The Banker's Comment

Quarterly Central Bank Watch

France/Germany: vice and virtue...or the opposite? A look back at the history of economic and monetary convergence – March 2019

Each quarter, Jean-Pierre Patat, Honorary Director-General of the Banque de France and a TAC ECONOMICS advisor, focuses on monetary policies and major central banks' behavior. The document also includes a brief statistical review and graphic illustration of central banks' policies. Email: jppatat@taceconomics.com

France/Germany: vice and virtue... or the opposite?

A seemingly promising relationship during the de Gaulle Republic

Inflation

Currency

The euro and misunderstanding

Suspicion

The French President's views regarding Europe's future, and the somewhat measured response of the new president of the German CDU party, illustrate, like an abscess that will not heal, several decades of latent divergences in economic, financial and monetary matters between the two countries. Divergences that remain fundamental, despite global disruptions that have occurred since the birth of the 6-nation Common Market in 1958.

A seemingly promising relationship during the de Gaulle Republic (1958–1968)

Accepting Common Market rules to shake up the French productive sector, stuck in protectionism, the General very quickly became obsessed with Germany. A Germany that he hoped to harness in the role of horse in a "Europe of six carriage" driven by France. Politically, it was about rendering the union sufficiently attractive to distance the Germans from their pro-American leanings. A difficult business, with the Germans so well aware of what they owed to the United States. This required that the French economy become equal to that of Germany with, in particular, a powerful industrial base and – this was capital – that France like Germany provide mastery of inflation, healthy finances and a stable currency. De Gaulle watched over this ferociously and the gamble seemed to pay off until 1968. However, with the monetary crisis in the autumn of that year, the Germans (Adenauer was no longer there) began to balk and, already, to display a superiority complex in the domain of the "fundamental balances".

Inflation: an absolute horror east of the Rhine, an indispensable stimulant to growth in the west.

All De Gaulle's successors, with awareness, tacitly, or even willingly, allowed inflation a free hand; some were convinced that impeding it too much would put the brake on growth. The oil shocks of 1973 and 1979 brought French price increases (until 1983) to levels close to, sometimes above, 10%; whereas in Germany the Bundesbank's careful policy kept levels at a 4% maximum. A divergence which is in the genes of the two nations. Germany, ageing, saving, and where the increasingly numerous elderly households do not go into debt, view inflation as a calamity. France, even if ageing is now starting to make itself felt, has been, since the end of the war, a relatively "young" country where at all levels – home, business and State – inflation was welcomed as something that wiped out the costs of a debt.

Has this difference of attitude disappeared or diminished with the disinflationary effects of globalised production of consumer goods, and since we have seen more moderate inflation over recent years? Not at all! Unlike the Germans, French leaders and economists have long persisted in sounding the alarm against an imagined risk of deflation. In a recent publication, one economist wrote that merely bringing inflation up to 5% would stimulate growth.

Currency sacred in Germany. In France, the active syndrome of the weak currency, concealed since the birth of the euro.

While de Gaulle had maintained the parity of the franc versus the deutschmark during his presidency (thanks mainly to the 1963 stabilisation plan) at 1DEM = 1.1750FRF, devaluations agreed or decided by his successors carried the value of the DEM against the FRF to 3.35 at the eve of the creation of the single currency. Devaluations that have not prevented an almost permanent deficit in external trade (except between 1993 and 1998). Devaluations seen not as defeats but as an outcome of the nature of things (the anti-Europeans now regret that with the euro one can no longer devalue), and which has contributed to confining our manufacturing industry in the middle range. It is quite the opposite in Germany, where the maintenance of a strong currency, an instrument of disinflation, verges on the religious and is well supported by the productive sector.

These divergences of approach and policy regarding inflation and currency stem in part from the status of the central banks. Until the euro, the Bank of France was not independent of government, unlike the Bundesbank, a royal gift from the occupation authorities in 1948.

The euro and the misunderstanding

Preparation of the exchange agreement that was the precursor of the monetary union, the European Monetary System (EMS), was marked by revealing conflicts. The French believed that the system could only function if the too-strong strengthening of one currency vis-a-vis others had as necessarily to be prevented and corrected as an excessive depreciation had to be. Why not? In practice, this was irrational. The "indicator of divergence" which was meant to respond to this preoccupation would not function.

Divergences of economic and monetary approach were also to show up during preparations for the passage to the single currency. Against the French who thought that the euro would create a salutary shock which would resolve all problems, the Germans opposed the so-called "crowning" approach. The economies had to "converge", notably in terms of price and the budgetary situation, before integrating into the monetary union. They gained satisfaction with the indicators of convergence and the Stability Pact, hated in France by a large part of the political class and economists.

