INSTITUT
MONTAIGNE

BETWEEN THE "G2" AND THE G20: EUROPE AND THE FINANCIAL CRISIS

*Briefing Paper - September 2009 (*www.institutmontaigne.org*)*

One year after the Lehman Brothers bankruptcy, the "crisis of the century" already seems out of fashion. However, the same causes are starting to produce the same effects: overindebtedness, this time on the part of governments, speculative bubbles, record bonuses in the investment banks. The world financial system is far from being cured. Six months after its briefing paper "Rebuilding the Financial System in order to Kick-Start the Economy", the Institut Montaigne formulates three proposals for the coming G20 summit meeting: an initiative to stabilise the world monetary system; a complete reform of the systems of remuneration in the financial sector; and the organisation of stress tests for the G20 banking institutions. But the crisis has produced a new and unexpected victim, namely Europe, which has become the sick man of the world. In order to re-exist alongside the continent-states, the European Union must cease to be a diplomatic, economic and political dwarf. Only the bringing together of France and Germany can enable Europe to get moving again. The heads of these two States have just two years to achieve this. For this purpose, we formulate several specific proposals, the principal one being that France share with Germany its permanent seat on the United Nations Security Council.

A lack of concrete results from the G20

On 24-25 September, in Pittsburgh, the G20 will meet for the third time since the beginning of the financial crisis caused by the bankruptcy of Lehman Brothers and the collapse of AIG.

The absence of concrete results from the two preceding summits is cause for concern:

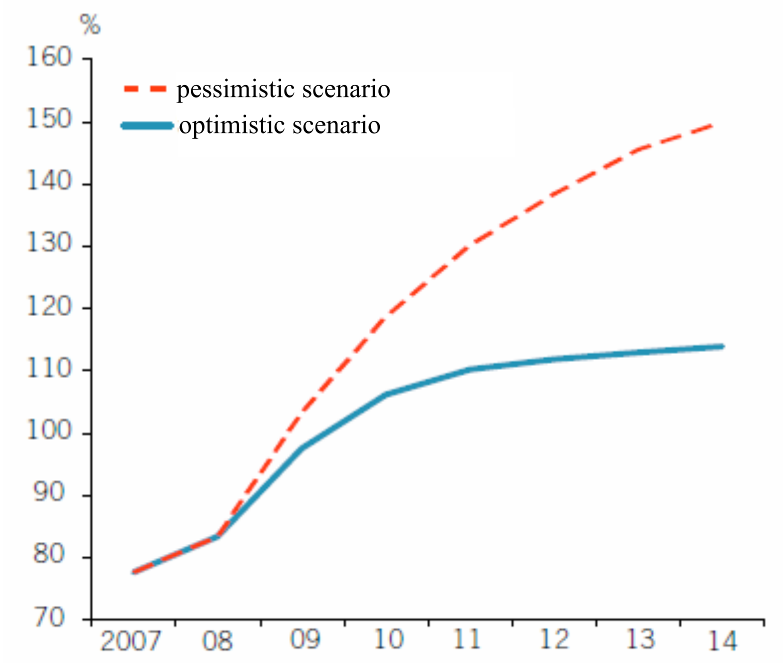
- **In the economic field, the re-stimulus packages and bailouts** have been on a massive scale and are starting to bear fruit. However, **these cannot be credited to the G20,** but entirely to unilateral decisions on the part of sovereign governments. The total amount involved nevertheless deserves to be discussed even in the absence of concerted action. According to the IMF, the total government debt of the ten richest G20 States is likely to reach 106% of their GDP next year compared with 78% in 2007. It could reach 150% of their GDP by 2014, a level unequalled except in time of war and always accompanied by inflation, currency disorder and even national bankruptcies. The American deficits, in particular, seem to be out of control[1]. The European deficits, notably that of France, are just as worrying: the French deficit expected for 2009 (more than 120 billion euros) is equivalent to the totality of French government expenditure on personnel. These figures give an idea of the economies to be made and/or the tax rises and social unrest to come, for the most heavily indebted G20 countries. They also put in their true perspective the first signs of a world economic revival, pumped up by additional debt instead of being based on improved economic fundamentals.

- **In the banking field, business as usual.** With their rescue barely assured, the American institutions are posting record profits, while market financiers have regained or even exceeded their pre-crisis remuneration levels. In the United States, a report by New York State Attorney General Cuomo revealed this summer that 5,000 employees of banks saved from bankruptcy by the American Federal government (by banking recapitalisations and the re-floating of AIG) had each received, for 2008, a bonus of more than 1 million dollars. 2009 looks like being an even better year for the banks, which, by an intriguing paradox, are enjoying a huge rent as a result of their past mismanagement: *de facto* disappearance of any form of price competition on certain markets (issues of shares, of debts and of

[1] Additional deficits of $ 9,000 billion expected in the next decade.

other liquidity-creating products), very low refinancing costs due to the massive and repeated interventions by central banks. It is the financial crisis and the inaction of G20 that have permitted this “loser-takes-all” situation: the bad boys of capitalism reap all the rewards, but at a significant cost for the remainder of the economy, particularly households and firms, who are finding themselves having to pay much higher borrowing costs and charges for banking services[2].

Debt/GDP (%) of the 10 most developed G 20 countries



Source: IMF, April 2009

- Lastly, **the efforts aimed at reinforcing financial regulation in a coordinated manner at world level have rarely gone beyond the stage of declarations of intent,** on either side of the Atlantic. In any case, they fall far short of the proposals set out in our previous briefing paper "Rebuilding the Financial System in order to Kick-Start the Economy": the essential reorganisation of banking activities, with a clear separation between activities irrigating the real economy and speculative activities, no longer seems to carry priority. The overhaul of remuneration systems in the financial sector is still at the stage of rhetoric and the necessary reform of the rating agencies has simply been forgotten.

