6 Snakes and Ladders

Navigating European Monetary Union

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6.1 Introduction

On 1 January 2002, the citizens of the Eurozone forsook 'the coins for Cortez' men looking out on to Darien; the money of Mozart for his music and Molière for his manuscripts; of Tiberius for his treasure and Krupp for his cannon' (Marsh 2009: 206). European statesmen had long contemplated monetary union, unafraid to evoke the memory of Charlemagne to soothe deep-seated national hostilities.[1] But while the major European currencies had been pegged for most of the previous century, the Euro was a different proposition.[2] Why, three years after locking their exchange rates, did the 315 million citizens of nations as geographically and culturally distinct as Finland, Greece and Luxembourg awake to find themselves using the same notes and coin? The Eurozone is not an Optimal Currency Area – labour is insufficiently mobile, the region absorbs economic shocks asymmetrically and fiscal policy is not harmonised.[3] As Martin Feldstein predicted in 1997, the costs of European monetary union (lower growth and higher unemployment) have outweighed the gains from increased trade and the creation of an independent European Central Bank (Feldstein 1997).

This chapter explains the genesis of the Euro within the strategic concerns of the two principal players, France and Germany. Others were involved, but with these two countries comprising more than half

[1] Speech by President François Mitterrand at Aachen City Hall, 20 October 1987, quoted in Dyson and Featherstone 1999: 73.

[2] For the Latin Monetary Union formed by France, Switzerland, Italy and Belgium in 1865, see Redish 1993: 68–85. For the Scandinavian Currency Union formed by Sweden and Denmark in 1873 (and joined formally by Norway in 1875), see Bergman, Gerlach and Jonung 1993: 507–17.

[3] Frankel and Rose argued in 1998 that the Eurozone might *become* an Optimal Currency Area following the establishment of the monetary union (Frankel and Rose 1998: 1009–25).

the Eurozone's economic output, Franco-German policy was paramount. As Charles de Gaulle pointed out in the early 1960s, 'l'Europe, c'est la France et l'Allemagne. Les autres, c'est les légumes' (quoted in Giesbert 1993: 280). It stresses the importance of monetary union to the wider project of European political union, driven by the German post-war policy of 'exaggerated multilateralism' – regaining national sovereignty through international integration – and by the French desire, particularly after the 1956 Suez debacle, to project diminished power on the global stage.[4] The economics of European monetary union have never completely added up.[5] But the political and geopolitical arguments have always made a great deal of sense. Indeed, it is only when we peer through the lens of the Cold War that the picture comes into focus. As befits a process that was shaped by the intrigues of international diplomacy, the journey towards the Euro resembles a game of 'snakes and ladders' – the snakes lying in wait for whenever monetary storms exposed the economic contradictions of European monetary union; the ladders hoisted to facilitate ever-closer Franco-German cooperation within the ebb and flow of the Cold War.

6.2 Square One: The Early Moves

An aversion to floating exchange rates has permeated post-war European economic policy. At Bretton Woods in 1944, the European delegates scarcely needed the US Secretary of the Treasury to remind them that

[4] The goal of a reunified Germany 'integrated in the European community' was enshrined in the 1955 Paris Treaties that ended the Allied occupation of West Germany. In November 1978, Chancellor Schmidt commented to the Bundesbank central council: 'The more successful we are in the areas of foreign policy, socioeconomic matters, and military matters, the longer it will be until Auschwitz sinks into history . . . it is all the more necessary for us to clothe ourselves in this European mantle', quoted in Mourlon-Druol 2012: 240; Dyson and Featherstone 1999: 308; Anderson 1997: 80–107.

[5] Harold James points out that monetary union was 'a response to genuine (and still existing) problems of currency instability and misalignment at the international level' and 'not simply . . . a fundamentally political project'. This chapter agrees with James's analysis, while stressing that political and geopolitical concerns provided critical momentum at the key junctures (James 2012).

All of us have seen the great economic tragedy of our time. We saw the worldwide depression of the 1930s. We saw currency disorders develop and spread from land to land, destroying the basis for international trade and international investment and even international faith. In their wake, we saw unemployment and wretchedness – idle tools, wasted wealth. We saw their victims fall prey, in places, to demagogues and dictators. We saw bewilderment and bitterness become the breeders of fascism and, finally, of war. (United Nations Monetary and Financial Conference 1948: 81)

After nearly six years of war, and with international monetary relations fixed by the Bretton Woods agreements, military considerations remained uppermost. Launching the European Coal and Steel Community in May 1950, French Foreign Minister Robert Schuman explained that binding the two industries most necessary for war at the supranational level 'will make it plain that any war between France and Germany becomes not only unthinkable, but materially impossible' (The Schuman Declaration, quoted in Szász 1999: 1). This was especially important given the need for German rearmament to counter the threat of Soviet expansion. Hence French Prime Minister René Pleven's proposal for a European Defence Community, agreed with West German Chancellor Konrad Adenauer, but voted down by nationalists in the French parliament in August 1954.