The French still fail to realise the sacrifice agreed to by the Germans who allowed their cherished deutschmark, symbol of their regained prestige, to be merged with other more doubtful currencies (the reaction of the French at the suggestion that they exchange their seat at the UN's

Security Council in return for a European one shows they are not ready for a sacrifice of that sort). The French consider that their neighbours across the Rhine are the main beneficiaries of the sole currency because their industry no longer has to suffer from devaluations by partner countries.

Suspicion

For a long time, the Germans showed more enthusiasm than did the French for greater European integration. Since the "euro crisis" they have been far more circumspect. The crisis starkly revealed what they already suspected - a structural proclivity on the part of some countries to transgress the zone's rules of play. Add to this the craziest proposals, yet ones that are supported by some leaders, such as the issuing of "eurobonds", that helped convince the Germans that increased integration would translate in practice to them paying for the others. In this context, although France is not the most mismanaged country in the euro zone, its past renders President Macron's ambitions suspect. When he pleads for a euro zone budget and a more social Europe, the Germans hear budgetary disorder and mutualisation of the debt (even though this is not suggested by the President). And yet, whatever is said, the Franco-German "hinge" has never been so indispensable in a Europe attacked by centrifugal sirens, demagogies, economic fragilities and assaults from the globe's great powers.

"*Stay with us for the night is late*". The Good Samaritan.

Exhibit 1

Central Bank Economic Indicators Dashboard

US Federal Reserve Bank

	2007M12	2016M12	2018M10	2018M11	2018M12	2019M01	2019M02

Fed total Assets (bn. $)	879	4 446	4 175	4 146	4 084	4 050	3 981
Federal Funds target rate (%)	4.25	0.75	2.25	2.25	2.50	2.50	2.50
3-month treasury bill minus fed funds	-0.96	-0.25	0.04	0.07	-0.10	-0.14	-0.10
Excess reserves (bn. $)	9	1 925	1 706	1 649	1 568	1 508	1 520
Monetary Base (bn. $)	837	3 532	3 521	3 476	3 401	3 347	3 353

Source: Federal Reserve Bank

European Central Bank

	2007M12	2016M12	2018M10	2018M11	2018M12	2019M01	2019M02
ECB total Assets (bn. €)	1 297	3 566	4 628	4 638	4 668	4 706	4 703
Euro ST repo rate (%)	4.00	0.00	0.00	0.00	0.00	0.00	0.00
Euribor 3-month minus euro repo rate	0.85	-0.32	-0.32	-0.32	-0.31	-0.31	-0.31
Excess reserves (bn. €)	1	706	1 242	1 242	1 253	1 205	--
Base Money (bn. €)	842	2 366	3 195	3 195	3 218	3 191	--

Source: European Central bank

Bank of Japan

	2007M12	2016M12	2018M10	2018M11	2018M12	2019M01	2019M02
BoJ total Assets (tn. Yen)	111	471	547	554	551	554	559
BoJ Policy rate (%)	0.50	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
3-month interbank rate minus policy rate	0.49	0.06	0.02	0.00	0.00	0.02	0.02
Excess reserves (tn. Yen)	--	240	343	340	336	333	333
Monetary Base (tn. Yen)	89	429	500	503	501	501	503

Source: Bank of Japan

Bank of England

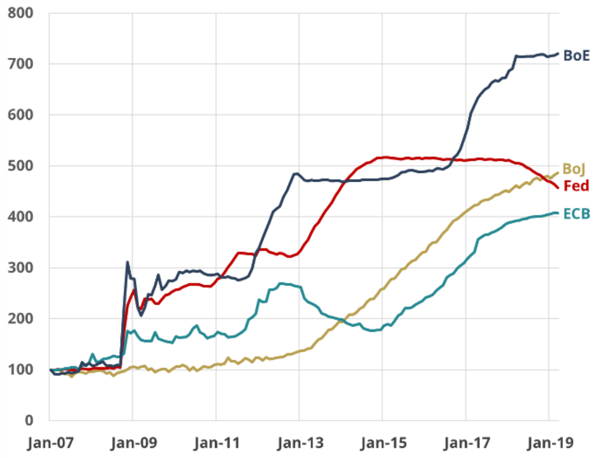
	2007M12	2016M12	2018M10	2018M11	2018M12	2019M01	2019M02
BoE Assets (bn. Pound)	97	457	593	589	591	592	592
BoE Base rate (%)	5.50	0.25	0.75	0.75	0.75	0.75	0.75
3-month interbank rate minus base rate	-0.19	-0.24	-0.05	-0.10	-0.05	0.00	-0.01
Monetary Base (bn. Pound)	75	450	574	572	570	570	572