[2] In 2009, the American banks will rake in almost $40 billion in income thanks to overdraft charges, twice the 2000 level (source: Moebs).

We set out in our complementary on-line document[3] an analysis of this minimalist attempt at financial regulation, in particular in the United States, basing ourselves on the work of two American think tanks, the Cato Institute and the Committee for Economic Development (CED), with which the Institut Montaigne has established working relationships.

If the G20 is incapable of inciting the developed countries to take concerted decisions to avoid the repetition of the financial crisis of autumn 2008, what purpose does it serve? The United States and China have answered this question in their own way by holding a one-on-one conversation at the time of the Washington Summit on 27-28 July.

From the G20 to the "G2": "Chinamerica" and the rest of the world

Following long preparation by the respective administrations, this "G2" meeting covered many subjects, including the environment, nuclear energy, economic questions and financial regulation. President Obama made the objective very clear, when he said at the opening session that: **"the relationship between the United States and China will shape the 21st century".**

The United States and China were able to reaffirm the importance of their bilateral partnership - *Chinamerica* - founded on unrestrained debt-financed American consumption on the one hand and on strong Chinese exports supported by an artificially low foreign exchange rate on the other. The Chinese give priority to the maintenance of high - but unstable - growth based on international trade, rather than on the slow and uncertain build-up of the domestic market. The Americans, for their part, do not intend to clean up their public finances too quickly, for fear of stifling their economic revival.

This agreement between the "G2" is at the expense of the "G18" and the rest of the world. It in practice ratifies the following: the foretold depreciation of the dollar, with destabilising consequences for the world economy: volatility of the money market, generating additional volatility on the financial markets in general; world

[3] Downloadable on the Institut Montaigne website: www.institutmontaigne.org.

inflation (related, in particular, to an inescapable increase of hedging operations and higher prices for oil and other raw materials traded in dollars); the drying up of the markets for private and public debt to the benefit solely of American sovereign debt (through a crowding-out phenomenon); downgrading of the non-dollarised exporting economies, the euro-zone countries especially.

From the "G2" to the G20, or the return of Europe and the emerging countries

There can be no acceptance of this **double fait accompli: (I) "casino finance", subsidised by governments** and from now on involving massive moral hazard - the most dangerous actors and those that have most failed the cause of capitalism (investment banks and speculative funds) are always the ones saved and rewarded, while the virtuous actors (profit-making firms and saving households) are punished by excessive taxes or inflation or both, and **(II) world monetary disorder, provoked by agreement between China and the United States to** the detriment of the whole world, Europe especially.

The Pittsburgh summit must not be a repetition of its predecessors, with plenty of media coverage but not very fruitful. On the contrary, this summit and other forthcoming meetings represent a historic opportunity for Europe, with Japan and the large emerging countries - together accounting for half world GDP - to propose concrete solutions for the current monetary, banking and financial disorders, these disorders being largely based on (I) the exorbitantly privileged position of the dollar as the world's only reserve currency, (II) a financial system that remunerates failure and short-termism more than lasting success, (III) a banking system that completely escapes the control of the governments which in the final analysis guarantee its survival (Europe, the United States) or, worse still, a banking system strictly dependent on the ruling power (China).

Three proposals for the G20

Proposal 1: to bring about a successful soft landing for dollar, prior to the construction of a monetary order based on the euro, the dollar and the renminbi

The inescapable depreciation of the dollar, the direct consequence of the sharply degraded US economic fundamentals, imposes a very heavy burden on both the creditors and the trading partners of the United States.

For example, China, which has seen its monetary reserves - mainly made up of American Treasury bills – rise to more than two thousand billion dollars. Any significant decline in the dollar would result in a depreciation of these reserves and probably in dangerous inflationary pressures.

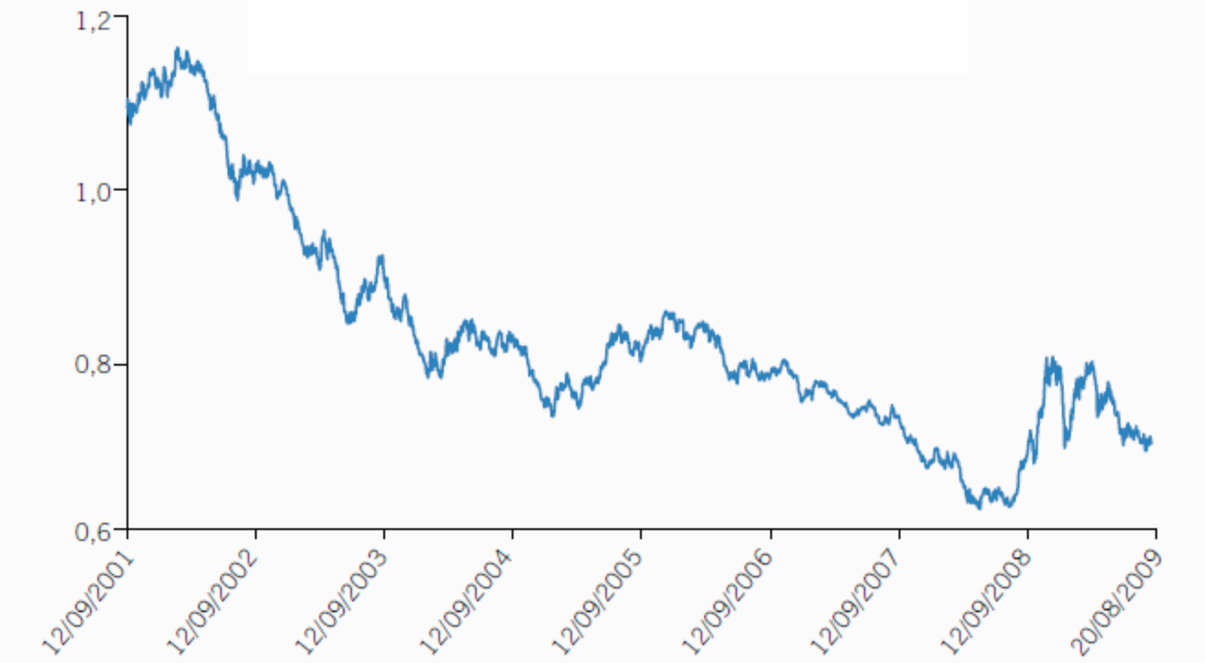
Take also the other G20 members, especially the European Union, which would be the principal and immediate victims of this coming disorder. As a mere adjustment variable, an overvalued euro would stifle European competitiveness, at the expense of private-sector employment, and hence of the financing of social welfare systems.