Military considerations also breathed life into the proposals for economic integration considered by the foreign ministers of the European Coal and Steel Community at Messina in June 1955. In November 1956, American pressure forced the French and British to withdraw their troops from the Suez Canal, nationalised by President Nasser four months earlier.[6] It was clear that France and Britain no longer enjoyed great power autonomy. As Adenauer remarked to the French foreign minister on the day the decision was taken to withdraw,

France and England will never be powers comparable to the United States and the Soviet Union. Nor Germany, either. There remains to them only one way of playing a decisive role in the world; that is to unite to make Europe. England is not ripe for it but the affair of Suez will help to prepare her spirits for it. We have no time to waste: Europe will be your revenge. (Quoted in Feldstein 1997: 27)

[6] The Americans were upset at both the lack of consultation and the impact the Anglo-French action would have on their attempts to draw Egypt into an anti-Soviet alliance.

'Unripe' England chose ever-closer ties to the American superpower. France turned to her neighbours, building on the foundations of the European Coal and Steel Community to establish the European Economic Community (EEC) with the 1957 Treaty of Rome, and signing the bilateral 1963 Elysée Treaty which pledged friendship and collaboration with West Germany on foreign policy, cultural and youth affairs.[7]

The Treaty of Rome established a Monetary Committee, charged with promoting 'the co-ordination of the policies of Member States in monetary matters to the full extent necessary for the functioning of the Common Market'.[8] With the major European currencies pegged to the dollar and linked to gold under the Bretton Woods arrangements, there appeared to be little need for elaboration.[9] As Harold James points out, 'so long as capital markets were not connected with each other and exchange rate policies were not problematical, the case for greater monetary cooperation was pretty weak' (James 2012: 44). The Treaty of Rome was primarily concerned with trade – what Jacques Delors would later call the 'marriage contract' (Cockfield 1994: 133–34). France would open its markets to West German goods and the Germans would subsidise French agriculture through the Common Agricultural Policy (CAP), regarded by the French as their major achievement at the Rome summit. The CAP sought to stabilise food prices throughout the EEC. An appreciating D-mark (revalued by 4.75 per cent in March 1961) threatened to undermine that stability by increasing German purchasing power. This would generate food price inflation in France as her farmers exported more of their produce. As a consequence, the European Commission recommended in

[7] Adenauer regarded the Elysée Treaty as both 'a political dam against the advance of Eastern Communism' and 'an alternative to American hegemony' (Dyson and Featherstone 1999: 272).

[8] Member states were also enjoined 'to maintain confidence' in their currencies, *Treaty Establishing the European Economic Community*, 25 March 1957, articles 104, 105 and 107 (European Economic Community 1962). Fluctuation margins between European currencies versus the dollar were narrowed from 1 per cent to 0.75 per cent with convertibility in 1958.

[9] The Treaty of Rome's articles on exchange rate policy echo the IMF's Articles of Agreement. Kaplan and Schleiminger note that the Europeans were 'careful not to tread on the toes of the IMF about exchange rates'. Indeed, in 1961 the D-mark and Dutch guilder were revalued by 4.75 per cent with very little consultation in Europe, but a great deal of consultation in Washington (James 2012: 45; Kaplan and Scheiminger 1989: 219).

October 1962 that members' exchange rates be irrevocably fixed.[10] This proposal gained little traction, partly because the Bretton Woods system was still functioning, but also because of the divide between the 'monetarists', who believed that monetary union could *drive* economic and political union, and the 'economists' who believed that monetary union should *crown* economic union.[11]

This was the fault line that ran through the European monetary debate. Should monetary union be the instrument or the goal of economic and political union? There was little theoretical support for the notion that monetary union would drive economic convergence. There was even less practical support from the 'strong currency' nations, principally West Germany and Holland, for whom monetary union would mean a greater share of the cost of defending the fixed parities. At Bretton Woods, Keynes had lost the argument with the Americans over a more equal response to current account imbalances. Surplus nations could continue accumulating currency reserves while deficit nations were invariably forced to deflate. Monetary union implied a pooling of reserves, or at least a greater symmetry of policy adjustment. But as the Dutch central banker Marius Holtrop pointed out, why should the thrifty ant share its resources with the profligate cricket? (Szász 1999: 13).

By the late 1960s the cracks in the Bretton Woods system, magnified by Robert Triffin in 1959, had become fissures as the United States pursued its policy of guns (in Vietnam) and butter (the Great Society) without raising taxes sufficient to pay for either.[12] The resulting balance of payments deficits would have forced devaluation and/or deflation on any other country. But the Americans did not have to defend the dollar against other currencies; they had to convert dollars into

[10] The European Commission's October 1962 'Action Plan' also set in train the process that produced the Committee of Central Bank Governors which met from July 1964. In January 1965, European Commissioner Robert Marjolin referred to monetary union as an 'inevitable obligation' (Szász 1999: 8).

[11] The term 'monetarist' here must not be confused with the monetary theory that emanated from the University of Chicago and was briefly in vogue in the early 1980s.

[12] In 1959 Triffin explained to the Joint Economic Committee of the US Congress that global economic growth required the United States to supply dollar reserves through continued balance-of-payments deficits, and that these continued deficits would themselves undermine confidence in the dollar (Triffin 1960: 1–20).

gold at $35 per ounce. For President de Gaulle, irritated at the 'exorbitant privilege' that allowed the issuer of the world's reserve currency to run 'deficit[s] without tears', requests to convert French dollar reserves into gold were intended to discipline American policy (Chivvis 2006: 708). If the Europeans had presented a united front, this might have worked. But strategic considerations continued to drive international monetary policy. With West Germany reliant on American military resources, particularly in West Berlin, Bundesbank President Karl Blessing assured Federal Reserve Chairman William McChesney Martin in March 1967 that the Germans would not join the French in demanding American gold for their dollar reserves (Marsh 2009: 44).