Source: Bank of England

Exhibit 2

Central Bank Total Assets

base 100 Jan. 2007, in local currency



base 100 Jan. 2017, in local currency

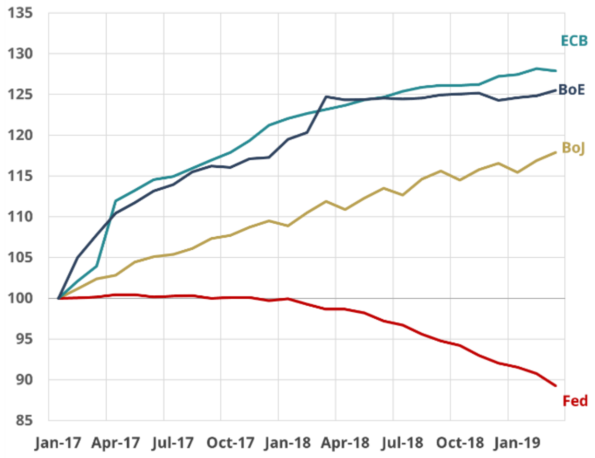
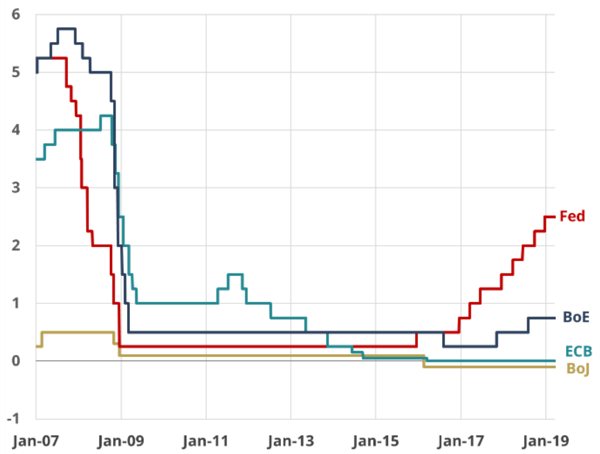


Exhibit 3

Central Bank Policy Rate (%)

from Jan. 2007



from Jan. 2017

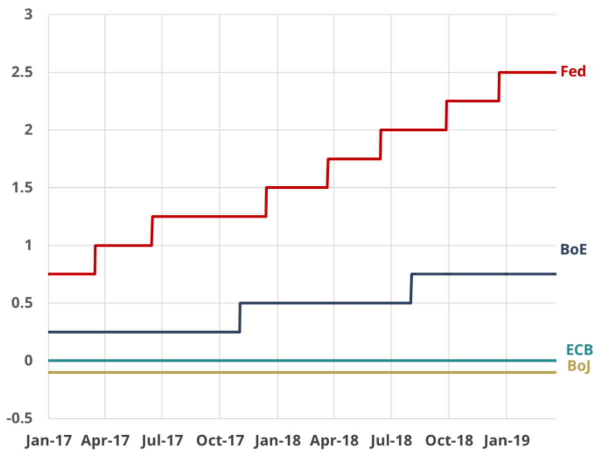
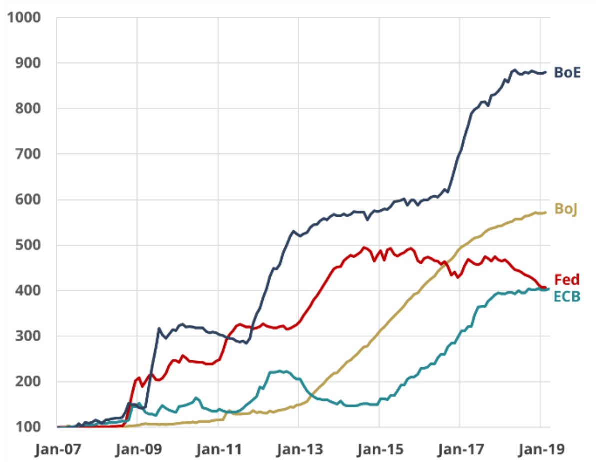


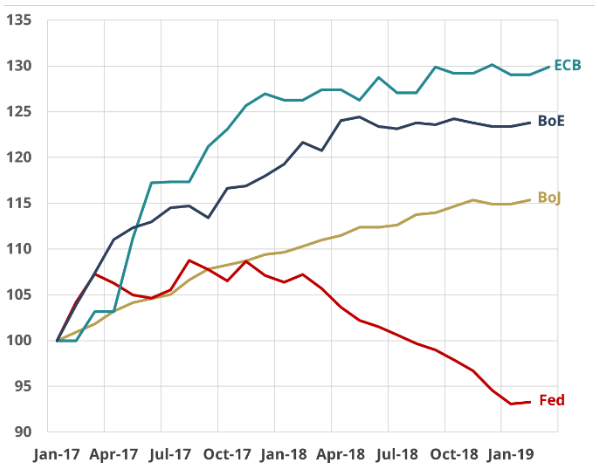
Exhibit 4

Central Banks Monetary Base

base 100 Jan. 2007, in local currency



base 100 Jan. 2017, in local currency



Source: TAC ECONOMICS, Central Banks

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