Such a pincer movement against the European currency by the Sino-American monetary authorities would be perilous, because it would increase the dependence of the world economy on the durability of a bilateral relationship whose fragility has been illustrated by the recent crisis. Moreover, with the European Union accounting for 30% of world GDP, to imagine a durable world recovery without a European recovery would be totally mistaken.

If the G20's aim is to find an alternative to the current monetary disorder, it must have three objectives: **(I) preventing excessive turbulence on the currency markets** - collapse of the dollar, overvaluation of the euro - that could put a halt to world recovery, **(II) steering the gradual decline of the dollar,** *de facto* the only reserve currency, **(III) preparing its replacement by a tripartite system of floating exchange rates.**

To attain this triple objective, as the preliminary to a tripartite monetary order (see the on-line complement to the previous briefing paper by the Institut Montaigne on the financial crisis), it is advisable to aim at a **progressive diversification in favour of the euro, through the purchase of European sovereign paper -** ideally a "Eurobond", a supranational security described below - based on returns that are probably more attractive than those of sovereign Japanese bonds but less subject to an abrupt surge in inflation, unlike US Treasury Bonds. Because of its role in diversifying exchange-rate risks and as a protection against seignoriage, the issue of this Eurobond would also have the great merit of facilitating the financing of EMU Members' government deficits, currently vulnerable to a bond-supply-shock (massive issues of T-bonds) and a rapid rise in interest rates.

Evolution in the USD/EUR exchange rate since 11 September 2001



Source: Bloomberg

A simple political decision will not be enough **to have the euro adopted as an alternative to the dollar and the renminbi in world foreign-exchange reserves.** The euro must also quickly establish itself as a universally recognised transaction currency. For this to take place, **the creation on the Euronext and Deutsche Börse trading platforms** (see proposals below) **of commodity contracts[4] denominated in euros would constitute a very beneficial initiative.** An easing of the rules governing IPOs and the creation of "European Depositary Receipts" equivalent to American Depositary Receipts would have similar positive repercussions.

[4] For gas and agricultural products in the first place.

Proposal 2: Remuneration - code of conduct and long-term run incentives

The affair of the bonuses awarded to market bankers financed by public deficits calls for a vigorous response on the part of governments. Certain recent American initiatives deserve consideration, such as taxation at a rate of 90% of the bonuses received by the employees of banks affected by government-financed re-capitalisations (Bill dated March 2009) or the introduction of public supervision of future remunerations in the industry (appointment of a `pay czar').

Such decisions, however legitimate, are nevertheless difficult to implement and could produce perverse effects (renewed interest in tax havens, in particular).

It is thus in the first place up to the private actors themselves to introduce - and quickly - new remuneration practices. Otherwise it will not be surprising if governments intervene, clumsily, in these questions that from now on come under the heading of public law and order. We propose two lines of thinking:

1. **Suppression of annual bonuses in favour of long-term incentives aligning the interests of the employee on those of his bank**. This recommendation was already contained in our preceding briefing paper. One of the attractions of having bonuses converted into shares (with an incentive for long-term holding) or stock-options is that the employee aligns his long-term interests on those of his employer. He loses all his bonuses in the event of failure or bankruptcy of the firm – as the employees of Merrill Lynch and Bear Stearns can testify. Such a system would in addition have made it possible for certain European and American market banks not to set aside, as of the first half of 2009, provisioning for bonuses whose annualised amounts are of the same order of magnitude as the public funds needed for their emergency re-capitalisations in the autumn of 2008. In order to facilitate the implementation of such a measure, and to increase virtuous transparency in this field, the obligation for financial institutions operating on the G20 markets to publish the list of their hundred highest-paid staff (at group level) would definitely be useful.
2. **A code of conduct enacted by the G20 of the finance industry.** The G20 will probably have certain difficulties in proposing a concrete initiative on the question of remunerations. The weight of the City of London in the British

economy and the way in which American democracy is financed[5] are powerful restraining forces in this respect. It will thus be necessary to rely initially on the large private operators in the financial industry (insurance companies, commercial banks, pension funds, financial managers of large companies), who are at the same time the core shareholders of the market banks and/or, very often, their principal clients (in terms of fund management, liquidity contracts, issuance of shares/bonds, financial advice, etc). It will be up to these world actors to meet - like the G20 governments - to enact a code of conduct to be imposed on their suppliers: traders, fund managers, brokers, investment banks, etc. This code would cover all the rules and possible ceilings (in terms of individual remuneration, for example) that the market banks should respect if they are to take part in their customers' invitations to tender.