French attacks on the dollar's privileged position included a series of 'unhelpful' interventions on sterling, the first line of defence for the Bretton Woods system.[13] These contributed to the 14.3 per cent devaluation announced by the British government in November 1967. But with sterling no longer overvalued and the dollar protected by the de facto American refusal to convert central bank reserves into gold, speculators turned their attention to the franc as the French government struggled to cope with higher production costs and *les événements de mai 1968*. The outcome was an ill-tempered 'Group of Ten' summit at Bonn in November 1968.[14] Despite Chancellorial and Bundesbank support for a D-Mark revaluation, West German Economics Minister Karl Schiller refused. He feared for the nascent economic recovery and implemented a package of fiscal measures to lower import prices and raise export prices instead. If the Germans would not revalue the D-Mark, then de Gaulle would not devalue the franc.[15] But with the General out of office after April 1969, the European Commission could proceed with its strategy of

[13] In July 1967, French foreign minister Maurice Couve de Murville 'acquainted the press' with his view that British membership of the EEC would first require a sterling devaluation (Callaghan 1987: 196).

[14] UK Chancellor Roy Jenkins advised Prime Minister Harold Wilson that 'German obstinacy, and Schiller's tactics and personality, have made it an extremely trying experience for all of us' (Owen 1976).

[15] French Finance Minister François-Xavier Ortoli discussed a 10 per cent franc devaluation in November 1968 but was overruled by de Gaulle. The franc was eventually devalued by 12.5 per cent in August 1969, and the D-Mark revalued by 8.5 per cent in October 1969 (Szász 1999: 24–25).

'widening' (admitting Britain, Denmark and Ireland) and 'deepening' (closer economic and monetary union).[16]

'Deepening' gathered momentum with the incoming West German Chancellor Willy Brandt's desire to build a 'western flank' for his *Ostpolitik* – establishing relations with East Germany, and 'normalising' relations with the Soviet Union, towards the ultimate goal of German reunification (Dyson and Featherstone 1999: 272). Despite possessing 'neither expertise nor enthusiasm for monetary issues', Brandt latched on to the European Commissioner for Economic and Financial Affairs' proposals for economic and monetary union (the 'Barre Plan') launched in February 1969.[17] This was part of Brandt's grand strategy of *Westbindung*, embedding West Germany within the EEC and NATO to assuage Western fears of a reunited Germany while strengthening his negotiating hand with the Soviet Union. All this to avoid the nightmare of German isolation – ending up on the wrong side of the balance of power equation that had proved so disastrous between 1914 and 1945.[18] As Brandt later explained, he was interested in European monetary union primarily for the free hand it gave him in the East (Szász 1999: 29). So while French Finance Minister Valery Giscard d'Estaing could promote monetary union at the meeting of heads of state and government at The Hague in December 1969 in pursuit of greater symmetry against the dollar, Brandt was laying down a path to German reunification.

6.3 The Werner Report and the European Currency 'Snake'

As a consequence of Brandt and Giscard's initiative, the heads of state and government commissioned a report from a committee chaired by

[16] Britain, Ireland and Denmark acceded to the EEC on 1 January 1973. Norway decided not to join after a referendum voted against it in September 1972.

[17] The 'Barre Plan' was a watered-down version of European Commissioner for Economic and Financial Affairs Raymond Barre's February 1968 'Monetary Plan of Action' which had called for the elimination of fluctuation margins between member currencies, a system of mutual financial assistance, adjustment only after mutual consent and the introduction of a single European unit of account.

[18] Pompidou noted that by signing the 'Eastern Treaties' in September 1970, a resurgent West Germany was acting 'without asking for permission', as it had done two years earlier at the Bonn summit in the monetary field. Pompidou's efforts to 'rebalance' the EEC help to explain his support for British membership (Szász 1999: 28).

the Prime Minister of Luxembourg, Pierre Werner, 'to identify the basic issues for a realization by stages of economic and monetary union' ('Werner Report' 1970: 35). The Werner Report was published in October 1970 and adopted in diluted form by the heads of state and government in March 1971. It recommended economic and monetary union to be achieved in three stages. Economic union would mean that 'the principal decisions of economic policy will be taken at Community level and therefore that the necessary powers be transferred from the national plane to the Community plane' ('Werner Report' 1970: 26). Monetary union would require 'an area with a single currency and a centralised monetary policy', albeit the report made clear that this 'may be accompanied by the maintenance of national monetary symbols' ('Werner Report 1970: 10). But monetary union was just a staging post – a 'leaven for the development of political union which in the long run it will be unable to do without' ('Werner Report' 1970: 26).

Stage One would run for three years from 1 January 1971 and involve a narrowing of the fluctuation margins between member currencies. By 30 June 1972 there would be an outline for a European Monetary Cooperation Fund (a 'potential Federal Reserve System for Europe') to finance currency intervention.[19] Stage Two was to involve financial market integration, the abolition of capital controls, the further narrowing of currency fluctuation margins and increased short-term economic coordination. During Stage Three exchange rates would be 'irrevocably' fixed, there would be full economic convergence and the institution of a Community-level system of central banks.[20]

Stage One was delayed by the onset of Bretton Woods' dying convulsions, themselves brought on by Richard Nixon's attempts to boost domestic growth ahead of the 1972 US presidential election. Lower interest rates generated an outflow of capital from the United States that saw the Bundesbank take in the equivalent of 1 per cent of West German GDP over the foreign exchanges in just 40 minutes of trading on 5 May 1971 (Owen 1976). Four days later, having closed the foreign exchange markets and failed to coordinate a joint float of

[19] The proposed Fund would technically be under the European Commission's control (James 2012: 63).

