14 or less	46
- 15 to 16	47
- 17 to 18	43
- 19 to 21	51
- 22 or more	65
- still in education	61
Profession (a)	
- Farmer	29
- Entrepreneur	44
- Manager, higher intellectual profession	70
- Intermediate profession	57
- Employee	44
- Production worker	42
- Inactive	55
Opinion on the working of democracy in France (b)	
- Works very well	81
- Works well	68
- Does not work well	28
- Works very bad	13
Confidence in one's professional and personal future (b)	
- Very confident	78
- Rather confident	76
- Rather worried	39
- Very worried	17

Sources: (a) SOFRES Exit poll, in SOFRES (1993); (b) BVA Exit poll.

In analytical terms, there is no clear evidence that inequalities and divisions within French society can be specifically attributed to *European* integration. The debate on the effects of international trade on the labor market has focused much more on the consequences of industrial relocation in, or trade with low-wage countries. However, European integration is frequently seen by those who oppose opening the French economy further as a symbol of globalization. Specific concerns relate to the elimination of public-service monopolies in certain sectors (utilities, telecoms, railroad and air transportation), the operation of the Single Market, and the limits European integration could put on the redistributive policies or policies aiming at the integration of recent immigrants into French society. This concern was expressed bluntly by Emmanuel Todd (the author of the ‘two Frances’ paradigm) after the June 1995 local elections, in which the extreme right made further progress. According to him, « there is an easy recipe for stopping the growth of the National Front [the far right]: declare that European construction is over»[28].

Even those who do not endorse this view acknowledge that there is now at least a *perceived* conflict of priorities between pursuing the goal of European integration and that of restoring social cohesion in a society which has been severely hurt by industrial restructuring, urban decay, tensions between natives and immigrants, and the rise in long-term unemployment, and whose cohesion traditionally rested on the integrating role of government institutions. One may dispute the existence of such a contradiction in the long run, as the authors of this paper do, yet it is indisputable that it arises in the short term, if only because of the budgetary requirements of the Maastricht treaty.

3.4. The company sector

Analyses of monetary and exchange rate policies in various industrial countries have highlighted the interplay between economic structures, private sector preferences and public institutions in shaping the political economy of monetary and exchange rate policy. Frieden (1994) argues that capital market liberalization fundamentally affects exchange rate politics, because it both magnifies and transforms the impact of monetary policy. He also emphasizes the divisions between traded and non-traded goods sectors vis-à-vis the variability of the exchange rate, and between producers and investors as regards the level of the exchange rate. In his study of the U.S., Germany and Japan, Henning (1994) stresses that the degree of interpenetration between bank and industry is crucial in determining whether the private sector's preferences are homogeneous, and are therefore able to influence policy. He argues that since banks tend to be agnostic about both the level and the variability of the exchange rate, the emergence of the private sector's view depends on the country's financial structure, and more precisely on the banks' participation in industrial shareholding and on the industry's reliance on bank credit for financing. According to this thesis, the US's frequent neglect of exchange rate issues is rooted in the almost complete separation of banking and manufacturing interests that characterizes the country. This kind of reasoning should not be applied without precaution to a country like France in which, according to a recent study (Bauer and Bertin-Mourot, 1995), 47% of the top executives of the major corporations are former civil servants. Nevertheless, analysis reveals interesting transformations.

