

Transcription of the interview with Yves Mersch (Sanem, 24 August 2010) — Full version

Caption: Transcription of the interview with Yves Mersch, President of the Banque centrale du Luxembourg and Member of the Governing Council and General Council of the European Central Bank (ECB), carried out by the Centre Virtuel de la Connaissance sur l'Europe (CVCE) on 24 August 2010 at the Château de Sanem. The interview was conducted by Elena Danescu, a Researcher at the CVCE, and particularly focuses on the following subjects: the personality and achievements of Pierre Werner, the Delors Plan and monetary Europe, the euro zone, the Stability and Growth Pact and economic governance after the Treaty of Lisbon, and the role of the ECB and central bankers in the European integration process.

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I. Yves Mersch on the personality and achievements of Pierre Werner

[Elena Danescu] Today, 24 August 2010, the Centre Virtuel de la Connaissance sur l'Europe is greatly honoured to welcome Mr Yves Mersch, President of the Banque centrale du Luxembourg, who has accepted our invitation to contribute his views to the research file on Pierre Werner. Welcome, Mr President.

[Yves Mersch] Thank you — both for your invitation and for honouring the memory of Pierre Werner on this 40th anniversary.

[Elena Danescu] When did you meet Pierre Werner for the first time, and how do you remember that meeting?

[Yves Mersch] I think we should distinguish between passive and active acquaintance. Passively, I knew Pierre Werner throughout my youth as the man who led the country during my awakening to politics in the 1960s. Subsequently, when I entered the civil service, Pierre Werner was in opposition, and I was sent to Parliament from time to time to monitor budgetary debates. Following Pierre Werner passively, I found him to be a man of great prudence and moderation, with a strong desire for consensus. He was not a born oppositionist who enjoyed opposition for its own sake: he was a unifier. Then, on his return to power, I had the privilege of working for him. That was when I first met him actively, so to speak, among other things in preparing for meetings of the International Monetary Fund, which he attended and to which he attached great importance, given his own background. Because, as you know, he worked for a while at the World Bank and was involved as a young man in the negotiations on a World Bank loan for reconstruction of the Luxembourg economy after the Second World War — one of the Bank's first loans to a country in devastated post-war Europe. He remained very interested in the functioning of the Bretton Woods institutions, the Bretton Woods authorities, and as I had just returned from the International Monetary Fund and the World Bank, to which I had been posted by the ministry, where my duties mainly concerned those institutions, I was in a position to meet Pierre Werner. I found a man with a great ability to listen, a man whose knowledge exceeded what one usually finds at the highest level of state

decision-making. He had a detailed technical knowledge of the issues but, at the same time, he was able to distinguish between what was politically important and what should be left to a civil servant to decide. For me, it was an education that supplemented my academic education, so to speak. It was an education in affairs of state, in which Pierre Werner was my first teacher.

[Elena Danescu] You mentioned your entry into the civil service, which followed your university and postgraduate studies. On joining the Ministry of Finance you were immediately assigned to financial issues involving international organisations. How did you choose that career, and what sparked your interest in the study of monetary phenomena?

[Yves Mersch] First of all, my studies were geared towards international relations, and I did part of my postgraduate studies in that field. So I had a good understanding of the functioning of international institutions, and when I returned to Luxembourg I gravitated naturally towards foreign affairs, on the one hand, and finance, on the other, because finance has an important international monetary aspect and also concerns international development aid in financial matters. I chose finance because I was immediately offered a post of assistant at the International Monetary Fund in Washington — assistant to a director on the Executive Board of the International Monetary Fund. I was also prepared for it by my studies in economics, which included international economic and financial relations. That was what led me to prefer finance to a diplomatic career as such.

[Elena Danescu] On 1 June 1998 you were appointed President of the Central Bank of Luxembourg — we'll come back to that in a moment — which was established in the context of the creation of European Monetary Union. Pierre Werner witnessed, at your side, the launch of the euro, the culmination, 32 years later, of the Werner Plan drawn up in 1970 by the committee of experts led by the former Luxembourg Prime Minister. Do you recollect how Pierre Werner felt about the realisation of the single currency? Did he ever speak to you about his role as chairman of the Werner Committee?