[20] The Werner Report was approved, slightly watered down, by a resolution of the Council and the Representatives of the Governments of the Member States on 22 March 1972. This was the first formal adoption of a plan to deepen monetary, financial and fiscal integration.

Community currencies against the dollar, the Germans floated the D-Mark.[21] On 15 August, fearing for US gold reserves, Nixon ended the convertibility of the dollar into gold at $35 per ounce. As André Szász points out, a floating dollar made European currency coordination both more necessary and more difficult (Szász 1999: 38). More necessary, since each country's competitive position would be affected by wider currency fluctuations; more difficult because policy differences would be reflected in very visible currency moves rather than opaque central bank reserve statistics.

Stage One finally began with the birth of the European currency 'snake' in April 1972. Fluctuations between member currencies were limited to 4.5 per cent (versus a potential 9 per cent agreed at the Smithsonian realignment of the broader Bretton Woods currencies in December 1971), with the burden of adjustment resting on the weak rather than the strong.[22] Although nurtured by the European Commission, the snake assumed a somewhat 'non-EEC' character from the outset. The parity grids were administered at the Bank for International Settlements in Switzerland, that is, at an institution outside the EEC.[23] Members included the United Kingdom and Ireland (briefly, and before their accession to the EEC in January 1973), Denmark and Sweden (before Denmark joined the EEC in January 1973 and more than two decades before Sweden joined in 1995) and Norway (which has never joined the EC). Switzerland also considered joining in 1975, only to be rebuffed by France which feared the consequent 'hardening' of the snake.[24] Of the founder members of the EEC, France left in January 1974, rejoined in July 1975 and left definitively in March 1976 after expending at least $4 billion of reserves in a failed

[21] The Dutch guilder floated alongside the D-Mark.

[22] The Smithsonian agreement permitted individual currencies to fluctuate by 2.25 per cent either side of a central rate against the dollar, i.e. by 4.5 per cent. If one currency fell from the top of its 4.5 per cent range to the bottom at the same time as another currency rose from the bottom of its range to the top, then these currencies would move by 9 per cent against each other. Graphically, the group of European currencies moving together within the broader band resembled a 'snake in a tunnel'.

[23] The 'director' of the European Monetary Cooperation Fund was a BIS staff member (James 2012: 14).

[24] Switzerland, along with Austria and Spain, maintained a de facto relationship with the snake while outside the EEC (Mourlon-Druol 2012: 23; Szász 1999: 40).

defence of the franc.[25] Italy left in February 1973. By 1977, with a membership of Germany, Holland, Belgium, Luxembourg and Denmark, the 'mini-snake' increasingly resembled the asymmetric D-Mark zone that France and the European Commission had sought to avoid. It certainly did little to protect the French economy from either D-Mark strength or dollar weakness.

6.4 The European Monetary System

In 1977, with France outside the snake and progress on closer European integration stalled, 'Euro-sclerosis' had set in. Notwithstanding European Commission President Roy Jenkins's efforts to exhort European union through 'monetary proselytising', it would take another geopolitical spur to quicken monetary integration.[26] The initiative came from Willy Brandt's successor Helmut Schmidt's frustration with the waywardness of President Carter's economic and foreign policy. Schmidt regarded the US President as 'a dangerous nitwit' with 'no notion of strategy' (Szász, quoted in Marsh 2009: 78; Schmidt, quoted in Szász 1999: 52). Carter's expansionary economic policies stimulated renewed capital flight, lowering the dollar against the D-Mark and threatening both the Bundesbank's successful battle against inflation and the competitiveness of German exports. Carter's unpredictably on defence further convinced Schmidt of the importance of the Franco-German alliance.[27] As with Brandt's *Ostpolitik* a decade earlier, a strategic challenge generated a monetary response. Germany could insulate herself against American unpredictability on defence by sharing French military capability; France could insulate herself against American unpredictability on economic policy by sharing German monetary credibility.[28]

[25] The French were annoyed at the British for allowing sterling to fall below $2 for the first time on 5 March 1976 (Needham 2014: 97).

[26] Jenkins used the first Jean Monnet Lecture in October 1977 to argue for monetary union as a catalyst for political union (Mourlon-Druol 2012: 139; Jenkins 1991: 474).

[27] In April 1978, President Carter abandoned the neutron bomb without consulting his European allies. As Mourlon-Druol points out, Schmidt's monetary initiative preceded Carter's announcement by at least two months. But having convinced his government 'with difficulty' that American neutron bombs should be deployed on German soil, the episode reinforced Schmidt's frustration with the Carter administration (Mourlon-Druol 2012: 185; James 2012: 153).

[28] The prospect of further EEC enlargement provided a third catalyst.