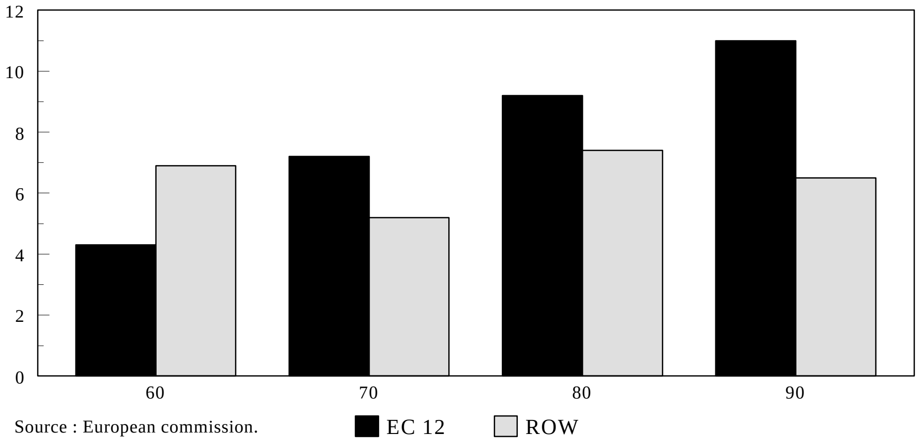
From the late 1950's to the 1990's, French enterprises experienced dramatic changes in their relationship with the rest of the world. In the 1950's, French industry was heavily protected and traded less with the future EC than with the colonies. The employers' association

[28] Interview with *Liberation*, 21 juin 1995.

(CNPF) opposed the European Coal and Steel Community in 1951 and only accepted with reluctance the establishment of the Common Market in 1957. It was more generally highly skeptical about the merits of foreign trade liberalization, and until the 1980s routinely called for periodic devaluations in order to restore profits margins and to maintain domestic and foreign market shares.

By and large, however, the French companies' experience with European integration has been a success story. Predicted catastrophes have not taken place, and France has been able to meet or even to anticipate the liberalization deadlines, while roughly maintaining a fixed real exchange rate vis-à-vis the DM since 1970. Over the last decades, dramatic changes in the economic structure have transformed the companies' involvement in European integration. The Community has progressively become the major market for French producers (Figure 9). The establishment of the Single Market has resulted in new efforts to devise European marketing strategies, especially by the small and medium-sized enterprises, which significantly enhanced their exports to the EC.

Figure 9: French Exports by Destination, 1960-1990



Source : European commission.

The launching of the Single Market and the liberalization of the capital account led larger industrial and financial companies to embark on ambitious foreign investment and acquisition programs, mainly in other EC countries. This was a significant break with the past, as foreign investment had traditionally be low in comparison to other industrial countries. Outward FDI grew from FF20bn per year in 1985-86 to FF150bn in 1990 (the flow thereafter decreased to FF 70bn in 1993), and according to the *Banque de France*, the stock of French FDI increased from FF276bn to FF774bn between 1987 and 1992. Most of this increase was due to intra-EC FDI, and at end-1992, the EC represented 58% of the total stock of FDI abroad. This proportion was even higher in financial sectors like banking (68%) or insurance, which essentially started developing abroad with the launching of the Single Market. Data on mergers and acquisitions point in the same direction, as they indicate that French firms were the most actively engaged in intra-European deals[29]. French

[29] According to the EC Commission (1994), French firms were involved as bidders in 27.6% of intra-EC cross-border acquisitions in 1990-92, a share significantly above France's share of EC GDP.

capitalism now has a stake in European integration, and while the FDI and M&A flurry abated in the early 1990s, the trend continues with the increasing involvement of transport, telecoms and utilities in the Single Market.

To what extent does this increased involvement in European affairs translate into adhesion to monetary integration? The evidence is scant, but available surveys of the attitude of European firms[30] (AMUE 1990, Coutu *et al.* 1993) indicate that in the early 1990s, support for monetary union was clearly weaker than for the Single Market. Summarizing the results from interviews with senior executives, Coutu *et al.* report that "the EMU's short- and medium-term benefits are not immediately obvious to the business community", while "full implementation of the internal market is an absolute priority". In short, EMU was perceived as a possibly positive addition to the Single market, but not as an essential one.