In a second phase, in order to encourage good practice, there would be drawn up **a `black list' of the financial institutions not respecting this code of conduct,** with which the G20 governments, as well as the international institutions (World Bank, IMF) and the central banks (Federal Reserve, ECB, BoJ, BoE) would decide no longer to work. To take a concrete example, a financial institution making use of tax havens to optimise the performance of its funds and the remuneration of its employees, and/or refusing to adopt the above-mentioned code of conduct, would no longer be permitted to manage the retirement pension funds of government institutions, nor to intervene on the sovereign bond primary markets. It would have only second-rank access to the facilities of the central banks, among other restrictions.

The Institut Montaigne proposes to initiate a concerted approach to the formulation of such a code of conduct, at the level of Paris and Frankfurt (see below).

Proposal 3: semi-annual stress-tests for the principal G20 financial institutions

The rescue of the American banking system seems as of today to be an accomplished fact. The first element of this initiative, arranged around stress tests, had as its principal function to convince the public of the solvency of these institutions. The

[5] Since 1990, the American financial industry has officially paid $2.2 billion in contributions to political representatives and candidates, more than all the other industries (*source : Center for Responsive Politics*).

rigour with which these tests were applied was highly debatable. Built around just two scenarios and applying only to those institutions with assets exceeding a hundred billion dollars, the exercise consisted of allowing the institutions to carry out an impact analysis of the two cases, under the remote aegis of federal experts. The evolution of capital adequacy ratios would then make it possible for the Treasury to impose various remedies on the institutions, depending on their degree of vulnerability: private recapitalisations, asset disposals or public recapitalisations amounting to *de facto* nationalisation.

The many technical shortcomings of these tests did not prevent the Fed and the Treasury from setting a floor on the valuation of bank balance sheets, reassuring investors and facilitating the raising of capital - restoring, in fact, the financial base of the industry. Sixty billion dollars were raised, of which two-thirds out of public funds: a relatively limited sum, whose smallness in itself made it possible to bring back confidence, to stabilise the value of bank securities and then to carry out numerous asset disposals and a large-scale liquidation of discounted assets.

Without ignoring the numerous and substantial perverse effects (re-starting of own-account trading activities rather than in-depth cleaning up of the banks' balance sheets), this operation will have enabled the American banking system to be resuscitated, at relatively limited cost to the American taxpayer.

The initiatives of the European Union, on the other hand, were less successful: several strictly national, uncoordinated and often incomplete attempts at enhancing the value of bank balance sheets - whose results, moreover, were never officially made public - had quite the opposite effect. Their lack of transparency, their absence of quantified conclusions and their strictly national character achieved a perverse tour de force by intensifying operators' concerns regarding the solvency of the European institutions.

To put an end to these unfortunate tendencies and the mistrust they create, it is up to **the European Central Bank to coordinate in a serious manner the conduct of semi-annual European banking stress tests.** Taking up and reinforcing the mechanisms installed by the American Treasury and the Federal Reserve, the ECB could ask each bank to give an analysis of the sensitivity of its portfolio to various scenarios, these analyses being carried out by an independent auditor.[6]

[6] See the on-line document for details concerning the scenarios to be constructed for these stress tests.

A transparent methodology would facilitate the application of these tests to the whole of the institutions of the euro zone. Explicitly-defined minimum capital adequacy ratios would determine the need for raising additional funds on the market or, in the most extreme cases, from governments. Such a procedure would make it possible to avoid both automatic and arbitrary nationalisations and the current reality, a situation in which banks, recapitalised at great expense by the public authorities, exploit this providential windfall to increase their speculative activities without any benefit to the real economy.

The ratios used for the stress tests should not be uniform: in addition to regional differences, sectoral differences will have to be taken into account, with the commercial banks (in the strict sense) enjoying more favourable ratios than the investment banks, whose balance sheets are prone to wider variations. Applied at the level of the group as a whole, the ratios in the case of mixed institutions would remain the highest of the relevant range. This prudential choice, encouraging a clear separation between institutions with very different risk profiles, will have to be reinforced by a requirement of segregation of funds (prohibiting the use of assets managed on behalf of third parties for financing on own account). Initially European, this initiative – whose results would have to be published – could then be widened to the other G20 members and its supervision entrusted to the Bank for International Settlements. It will, however, be desirable to ensure comparability of the accounting methods and capital adequacy ratios used, which are at present very unfavourable to the European banks compared with the US banks[7].

Europe, the new sick man of the world?

In order to make itself heard on these proposals aimed at a reorganisation of the world's monetary, banking and financial systems, Europe still has to be credible economically and politically, and this is far from being the case at present. Indeed, whereas the large continent-states have quickly adjusted to the new state of affairs

[7] The ECB, unlike the IMF, has in fact taken this point strictly into account in its evaluation of the potential losses and re-capitalisation needs of European banks (losses of $283 billion according to the ECB, $750 billion according to the IMF).

resulting from the crisis, capitalising on their fundamental characteristics to bounce back (China with its managed economy, the United States using and misusing the dollar's reserve-currency status), Europe seems petrified, unable to change in order to move forward.

Economically, financially, institutionally, the Old World is on its way to becoming the sick man of the planet. It is as if this financial crisis, which was not of its making in the beginning, then brutally revealed its deficiencies.