France had left the snake because depleted foreign exchange reserves were insufficient to protect the franc from higher French inflation. To satisfy *amour propre*, any new monetary arrangement she might join had at least to appear more symmetrical.[29] In 1978, Schmidt and Giscard, in concert with Jenkins, oversaw the design of an Exchange Rate Mechanism (ERM) which included a 'divergence indicator' based on the European Currency Unit (ECU) comprised of a weighted average of member currencies.[30] The intention was that the D-Mark (most likely) could approach at its upper intervention point without any other currency necessarily approaching its lower intervention point. This would, in theory, make the ERM more symmetrical than the snake, since intervention on behalf of the weaker currencies would be less frequent. Also, if the D-Mark approached its upper intervention point, the Bundesbank could sell D-Marks and buy dollars (rather than the weaker European currencies), push down the ECU, and thus improve the competitiveness of *all* member currencies against the dollar. But shifting more of the burden of adjustment on to the Bundesbank could mean increased creation of D-Marks to buy dollars. This might threaten published targets for the growth of the domestic money supply. On 30 November 1978, Schmidt agreed with Bundesbank President Otmar Emminger that West German money supply targets would take precedence over the creation of D-Marks to buy foreign currency within the ERM, an agreement made public in March 1979 (Marsh 2009: 83–85). This was an immediate breach of the new 'rules of the game'. Coupled with the shelving of plans for a European Monetary Fund (empowered to issue conditional loans drawn from pooled member resources) in favour of modestly increased responsibilities for the European Monetary Cooperation Fund, it produced little more than a snake with a new skin. This 'new' system certainly worked to West Germany's advantage. As Finance Ministry Secretary of State Manfred Lahnstein explained to British Chancellor Denis

[29] Giscard had staked his prestige when announcing in May 1975 that the franc would rejoin the snake; ejection in 1976 was a personal defeat. Schmidt described the EMS as 'swimming trunks, make-up, since the French are entering for the third time into a European monetary alliance that they have already left twice', quoted in Mourlon-Druol 2012: 238.

[30] The ad hoc committee appointed to flesh out Schmidt's proposals was Franco-German-British, comprising Bernard Clappier (Governor of the Banque de France), Horst Schulman (Schmidt's senior economic adviser) and Kenneth Couzens (Second Permanent Secretary at HM Treasury).

Healey just before launch, 'the key principle of German economic policy was to persuade the French and Italians to pay to lower the value of the D-Mark so as to make Germany more competitive' (Healey, quoted in Marsh 2009: 80; Healey 1989: 438–39). This aim was shared at the highest level with Schmidt telling Prime Minister James Callaghan that 'one effect' of his monetary plan 'would certainly be to weaken the German mark' (quoted in Mourlon-Druol 2012: 165).

The ERM commenced operation in March 1979. Its first four years coincided with the second oil shock, a global economic downturn and, perhaps equally significantly, a defining moment in the presidency of François Mitterrand. Elected in May 1981 and faced with rising unemployment, Mitterrand had initially boosted demand, nationalised the banks and several large companies, lowered working hours and the retirement age and increased welfare benefits. This produced two franc devaluations within a year.[31] But in 1982, facing a large current account deficit and a possible approach to the IMF, Mitterrand began executing an economic U-turn (Dyson and Featherstone 1999: 142). Having declared that the budget deficit would be limited to 3 per cent of GDP, he announced in March 1983 that his government would embark upon a policy of economic *rigueur*, partly in order that the franc could remain in the ERM, albeit after a further devaluation.[32] David Marsh identifies this decision, taken with the advice of Finance Minister and future European Commissioner Jacques Delors, as 'a turning point in the chronicle of European money' (Marsh 2009: 100). It was made in consultation with Bonn, which agreed to share the cost of the currency adjustment by revaluing the D-Mark by 5.5 per cent versus a franc devaluation of just 2.5 per cent. This came shortly after Mitterrand marked the twentieth anniversary of the Elysée Treaty by supporting recently elected Chancellor Helmut Kohl's decision to allow nuclear missiles on West German soil (Marsh 2009: 97–99). Once again, strategic considerations were shortening the path to monetary union.

31 There were also two D-Mark revaluations, three Dutch guilder revaluations, four Italian lira devaluations, three Danish krone devaluations (and one revaluation), one Belgian franc devaluation (and one revaluation), and an Irish punt devaluation (Padoa-Schioppa 2000: 223).

32 A budget deficit limit of 3 per cent of GDP would later form part of the Euro convergence criteria.

Economic *rigueur* and remaining in the ERM meant aligning the French economy more closely with West Germany rather than continuing with expansionary policies behind the capital controls that had remained in place since 1968 (in breach of France's treaty obligations). The *franc stable* would remain pegged to the D-Mark in the ERM until 1986. Without Mitterrand's *tournant*, it is likely that the ERM would have reverted to being a D-Mark hard currency zone *sans* the franc.

6.5 The Single European Market and the 'Trilemma'

Mitterrand's 1983 *tournant* was a defining moment. It may not have been *the* defining moment. A claim may also be made for Jacques Delors' presiding over the creation of the Single European Market as President of the European Commission from January 1985.[33] In this he was aided by Margaret Thatcher's former treasury minister, Lord Cockfield, appointed European Commissioner for Internal Market, Tax Law and Customs in 1985. Cockfield was the principal architect of the Single European Act which, crucially for monetary union, provided for the free movement of capital throughout the EEC after July 1990. This cut through the arguments of the 'economists' – that monetary union must *follow* economic convergence. Once capital controls were removed, member states were subject to the remorseless logic of the 'trilemma'; in the absence of a large stock of foreign exchange reserves, a country may only fix its currency if it accepts the monetary policy of the most powerful economy, in this case West Germany. Without capital controls and a large stock of reserves, countries wishing to exercise monetary policy autonomy must allow their currencies to float.[34] Unregulated capital flows undermine most attempts to run an independent monetary policy alongside a fixed exchange rate. Having chosen to stay in the ERM in 1983, the French were agreeing to closer monetary union by signing the Single European Act. As Harold James points out, '[I]n 1985, Delors had reached the conclusion that free capital movement was essential to the realization of the 1992 program, and that it was equally apparent that

[33] The Single European Act was the first revision to the 1957 Treaty of Rome.