[Yves Mersch] At the beginning of the establishment of the Banque centrale du Luxembourg, I had the pleasure of having Pierre Werner as a member of my board. During the board's discussions he often invoked history and past events, and again demonstrated his thorough knowledge of monetary issues, which set him apart from many other Luxembourg politicians. Unfortunately, by the time the currency was physically introduced, Pierre Werner had suffered a health setback which reduced his ability to express himself. But all the members of his family assured me that he still understood what was happening around him and that the introduction of the single currency filled him with deep satisfaction. I can tell you that in the years preceding his health setback he was happy to see the culmination of that aspect of European integration to which he was so attached and had contributed so much, and to which he had so often referred during the meetings I had with him, even after he left power. I recall that I was occasionally invited to dinner at his home, where we often discussed monetary issues and the realisation of an idea that meant so much to him.

[Elena Danescu] Did he tell you when exactly the idea of a common currency as an instrument of monetary integration crystallised in his thinking and political action?

[Yves Mersch] Not directly, but you must understand that Pierre Werner, a lawyer by training, worked in banking. It was through finance that he approached economics and that he had a thorough knowledge of the subject. It seemed to him that with the emergence of finance in relation

to the real economy, the monetary aspect would become more important. In the Treaty of Rome, however, the monetary aspect had been to some extent neglected and treated as an annex to economics. Pierre Werner had certainly seen that the monetary aspect was a separate political instrument, an instrument that also had to be dealt with at Community level to prevent it giving rise, if left at national level, to additional economic barriers to economic integration and creation of the common market.

[Elena Danescu] After retiring from politics in 1984, Pierre Werner devoted his efforts to promoting the single currency and to a project which led to the foundation of the Luxembourg satellite services company, the Société européenne des satellites. You have direct knowledge of that company, since you were the state representative. Do you have any recollections concerning the development of the project and Pierre Werner's personal involvement in its success?

[Yves Mersch] I do indeed, since, like all projects, money was the issue and this particular project was carried out against strong opposition in certain neighbouring countries, which I shall not mention by name. Furthermore, a group of contributors had to be found that was capable of financing such a large amount of risk capital. I recall that it was necessary to call on the largest Luxembourg banks, which were also averse to taking risks. They had to be persuaded to participate, and a major factor in persuading them was the commitment of the state itself. The state had to provide guarantees for loans to the company, and those guarantees were, of course, negotiated by the Treasury Directorate, where I worked at the time. I was therefore in a position to appreciate the great importance Pierre Werner attached to the project and his vision of it as a major diversification of the Luxembourg economy that would enhance the country's impact at international level, which was also a constant concern of his.

[Elena Danescu] Did that project also have a European dimension, in relation to European integration?

[Yves Mersch] As I said, Luxembourg's impact at international level, and particularly in Europe, was a constant factor in the political motivation of Pierre Werner; the same can also be said of his successors. The SES project was intended to promote Europe's emerging identity throughout the world. If that identity began to take shape in Luxembourg, so much the better! That was his aim.

[Elena Danescu] After his retirement from politics, given his international prestige, do you know whether he was co-opted to government deliberations on the long-term development of international relations or on long-term strategic projects?

[Yves Mersch] A former prime minister, above all a former prime minister of Pierre Werner's stature, is sure to be consulted. As I said earlier, I met with him from time to time for an exchange of ideas, either at his initiative or at the initiative of the government. At the level of his own political party, he continued to give advice, which was only to be expected. He was frequently invited to speak at international level and occasionally called me to discuss his speeches. He was regularly involved in discussions on the monetary aspects of European integration, for example the talks on the ECU held in Lyon. He was often accompanied at that time by a very young man called Luc Frieden. As I was also invited to those monetary discussions, which were convened, by the way, at the initiative of Raymond Barre once again, we saw each other at that level too, for talks on European monetary construction, which consisted in an exchange of ideas between people who

were still involved in day-to-day decision-making and others, like Raymond Barre and Pierre Werner, whose greater detachment added depth to the discussions. Yes, he continued to take a very strong interest in the matter.

[Elena Danescu] As you said, you had a great deal of contact with Pierre Werner during the last years of his life. Following his death in 2002 you founded the Pierre Werner Lecture, which has been delivered by eminent European and international economists and thinkers, and, thanks to your initiative, the European Central Bank's new building bears his name. What was Pierre Werner like as a man, and what are your strongest personal memories?

[Yves Mersch] I'll answer the second question to shed light on the first. When I held in my hands the first banknotes printed in euros, my first visit was to Pierre Werner. As I told you, he had suffered a serious health setback. But when he saw the five hundred euro note I presented to him, he took my hand and squeezed it. He had tears in his eyes. For me, that was proof that he still understood what was happening, and I was happy that he had been able to witness the physical issue of notes in euros. And that he was very glad that I was as strongly attached to his way of thinking as he was himself. For me — he was, of course, my father's age, and they were at school together, by the way — he was also in a way my mentor, from whom I learnt a great deal. As I said at the outset, he was a man of moderation, a unifier, but also a visionary able to unite people behind him and forge ahead — a man not concerned only with the very short term. What impressed me most of all was that, beyond the horizon of the next election, he kept his eyes fixed on the medium and long term. He had a great concern for his country, but also for his country as part of the Europe in which he believed so strongly — like many people who lived through the Second World War.