Economy: Europe as the back-marker of the world

Leaving aside the good news concerning the second quarter, whose durability we question, Europe is likely, according to the IMF, to be the worst-hit economic zone in the world in 2009 (GDP down by 4.2%, with only Japan and Russia, among the large countries, doing worse). In 2010, whereas most of the leading economies will have returned to positive growth rates (3.9% for Africa, 5.6% for India and 7.5% for China), Europe will stand out by having an expected negative growth rate of 0.4%)[8]. Europe in fact risks having been plunged deeper into crisis than the other regions and remaining in recession longer than the others.

Social unrest: worrying signals

In our on-line document, a table summarises the paradox of the current crisis: while since the beginning of the crisis the number of unemployed in the United States has risen by 7 million and 6 million American families have had their homes repossessed; while General Motors and Chrysler have been forced into bankruptcy and the 50 States have been obliged to make savage cuts in their budgets and services, there has not been one strike, not a single case of social unrest.

Conversely, in spite of its national social shock-absorbers, Western Europe, and especially France, has been sending out worrying signals: kidnapping of company managers, threats to blow up factories to obtain dismissal indemnities, active search for scapegoats (in the financial sector today, perhaps tomorrow in ethnic groups), etc. Europe is becoming ever deeper bogged down in a major social crisis. France, in particular, with one of the highest youth unemployment rates in the OECD, is

[8] Figures as of 12 August 2009, liable to be slightly improved following the publication of the Euro-zone GDP for Q2 2009 (an expectation of -0.1% compared with 0.5%).

showing the limitations of its model.

Institutions: no reaction from Brussels

The on-line document contains a table summarising the principal actions of the European Commission since the Lehman Brothers bankruptcy, marking the start of the crisis of the century. These include searches of EDF premises, the imposition of disproportionate fines on Saint-Gobain and Intel, the opening of investigations into possible cartels between the makers of components for refrigerators (sic) or of underwater electric cables. The Commission seems to have been living on another planet, or in another age. Devoting considerable time and energy to putting spokes in the wheels of European companies, the Commission did not, on the other hand, do anything, or even try to do anything, to prevent the substantial distortions of competition in the European financial industry caused by nationalisations and public recapitalisations. But how can one still speak of a balanced market, when British, Dutch and German banks and insurance companies benefit from government guarantees – and hence reduced financing costs - whereas their better-managed competitors can count only on their private resources?

In the final analysis, the present crisis provides Europe with an opportunity to learn from its current difficulties: problem of leadership at the European Commission; absence of a real programme, disputable representativeness of the people (56% abstention rate in the elections for the European Parliament); and a European enlargement that has paralysed European governance (the impossibility of achieving unanimity among 27 members). In reaction to these shortcomings, nationalism, in particular economic nationalism, is making a worrying comeback in the European Union (see on-line document).

A solution: France and Germany to be the advance guard of a revived Europe

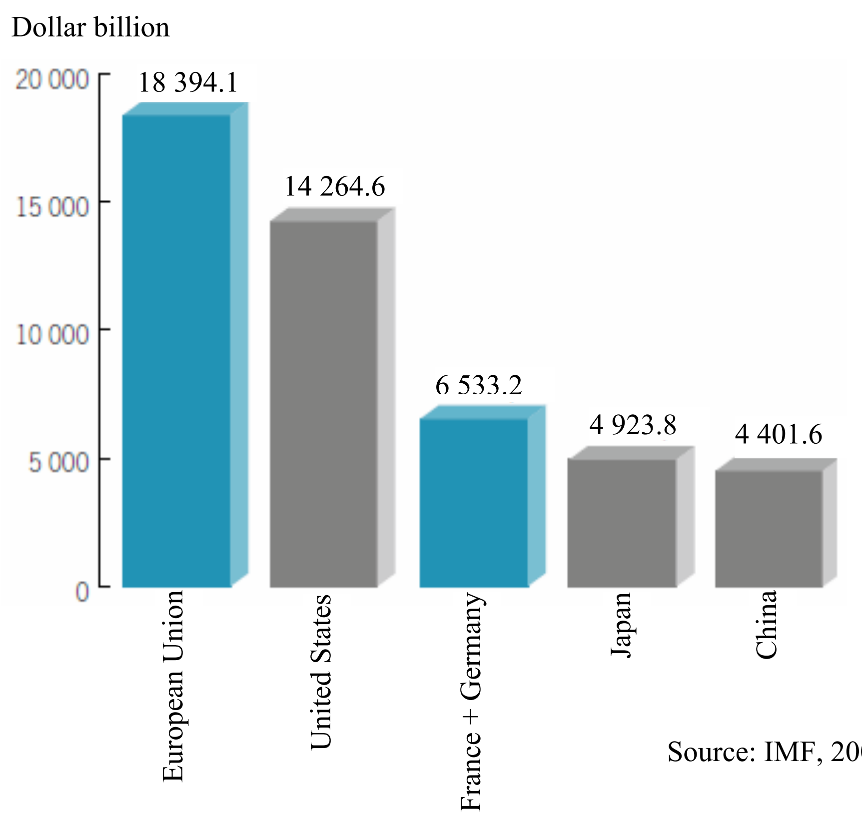
The Institut Montaigne proposes a solution to prevent this scenario of decline. This involves the ambitious rapprochement of France and Germany, as the open-ended advance guard of the European Union. Without France and Germany, Europe simply does not exist. It is not necessary to go back to the Roman Empire or to Charlemagne to understand this.

In terms of geography, these two countries have access to all the frontages and horizons of Europe: to Eastern Europe, to the North Sea, to the Atlantic, to the Mediterranean and to Africa.

In terms of language, French (romance language) and German (tudesque language) are at the crossroads of all the languages of Europe.