[34] The 'trilemma' may be extended to the 'inconsistent quartet' with the addition of a free trade objective. We can take the free trade aspiration of the Single European Market as a given.

the free circulation of capital would require a new approach to monetary policy' (James 2012: 213).

Why did France agree to the free movement of capital? Part of the answer lies in the French Treasury's long-standing efforts to modernise French industry by exposing it to international competition. This process gained momentum after Mitterrand's 1983 *tournant* with the deregulation of French capital markets, a process that was taking place across Europe.[35] Free movement of capital requires the freedom for banks to operate across borders, which itself implies some harmonisation of monetary policy. But there was another, older reason for the Single European Act to contain a monetary dimension. The *Financial Times* explained that Jacques Delors' call for the ECU to become a reserve currency grew out of the traditional French view that 'the burden placed on the dollar is too great: a Community currency would enable central banks to diversify their resources' (Cheeseright 1985). A single European currency would help to 'persuade the US to introduce the internal discipline which would make for relative stability on the foreign exchanges' (Cheeseright 1985). The former French Finance Minister was using the same argument that de Gaulle, Pompidou and Giscard had used in the 1960s and 1970s. The Americans, who had allowed the dollar to rise from less than four francs in 1980 to more than ten francs in 1985, must be subjected to the same discipline as everyone else. This would not happen while they enjoyed a virtual monopoly on issuing the world's currency reserves.

If France was once again in the position of *demandeur* of closer monetary union, why did the Germans agree? After all, viewed from Bonn, the ERM was working rather well. As Dorothee Heisenberg points out,

> German businesses were in the internationally unique position of having their cake and eating it too – with the Bundesbank setting interest rates according to the exigencies of the German economy and the EMS limiting exchange rate fluctuations with their trading partners. The cost of occasional revaluations of the DM under the EMS regime was far less than the potential costs of monetary union with France, let alone Italy or Spain. (Heisenberg 2005: 97)

Opening up other member states' markets to German capital to drive convergence was a long-standing aim of the ordo-liberals in the

[35] West Germany removed its capital controls in 1974. The United Kingdom dismantled its controls between 1977 and 1979.

Bundesbank and the German Finance Ministry. If capital outflows could hold the D-Mark down and maintain the competitiveness of German industry at the same time, then so much the better. But this did not require monetary union, even less a single currency. As late as 1988, the Bundesbank was arguing that 'the EMS in its present form would . . . provide sound underlying conditions for the internal market to function smoothly' (quoted in Chang 2003: 228). Szász explains that 'the Germans had their own misgivings about a monetary dimension in the Treaty, but once it was clear that some countries made this a condition for accepting the completion of the internal market, it was obvious to Chancellor Kohl that he had to find a compromise' (Szász 1999: 93–94).

There was another reason why monetary union gained traction after 1985. The election of Mikhail Gorbachev as General Secretary of the Communist Party of the Soviet Union offered the prospect of a new *Ostpolitik*, and the ultimate prize of German reunification. But to secure support for reunification, Kohl needed to show renewed commitment to the twin pillars of the Western alliance – NATO and the EEC.[36] This was especially important when in 1986 President Reagan offered to eliminate all ballistic nuclear missiles, without consulting his NATO allies, at the Reykjavík summit. Soviet entreaties and American unpredictability pushed the Germans closer to the French. In 1988, Mitterrand and Kohl marked the twenty-fifth anniversary of the Elysée Treaty by creating the Franco-German Defence Council. During the negotiations, Mitterrand adviser Jacques Attali made the link between defence and monetary policy explicit by suggesting 'so that we can have a balance, let us now talk about the German atom bomb' – the D-Mark (Marsh 2009: 114). This produced the Franco-German Economic and Finance Council, a largely consultative body that nonetheless marked a new stage in Franco-German monetary cooperation.

6.6 The Train Leaves the Station: Towards the Single Currency

Despite the promise of capital market liberalisation under the terms of the Single European Act and the linking of monetary policy to defence policy, two franc devaluations in quick succession following the

[36] Mitterrand conceded that he could not prevent German reunification, but he could affect its timing.

appointment of the expansionist Prime Minister Jacques Chirac in 1986 confirmed West German scepticism about the merits of closer monetary union. As Mitterrand's adviser Elisabeth Guigou warned in 1987, the EMS could be 'blown away on the next monetary storm' just as the Werner Plan had been fifteen years earlier. Certainly, Chirac did little to promote monetary harmony with his criticisms of the Bundesbank's 'egotistical' monetary policy and his specious claim that the January 1987 ERM realignment was 'a crisis of the D-Mark, not the French Franc' (Marsh 2009: 112). In reality, this 'rancorous' realignment was as much to do with the precipitous decline of the dollar that ended with the Louvre Accord signed by the Group of Seven nations in February 1987 (Marsh 2009: 102–03). This prompted Gaullist ministers to place EMS reform back on the agenda during 1987. If France were to accept the monetary policy of a hegemon, in accordance with the 'trilemma', better that the hegemon be a European Community institution operating under French influence than the Bundesbank or, worse, the US Federal Reserve.