Since then, companies' attitudes have been affected by the evolution of exchange rates and the monetary policy implications of the exchange rate policy. Until September 1992, nominal exchange rate stability was taken for granted, and as long as higher-inflation countries like Italy and Spain were experiencing real appreciation within the ERM, French enterprises benefited from a steady improvement in their competitiveness (this was the logic of *désinflation compétitive*). This process came to an end in September 1992, and in mid-1995 the peseta and the lira had respectively lost about 30% and 40% of their value vis-à-vis the franc. Depreciations of this size more than correct for overvaluation, they create misalignments within the Community. This is an unprecedented experience, since the creation of the Single Market has removed all remaining safeguards against 'unfair' competition, as well as the possibility for a government to subsidize loss-making enterprises. The compatibility of the Single Market with floating exchange rates has therefore been put to a real test.

This new situation may affect significantly the companies' attitudes towards EMU. According to a 'One market, One money' logic, it could trigger demands for monetary union as a way to avoid misalignments. A number of declarations have been made in this direction by industrialists and representatives of the agricultural sector. Yet as monetary integration will certainly be of a two-speed type, EMU is unlikely to bring a full solution to the problem in the short run. On the contrary, the formation of a core EMU between Germany, Denmark, France and the Benelux countries could be seen as offering to those outside the core a golden opportunity to pursue non-cooperative exchange rate policies. This concern was repeatedly expressed by French industrialists as well as politicians. An alternative possibility could be that if the Single Market fares well despite the currency turmoil -assuming for example that undervalued currencies will appreciate again- then the perceived link between real and monetary integration will vanish. It is afterall what happened when the world economy moved to flexible exchange rates in 1973. In both cases, their support for EMU would be affected.

Finally, there is the issue of the exchange rate of the franc vis-à-vis the U.S. dollar and other currencies, especially those of emerging economies. Industries which produce for the world market, or whose profitability largely depends on the exchange rate of the home currency

[30] There are no equivalent surveys for French firms.

vis-à-vis the dollar frequently perceive the tight money policy of the *Bundesbank* as conducive to an overvaluation of the DM and the franc vis-à-vis the US dollar. As the provisions in the Maastricht treaty emphasize the objective of price stability at home rather than external objectives like the avoidance of misalignments vis-à-vis other currencies[31], industries like aerospace, chemicals, telecom equipment, etc. which are primarily interested in the franc-dollar exchange rate, may be apprehensive of the external effects of EMU[32].

A second significant factor that has been shaping companies' attitudes towards EMU is their dependence on short term interest rates. The British experience of 1991-92 has demonstrated that an extensive reliance on financing indexed to short-term rates could be incompatible with the maintenance of a fixed exchange rate. In France, opposition to the *franc fort* was especially vocal in sectors with a significant dependence on short-term rates. It has been suggested by some observers that asymmetries in the borrowing structure between France and Germany could be an obstacle to monetary integration.

When the private agents' borrowing is primarily linked to bond rates, they should favor a stability-oriented policy like the one conducted by the Bundesbank. When they rely more on short-term rates, they are likely to be critical of a monetary policy that may imply short-term rates hikes. A recent study by the BIS (Borio, 1995) confirms that both France and Germany clearly differ from the U.K. as regards the extent of fixed-term lending to households, but it also indicates that French firms actually rely more on short-term or adjustable-rate credit than do German ones (Table 4). There is therefore a rationale behind the differences between French and German reactions to interest rates hikes[33].

Table 4: Borrowing Practices in France, Germany and the U.K.

as a percentage of total borrowing of each sector

	France	Germany	UK
Households:			
- short-term and adjustable medium and long-term	13	36	90
- fixed long-term	87	64	10
Business sector:			
- short-term and adjustable medium and long-term	56	40	48
- fixed long-term	44	60	52

31 See, for example, Bénassy, Italianer and Pisani-Ferry (1993), and the references therein.

32 It is not clear why French industrialists seem to be much more sensitive to exchange rate fluctuations than German ones. Detailed analysis of foreign trade structures (Freudenberg and Unal-Kesenci 1994) suggest that German enterprises are more frequently specialized in specific 'niches', and more generally that vertical differenciation is more prevalent in German foreign trade than in the French trade, but econometric estimates do not confirm a higher price elasticity of French foreign trade in comparison to Germany.