These past fifty years, the Franco-German relationship has been at the origin of all the advances made by Europe. From the European Coal and Steel Community to the common currency, through the Treaty of Rome, the Schengen, Eureka and other agreements, the roadmap was always the same: France and Germany together proposed a new step forward for Europe: the other States, seeing their interests, always finally fell into line. And when not all the others joined, France and Germany launched the project with the most interested countries, thus managing to assemble broad majorities, as in the case of the euro, the Schengen space, the European Space Agency or Airbus.

GDP of the world's leading economies



Source: IMF, 2008 data.

Finally, remember that, together, these two countries carry such weight in the European Union that they are at the same time its centre, its engine and its pillars. France and Germany account in combination for one-third of the EU's population and GDP. They also constitute the world's second economic power, far ahead of China, with a GDP of $6.5 trillion. Together, they potentially form the world's second military power in budgetary terms.

Nothing serious can be undertaken in Europe without a coordinated impetus from France and Germany. Their advantages are too complementary and their intrinsic weaknesses too important (see on-line document) for their rapprochement, as necessary for themselves as for Europe, not to be carried through.

The financial crisis of 2008, the crisis of identity of a European Union served by an exhausted Commission and the dangerous Chinamerica partnership provide the occasion to launch such a project.

For this purpose, the Institut Montaigne formulates three major proposals in the diplomatic, economic and financial fields, supplemented by a series of proposals in the energy, cultural and educational fields.

Three major proposals

Each proposal must be the subject, initially, of implementation by France and Germany, while remaining open, in a second phase, to all the European countries wishing to be associated with it.

Proposal 1: France to share with Germany its permanent seat on the United Nations Security Council

It is up to France make this first move, which is significant for three reasons:

- it affects the ultimate level of state sovereignty: the five permanent members of the United Nations Security Council are the world's five leading military powers, possessors of the atomic weapon;
- it concerns an emblematic inheritance from the Second World War: the permanent members of the Security Council comprise the victorious countries, or in any case those deemed as such. It excludes the defeated countries (Germany and Japan) and the large emerging countries, regardless of their demographic and economic importance.

To call into question this heritage is equivalent to closing the door on the post-WWII period and hence drawing a line under all the international debts and claims generated during it.

- it implies, through a series of knock-on effects, a natural rapprochement of all the agendas of the two countries, in the following fields:
    - intelligence and defence policy: once the two countries share a seat on the Security Council, they will necessarily in time have the same priorities, the same level of information. Having to respond together to the same questions of security, they will be prompted to define a common vision of their security interests. This *de facto* convergence will in turn create a strong momentum for unification of their military and intelligence structures, in a first step towards a genuine European defence project. This will be all the more necessary in that budgetary constraints will inevitably mean a withdrawal of American forces from Europe.
    - diplomacy and diplomatic practices: the sharing of the Security Council seat implies the merger of the two countries' diplomatic representations, not only in New York (the headquarters of the United Nations) but also in the major policy-making capitals (Washington, Beijing, Tokyo, etc). This rapprochement will have to be rapidly extended to the entire consular and trade support services. The regrouping of "economic expansion posts" and of French foreign trade advisers with the Deutsche Haus network should make it possible to ensure the support of European firms that are world leaders in their fields (whether their names be Siemens or Alsthom, Allianz or Axa, Mercedes or PSA), thus avoiding the destructive forms of competition that in most cases lead only to the victory of the more socially backward and to the abandonment of technological leadership;
    - industrial policy in the armament and space fields: There is today a singular lack of major Franco-German programmes in the field of arms technology and research. And yet the history of military co-operation between France and Germany has been mainly a string of successes (Milan missile, Tigre helicopter, Transall, Alpha Jet, etc). To remedy this state of affairs, several initiatives might be envisaged:

– to give concrete reality to the European Defence Agency, of which France and Germany will have to become the leaders, by developing research and investment programmes;

– to carry out, at bilateral level, major cooperative R&D programmes in the armament and space industries. These programmes would make it possible to reinvigorate the ongoing process of industrial integration (Eurocopter, MBDA, etc). In this connection, France and Germany should take greater advantage of the commercial success of EADS, making this company the preferred supplier of the French and German armed forces (air, sea, land). In the space industry, Germany and France must take the initiative in launching the sixth Arianespace programme, so that Europe does not lose the advance it has succeeded in gaining in this strategic domain.

By working together and pooling activities in such fields, France and Germany will be called on to cooperate in related fields, touching on numerous aspects of the economic life of the two nations.

How to proceed, concretely?

The sharing of the seat on the Security Council between France and Germany would start with a merger of the French and German missions in New York, in order to prepare together the decisions and interventions of the two countries in the Council debates. It should be made clear that, pending the revision of the UN Charter, only France will be able to take a seat at the Council, representing Germany as well as itself.

The difficulty of implementing such an ambitious proposal must not be underestimated, especially insofar as it concerns the two diplomatic corps concerned, with their legitimate desire to preserve their prerogatives and defend their countries' interests. Nevertheless, this initiative would have all the greater chances of success in that it would fit in with the ongoing process of reform of the UN Security Council, which is now hampered by a significant problem of representativeness (no permanent representation of Moslem countries, nor of Japan, India, Africa, South America).

This future Franco-German seat on the Security Council is therefore to be seen as a first step to the creation of a single seat for the European Union, alongside the future seats allotted to China, India, South America, Africa, the United States, Japan and the Moslem world[9].