A further step was taken with French Minister of Finance Édouard Balladur's January 1988 proposal for 'the construction in the longer term of a zone with a single currency' (Szász 1999: 102). This marked the culmination of a series of coordinated speeches in favour of monetary union by senior French politicians, which would likely have had as little impact as previous initiatives had they not coincided with the 'policy entrepreneurialism' of West German Foreign Minister Hans-Dietrich Genscher, as concerned as Willy Brandt had been to build a 'western flank' to his own *Ostpolitik*. To the chagrin of the Bundesbank and the Ministry of Finance, Genscher responded in February 1988 with his 'Memorandum for the creation of a European monetary space and a European Central Bank', which stressed the need for monetary union to accompany the completion of the single European market by 1992. Helmut Kohl followed this with a speech in which he stated that 'we shall only achieve the political unification of Europe if we also create a common currency for Europe', agreeing with Genscher that the Germans should use the opportunity presented by their six-month Presidency of the European Council in 1988 to provide a 'signal for the creation of a European monetary space and a European Central Bank' at the forthcoming Hanover summit (Szász 1999: 105–06).

Momentum gathered with Mitterrand's second presidential election victory in May 1988. Having defeated his Gaullist Prime Minister, Jacques Chirac, Mitterrand confirmed on the eve of the Hanover summit in June that France would finally meet her treaty obligations by removing capital controls (Marsh 2009: 118). He further agreed with Chancellor Kohl that the committee of EEC central bankers (and other independent figures) to be appointed on Genscher's initiative to enquire further into monetary union would be headed by the newly reappointed head of the European Commission, Jacques Delors.[37]

The Delors Committee produced its final report in April 1989. The significance lay less in its content than in the unanimity of the 'epistemic community' of central bankers and independent experts that authored it. This was achieved partly with the promise that the proposed European System of Central Banks Council would be committed to price stability and 'independent of instructions from national governments and Community authorities'.[38] A future European Central Bank would be modelled on the Bundesbank. But it was also because some of the signatories doubted that their recommendations would ever be implemented. Bank of England Governor Robin Leigh-Pemberton later admitted that 'most of us, when we signed the Report in May 1989, thought that we would not hear much about it. It would be rather like the Werner Report' (Blair 1999: 151).

As with the Werner Report, there would be three stages. The first, commencing on 1 July 1990, would entail 'a greater convergence of economic performance through the strengthening of economic and monetary policy coordination within the existing institutional framework' (Blair 1999: 30). There would be no new institutions, but capital flows would drive monetary convergence. Stage Two would involve the creation of the 'the basic organs and structure of the economic and monetary union' – a European Monetary Institute (to replace the European Monetary Cooperation Fund), and then a European Central Bank (Blair 1999: 33). This would require an amendment to the Treaty of Rome, and therefore an intergovernmental conference. Stage Three, the irrevocable fixing of currencies, would take place in January

[37] The import of having the EMU enthusiast heading the committee was not lost on the British Chancellor Nigel Lawson, who referred to Delors' appointment as a 'disaster' for his and Mrs Thatcher's attempts to undermine EMU (Lawson 1992: 903).

[38] This nuance perhaps escaped Margaret Thatcher, who was furious that both the Governor of the Bank of England and the President of the Bundesbank, who she had expected to veto the proposals, signed the report (Delors Report 1989: 22).

1999 at the latest. A single currency, while not essential for monetary union, would be 'a natural and desirable further development ... [and] clearly demonstrate the irreversibility of the move to monetary union' (Delors Report 1989: 15).

The EEC heads of government gathered in Madrid in June 1989 to adopt the Delors Report and agree to the intergovernmental conference without fixing a precise date. Once again, international relations opened up a shortcut. On 9 November 1989, the East German authorities opened the gates through the Berlin Wall. A week later, having delayed setting a date for the intergovernmental conference for electoral reasons, Helmut Kohl agreed that the conference should start before the end of 1990.[39] More than ever the West Germans needed a 'western flank' for reunification.[40] At the Dublin European Council in June 1990, the heads of government confirmed that the inter-governmental conferences on political and monetary union would commence on 14 December 1990 (Szász 1999: 131). Four months later at an extraordinary Council in Rome, they agreed that Stage Two would begin on 1 January 1994. The timetable for Stage Three was set at the Maastricht Council in December 1991, where the convergence criteria were also laid down. In order to proceed from Stage Two to Stage Three, a member state had to have:

1. inflation of no more than 1.5 percentage points above the average rate of the three EU member states with the lowest inflation over the previous year;
2. a national budget deficit at or below 3 per cent of GDP;
3. national public debt not exceeding 60 per cent of GDP[41];
4. long-term interest rates no more than two percentage points above the rate in the three EU countries with the lowest inflation over the previous year;
5. no currency devaluations within the previous two years.

Monetary union could commence in 1997 if the majority of member states had achieved the convergence criteria. Otherwise the start date would default to 1 January 1999.

[39] West German parliamentary elections were scheduled for December 1990.
[40] There is a suggestion that Kohl preferred to give up some of the Bundesbank's power, rather than his own, to secure German reunification.
[41] A country with a higher level of debt could still adopt the Euro provided its debt level was falling steadily.