33 In Table 4, borrowing by French firms includes bonds, which account for some 15% of total borrowing (Grunspan, 1995). It should be kepts in mind that only a few companies issue bonds, and that most of them belong to the state sector.

Source: Borio (1995).

Furthermore, there is a significant difference between large firms which rely more on self-financing and on borrowing in the bond market, and SMEs which depend more on short-term bank credit whose rates are indexed to the money market rates (Table 5)[34]. SMEs were therefore more exposed to the upward shift in short-term rates and to the invertion of the yield curve that occurred in the early 1990s, and they might give preference to a policy of low real money market rates, rather than of low nominal bond rates.

Table 5: Financing of French Companies, 1992-1993

in percent of total resources

	Small and medium size firms		Large firms	
	1992	1993	1992	1993
Self-financing	75.1	77.1	83.3	83.7
Debt	24.9	22.9	16.7	16.3
of which				
- bond financing	0.6	0.8	2.5	3.7
- short-term bank credit	9.7	8.7	4.6	3.9

Source: Banque de France.

What can be drawn from this analysis is that there is now a strong constituency for European integration in the company sector (at least a much stronger one than ten years ago), but that support for European integration does not automatically translate into support for EMU. Attitudes vis-à-vis monetary integration are diverse, and there are rationales for this diversity. This is a very significant difference with the Single Market program, which obviously attracted opposition but was soon perceived by the companies as beneficial for business. Visible hesitations persist on EMU.

3.5. The banking sector

The banks' attitude towards European monetary integration differ depending on their involvement in international transactions, but they have generally been supportive of the process of monetary integration. Although they are bound to lose from the elimination of some exchange market operations, this attitude is understandable in view of the benefits they would draw from the merging of national financial markets. In contrast to German banks, French banks are also much less engaged in long term relationships with companies and, as shown in Table 6, France has been moving quite rapidly away from the German

[34] In addition, the cost of credit depends on firm size. A task force of the Conseil National du Crédit documented an empirical investigation in the course of 1988 concerning a possible discrimination between large and small firms as regards lending rates. The conclusions were straightforward: during the period 1977-1987, there was a systematic spread whose magnitude depended on the type of credit. It was around 150 basis points for discounting facilities, 200 to 250 basis points for overdrafts, etc.

model and in the direction of the Anglo-Saxon one: the two intermediation ratios calculated by the *Conseil National du Crédit* both indicate a dramatic extension of disintermediation during the period 1982-1986, that resumed dramatically in the 1990s after having been somewhat interrupted by the October 1987 stock market crash. The banks' views on monetary integration are therefore increasingly independent of those held by companies.

Table 6: Intermediation Ratios, 1983-93

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Demand approach*	0.66	0.58	0.57	0.34	0.55	0.63	0.54	0.59	0.46	0.18	0.02
Supply approach**	0.76	0.74	0.74	0.58	0.68	0.73	0.65	0.66	0.63	0.53	0.51

* Ratio defined as net bank credit to non-financial agents (households, firms) over the overall net financing of non-financial agents (annual flows).
** Ratio defined as net bank financing to non-financial agents (through various channels: credit, the purchase of securities, etc.) over the overall net financing of non-financial agents (annual flows).
Source: Banque de France.

Against this background, French banks have, in the recent period, underlined the micro-economic costs generated by the transition to a single currency in Europe. These costs depend on the *modus operandi* of the transition, for which several proposals have been put forward[35], and they vary depending on a bank’s involvement in cross-country transactions. The costs are various, since they include the adjustment costs of computer software, those arising from the transformation of payment and accounting systems, etc. In early 1995, several large commercial banks estimated their bill, without taking into consideration the externalities and the collective benefits of a single currency in the medium and long term. The figure which was released is around FF1bn per large bank (but FF2.4 billion for *Société Générale*). This is certainly an overestimation of individual costs. It is also clear that, in case transition costs would be abnormally high for individual banks or the banking system as a whole, a part of them will have to be collectivised one way or another.