Proposal 2: A Eurobond and a European "Livret" small savers' vehicle": two instruments to finance tomorrow's Europe

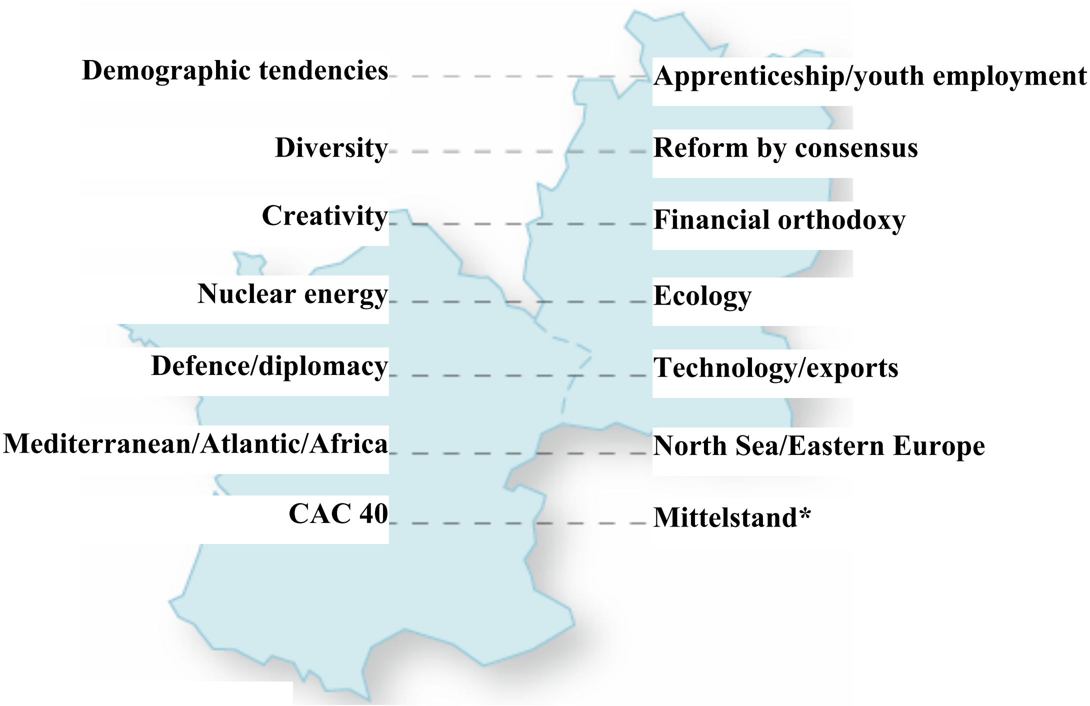
In order to bring closer together the interests of Member States with varying fiscal antecedents but confronted with the same problem of liquidity, the Institut Montaigne recommends the adoption of a structure-creating instrument, namely a supra-sovereign, initially Franco-German, Eurobond issue. Technical in appearance, this measure is in fact very ambitious, in that it implies that in the event of default on the part of one of the States the other guarantees the repayment of the bond.

The creation of a supra-sovereign agency specific to the two countries will make it possible to raise longer-term capital, in an operation whose proceeds will then be redistributed to the national Treasuries in accordance with their budget forecasts. Initially intended to support the completion of bilateral long-term projects, these funds could at a later stage become the preferred funding source for the two founding States - and, in the end, for other euro-zone member countries.

The proposed major French public loan could for this reason constitute an ideal first stage: extended to Germany, consolidated in its ambitions by an increase in its volume – close to the 100 billion euros envisaged - structured around common large-scale industrial projects, this loan would be the concrete manifestation of a completely re-structured debt policy and could at some stage lead to a more cooperative European fiscal policy, in that access to the common resources would be conditional on respect for a common repayment schedule. This materialisation of the Growth and Stability Pact would guarantee financing at competitive cost for the whole of Europe without penalising the more virtuous members.

[9] At some stage in this process, the question will also naturally arise of the representativeness of the UK seat.

The complementary advantages of France and Germany



* Network of competitive and well-financed SMEs.

Such an ambitious objective requires a progressive effort. The use of the receipts of the Eurobond, initially Franco-German, could in the first stage be used for precise and structure-creating investment projects, implemented with the support of the European Investment Bank (biotechnology, nanotechnology, renewable energy, energy-saving programmes, etc).

To accompany the birth of this new instrument, the introduction of common untaxed small savers' accounts in France and Germany (perhaps to be known as E Livrets) carrying attractive interest rates might be considered. A single institution, for example the EIB, would have responsibility for managing an increasing portion of the sums reinvested in the financing of the above-mentioned projects and in Eurobonds, in order to hold down the interest rate.

These "E Livrets" would also incarnate and popularise with the wider public the European project associating France and Germany.

Proposal 3: Rebuild a European stock market around Paris and Frankfurt

In 2006, the management of Euronext, deserted by its traditional shareholders, turned its back on the project of a unified European market by selling out to the New York

Stock Exchange.

This abandonment not only leaves the Frankfurt stock exchange isolated, but in addition encourages a tendency towards compartmentalisation of the European economy: the increasing recourse by French, Belgian and Dutch companies to financing by American institutional capital distends the natural bonds that exist between shareholders and their companies in the traditional Rhineland capitalist model.

The constitution of a single Paris-Frankfurt financial centre involves, in particular[10]:

- standardisation of the operating rules of the two centres and the introduction, in the longer term, of a single Financial Markets Code applicable in both France and Germany (and later throughout the Union);
- the merger of the regulatory bodies for the financial markets, banks and insurers (BaFin and AMF-ACAM), with a view to a revision of the Basel II and Solvency II agreements;
- the alignment of the tax regimes relating to investment in France and Germany, substantially revised and slimmed down in order to enhance their competitiveness - the only terrain on which a joint Paris-Frankfurt financial centre will be able to exert effective competitive pressure on London;
- the installation of transport infrastructure encouraging the development of an axis linking Paris and Frankfurt, through the building of a high-speed railway line directly connecting the two cities.