In the interim, of course, were the monetary storms of 1992–93 that saw sterling withdraw from the ERM on 16 September 1992 ('Black Wednesday'), the Italian lira depart the next day, and the 'battle of the franc' commence with the *petit oui* in the French referendum on the Maastricht Treaty.[42] The battle ended, after the expenditure of much French reserves, with the widening of the ERM intervention bands from 0.75 per cent to 15 per cent in July 1993. Nonetheless, a victorious France emerged even more committed to EMU, little swayed by the sight of a low inflation, export-led recovery outside the ERM across the English Channel. As the French European Commissioner for monetary affairs commented in 1995, 'If the single currency does not arrive, the very existence of the single market would be threatened' (Marsh 2009: 184). The Bundesbank's Otmar Issing agreed: 'The decisive moment came with the currency crises of 1992–93 ... I and others came to the conclusion that the Common Market would not survive another crisis of this dimension' (Marsh 2009: 185). More to the point, an ERM collapse would have seen an appreciating D-Mark decreasing the competitiveness of German exports with negative consequences for both growth and unemployment. As Richard Portes points out, 'the only way to go was back to floating or capital controls, or forward to full monetary union ... [and] going back would endanger the very integrity of the Union' (Portes 2001).

Given that EMU was conceived partly to protect Europe from the vicissitudes of US economic policy, it is ironic that the project was given a fair wind by the 'Clinton boom' of the mid-1990s. A stronger US economy and an appreciating dollar boosted European growth which had dipped, partly as a consequence of German reunification, but also because of the deflationary measures taken by member states to meet the Maastricht criteria. This provided a contrast with the early years of both the snake and the ERM when US policy had been less conducive. But the key was the compromise brokered by Jacques Delors in 1989 over central bank independence. A European Central Bank free from political interference looks very different to the proposals that emerged from the Werner Committee in 1970 and the Bonn summit in 1978. Without an independent European Central Bank,

42 On 20 September 1992, a French referendum approved the Maastricht Treaty by 51 per cent to 49 per cent. For a lively account of the 'battle of the franc', see Marsh 2009: 162–75.

there would have been little German support for monetary union; without German support, there would be no monetary union. With this support, some judicious fudging of the convergence criteria, and a little creative fiscal accounting, the monetary aspirations of the founders of the European Economic Community, the drafters of the Werner Plan, the architects of the European Monetary System and the members of the Delors Committee were realised as eleven European nations devolved monetary policy to the European Central Bank in July 1998 and locked their currencies on 1 January 1999.[43]

6.7 Conclusions

This chapter has focused on the journey towards monetary union from the perspective of France and Germany. Why were (most) other member states keen to participate? For the periphery nations, membership offered the benefits of imported monetary discipline and a seat at the European 'high table'.[44] There is also Richard Baldwin's 'domino theory of regionalism' – 'an event that triggers closer integration within an existing bloc harms the profits of non-member exporters, thus stimulating them to boost their pro-membership political activity' (Baldwin 1993). This explains why Italians accepted the 'Europe tax' imposed to help to meet the Maastricht criteria. Italy was an enthusiastic founding member of the EEC, and has been prepared to accept some domestic deflation justified in terms of 'Euro-discipline'.[45] By contrast, as Nigel Lawson explained to Mrs Thatcher at the launch of the ERM in 1978 (just three years after the referendum on continued UK membership of the EEC), any such deflation would be 'political suicide' for a British government (Lawson 1978).[46] This was most apparent after Black Wednesday in 1992.

[43] In October 1996, three days before the convergence criteria forecast deadline, Eurostat approved an 'exceptional' transfer of 37.5 billion francs (0.45 per cent of GDP) of pension funds from France Telecom to the French government (European Commission and World Bank 1999: 93–94).

[44] The prospect of budgetary savings with lower interest rates was not lost on the periphery nations (James 2012: 257).

[45] There is also the suggestion that policymakers from Southern Europe supported monetary union because it would take power away from their national institutions which they felt were incapable of modernizing their own countries.

[46] Underlining in the original.

Dyson and Featherstone suggest that the French have been playing a 'three-level game' with monetary union. The French state could use monetary integration and the discipline of increasingly mobile capital to drive the modernisation of French industry. Also, EMU was a means of 'binding down' the German leviathan by 'Europeanizing' monetary policy. Finally, EMU was intended to protect the French economy, and especially the CAP, from the volatility that flowed from the US monetary hegemon. All three levels of this game pointed to monetary union preceding economic or political union. This put the French 'monetarists' at odds with German 'economists' who insisted that monetary union should 'crown' economic and political union.

As with any negotiation, the process involved compromise. The Germans have not yet reached the 'top square' on the snakes-and-ladders board – European political union.[47] But they have achieved German reunification, the free movement of capital and an independent ECB. The French have not achieved political control over European monetary policy. But they have reduced European dependence on the dollar and insulated their economy somewhat from the vagaries of US policy, the recent global financial crisis notwithstanding. In this light, the Germans appear to have done rather better, and this is borne out by the recent performance of the respective economies. Nonetheless, the French were starting from a weaker negotiating position, economically if not militarily. Indeed, the story told here is one of the French skilfully using the ebb and flow of the Cold War to persuade the Germans that monetary union could precede both economic and political union. To this extent, discussion of how far the Eurozone constitutes an Optimal Currency Area may be relevant for how policymakers deal with the manifest challenges thrown up by the Great Recession. It is less relevant to explaining how we got here.

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[47] German attempts to impose fiscal discipline on member states backfired when they breached the terms of their own 1997 Stability and Growth Pact.

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