The interest of the current discussion is nevertheless to highlight potential winners and losers in the transition to EMU and to show that the distribution of transition costs will depend on the transition strategy. Since a rapid introduction of ecu banknotes is technically not feasible, and since the main political cost arising from the transition to a single currency will certainly be that of introducing the ecu at the retail level, governments may be tempted to delay it. In this case, the costs of maintaining a dual currency system would accrue to the banks. A possible strategy for the introduction of the ecu at the retail level might even be to leave it in the hands of the banks. Since they would collectively profit from the elimination of the national currencies, there would be an incentive for the banking system to price their services differently for ecu and national currency operations. However, the adoption of

35 See especially the Green paper published by the EC Commission in June 1995, and also the report of the Maas group (Maas, 1995).

such a strategy would significantly affect the expected gains from EMU for the banks, and it might affect their attitudes. This again illustrates the instability of constituencies for or against EMU.

3.6. Conclusions about the private sector

Summing up, there is no evidence of strong private sector preferences in favour of or against EMU. Households appear to be essentially divided on the issue between the "losers" and the "winners", a division that is deeply disturbing both for the political parties and for a country as a whole. Companies are much more favourable to European integration than in the past, but they seem to be more agnostic on EMU. There are no stable constituencies for or against EMU in the business sector, and it is likely that its attitude will be shaped by perceptions of the immediate macro effects of monetary integration. Finally, banks are probably more favourable to monetary integration, although they are also concerned by the possible costs of introducing the single currency. How they will line up in the discussions on EMU will depend on the kind of scenario that will be adopted for the introduction of the single currency.

CONCLUSION

For a long time, the French attitude vis-à-vis European economic and monetary integration has been driven by the political and technocratic elites' view of the country's long-term interests. The French leaders' commitment to the goal of European integration has been an extremely powerful force that has contributed to trigger major changes in the economy, both at the macro and at the micro levels. These changes towards disinflation and liberalization have been undertaken and accepted by the private agents in the name of European integration. In short, Europe has been, at least for the last fifteen years, a driving force of modernization and economic reform.

This dominance of an external political and economic agenda was made possible by a number of factors. Some, like the president's role in shaping foreign policy, are institutional. But the dynamics of French integration in Europe was also made sustainable because its own successes gave rise to the buiding of constituencies: companies' initial reluctance gave way to support as their involvement in cross-border goods and asset transactions increased, and disinflation was supported because under a fixed exchange rate regime, it was delivering competitiveness. Opposition to the process existed, because they were losers along the way, but it was divided and unable to find political expression.

The Treaty of Maastricht was conceived as the coronation of this process, as the achievement of a goal already implicit in the creation of the EMS. It was a clear expression of the strategy of reform through Europe and the changes it introduced, especially the independence of the central bank, which were of a quasi-constitutional nature. By the time it had to pass the test of a popular vote, however, the balance of costs and benefits from participating in a fixed exchange rate regime had deteriorated sharply as a consequence of the recession and of German unification. Opponents to the Treaty were able to build on the frustration accumulated among the losers in the European integration process to form a coalition that attracted almost 50% of the votes. This event demonstrated that French society was deeply divided and generally much more reluctant about European integration than had been anticipated.

Maastricht could have been expected to trigger a realignment in French politics. It did not. Analysis of the debates and the preferences of the private sector help to understand why: divisions on European matters between the losers and the winners in the integration process are widespread and run deep in each party or each category of economic agents. Furthermore, opponents to the European strategy have made a case against the economic consequences of the ERM, but they have had difficulties in designing an alternative strategy of modernization and internationalization. Continuity in policy has therefore prevailed.

But the *malaise* has not vanished. Instead of a realignment, the debate over Europe that emerged in the early 1990s gave rise to the perception of a conflict of priorities between domestic concerns and European objectives. Since the 1992 referendum, and in spite of the economic recovery, this conflict of priorities has been haunting French politics. How to solve it is probably the single most important issue that the Chirac administration has to address.

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