To advance this major project, structuring a possible future European capital market, we recommend the creation of Europlace, a single organisation to represent the French and German financial markets (replacing the national equivalents, i.e. Paris-Europlace and Finanzplatz Frankfurt). This organisation, neither French nor German, would act as a lobby with the public authorities of the two countries for the emergence of the Paris-Frankfurt financial centre.

[10] For details, see the on-line document.

An indispensable condition: coordination of fiscal and tax policy

Our on-line document contains a proposal of a different kind, affecting more the national representations and the higher administrations of the two countries: **the necessary coordination of economic, fiscal and tax policies and practices between the two countries.** In a way, this coordination, without which any economic and monetary union is a risky enterprise, is the indispensable condition for the success of the proposals of an economic nature in this document (Eurobond, reinforcement of the euro, joint industrial and investment policies, etc). It would involve the following procedures - later on being widened to the other European countries wishing to join these initiatives:

- the drafting of the budget guidelines and the finance bills would be carried out in close concertation between the French and German executive branches;
- the parliamentary debates would take place in the presence of deputies or senators from the other country, these representatives having the right to intervene during the session;
- the final vote would be preceded by a special consultation procedure, making it possible to take into account the priorities adopted by the other government and the other Parliament.

The other proposals

The other proposals, set out in more detail in the on-line document, concern:

- harmonisation of the French and German energy markets, with the introduction of integrated management of transmission networks and the promotion of a "smart grid"
- joint initiatives in the fields of research, innovation and knowledge, particularly the creation in its own right of an autonomous Franco-German University, financed on a parity basis by the two governments
- joint investments in the media and cultural fields, starting with the public audio-visual sector (regrouping of the so-called “external audio-visual channels” of the two countries around the existing Franco-German "Arte" channel).

Conclusion

Franco-German rapprochement is potentially the most important European initiative of the early 21st century. It will not be achieved overnight. Significant and well-organised interests will seek to oppose it. The widely differing political practices and structures of the two countries, (centralised in the case of France, federal in the case of Germany) may also delay or even tend to halt the rapprochement momentum.

Proposing and implementing such an advanced rapprochement will therefore need statesmen endowed with exceptional political courage and historic vision. We are prepared to bet that the current French President and the future head of the German government following the forthcoming general election will be capable of such an initiative, which in a way goes even further than what General De Gaulle and Konrad Adenauer achieved in their time.

In order to achieve this revival of the European Union, the two heads of the Executive could take three steps in the field of appointments.

1. **Appointment of a Minister of State in charge of Franco-German rapprochement and European Affairs.** It is in fact highly regrettable that the French minister in charge of European Affairs (in practice only a Secretary of State) remains within the orbit of "Foreign Affairs". It is necessary that there should be at the highest level of the French government a major political figure, ideally a German-speaker, capable of giving impetus to such an ambition.
2. **Agreement between Germany and France to nominate top-flight politicians as members of the European Commission.** Lastly, from the medium-term point of view, it appears imperative to us to associate the United Kingdom with the European project. Ostensibly turning its back on Europe (repeated refusal to join the euro, increasing – and increasingly vocal – Europhobia on the part of its political community and the media), the United Kingdom will soon be led to reconsider its position, in view of the growing disinterest of the United States in co-operation in the economic and military fields (illustrated by the placing of British forces under American command in Iraq and Afghanistan) and the diplomatic field. The pre-eminently British qualities (capacity to bounce back, creativity, flexibility in decision-making

and -execution, significant military capacity, an aptitude to "think different") are in addition too important not to find their full expression in a European dynamic.

3. This is why, when the Treaty of Lisbon is ratified, we recommend **that France and Germany send an unambiguous signal to the United Kingdom, supporting a high-level British candidate for the future Presidency of the European Council.** While Europe cannot exist without the Franco-German rapprochement, it would be incomplete without the "British exception".

Edouard Tétreau,
Research Director, AXA Private Equity

Jean-Paul Tran-Thiet,
Partner, White & Case,

Frédéric Bonnevay,
Économist

Acknowledgements

The authors and the Institut Montaigne particularly wish to thank the following personalities who graciously agreed to provide their experience and their recommendations concerning Franco-German relations in the industrial, political and diplomatic fields.

• **Léo Apotheker,** CEO of SAP AG • **H.E. Joachim Bitterlich,** German Ambassador (1993-2002) ret., Director for International Affairs, Veolia, Diplomatic and Security Adviser to Chancellor Helmut Kohl (1993-1998) • **Thomas Enders,** Chairman and CEO of Airbus • **Louis Gallois,** Chairman and CEO of EADS • **Elisabeth Guigou,** Deputy for Seine-Saint-Denis, Minister for European Affairs (1990-1993), Adviser on European Questions to President François Mitterrand (1988-1990) • **Henri Lachmann,** President of the Board of Trustees of Schneider Electric • **H.E. Claude Martin,** French Ambassador to Germany (1999-2007), Principal Adviser to the Court of Auditors • **H.E. Bernard de Montferrand,** French Ambassador to Germany since 2007 • **Ana Palacio,** Director for Foreign Affairs of the Areva group, Foreign Minister of Spain (2002-2004) • **Heinrich von Pierer,** Chairman of Siemens (1992-2007) • **H.E. François Scheer,** French Ambassador to Germany (1993-1999), Adviser to the Chairman of the Executive Board of Areva • **Nicolas de Tavernost,** President of the Executive Board of M6, Member of the Board of Trustees of RTL.