II. The Werner Plan, the Delors Plan and monetary Europe

[Elena Danescu] What did the Werner Plan mean to you as a young Luxembourg student, and how was it received in Luxembourg and in the French academic circles in which you moved at the time?

[Yves Mersch] What meant most to me was its significance for progress in the integration of Europe. I had a strongly pro-European upbringing. For me, the Werner Plan represented a further stage in reconciling the peoples of Europe and bringing them closer together, which was the essence of the European project. That was an idea which my father, who had been in the Resistance, had inculcated in me throughout my youth. Secondly, I saw the plan as supplementing what had been done in the work leading to the Treaty of Rome, since at that time only a few short sentences had been devoted to monetary issues, not even a whole article. The Treaty of Rome simply said that monetary matters were to be treated as a common interest. It turned out, however, that currency was an additional instrument of economic policy and was becoming increasingly important. And since, as part of my studies, I was also taking courses at the Institut des études communautaires in Paris, which was then headed by Professor Teitgen but was also fortunate to have European economics taught by Professor Raymond Barre, a former prime minister and former member of the Commission, I followed these events very closely.

[Elena Danescu] In the thinking that followed the period of monetary tension, the Werner Plan was a source of inspiration for European monetary integration. Proposals such as the Spierenburg Plan, the Tindemans Plan and the Report of Lord Cromer's Group were put forward. After the Werner Plan was abandoned, do you know whom Pierre Werner saw as his successor on monetary issues?

[Yves Mersch] On that point, I have to say I don't believe he thought of European integration as something attached to a person, or that the monetary torch had to be taken up by someone else. I believe he was deeply convinced that the dynamics of European integration were primarily rooted in a fundamental understanding between France and Germany which would ultimately be translated into political action, and that the role of the smaller countries was to help the larger countries implement the ideas on which they had reached agreement. So I would say that, after the Werner Plan was put on hold, we should pay tribute to the efforts of Chancellor Schmidt and President Giscard d'Estaing to maintain the monetary aspect as a vector of European policy. However, they thought more in intergovernmental terms, whereas the Werner Plan was a Community initiative, which was why it was particularly helpful when there was something of a return to the Community approach after the 1985 summit meeting, in Hanover, I think (or was it Bremen? A city in northern Germany, anyway), and the idea of European monetary construction was relaunched. It was there, following the introduction of a first paragraph in the minutes of the European Council meeting in Luxembourg, chaired by Jacques Santer in 1985, I think — the summit meeting in Germany took place a year later — that the European monetary dimension was reconfirmed at the highest level by all the Heads of State or Government of the Community, and not just as the endorsement of an agreement drafted by France and Germany.

[Elena Danescu] In April 1989 the Delors Report set out the stages and measures to be adopted for the introduction of a single currency by 1999 at the latest. To prepare for the creation of a European system of central banks, a monetary institute was established. In 1990 Pierre Werner wrote that there were no fundamental differences of doctrine or method between the Werner Plan and the Delors Plan. Do you agree with that, and what are the common points and areas of divergence between the two plans?

[Yves Mersch] In broad outline, it is fair to say, as he observed, that the aim and stage-by-stage methodology were shared by both plans. What they had in common, as I said earlier, was the Community approach. By that I mean involving all the countries in the deliberations rather than adopting the method of intergovernmental arrangements between the large countries — if I may make that small distinction with reference to the methods adopted in the case of the EMS and, on the other hand, the Werner Plan and the Delors Plan. But there were also some differences, due perhaps to the distance of twenty years that separated them. What probably also contributed to their similarity was that, in certain cases, the same individuals were still involved. Don't forget that, on the German side, one of the youngest members of the Werner Committee was Tietmeyer, and in the 1980s Tietmeyer had, by way of the Ministry of Economic Affairs and the Ministry of Finance, already become Germany's representative on the European Monetary Committee. Others, too — I recall that a Netherlands representative who had taken part in the discussions in the 1960s was still a member of the Monetary Committee, at least in the early 1980s. So there was, so to speak, some continuity in the technocratic superstructure. The main difference, however, was that the Delors Plan was not drafted by politicians — bearing in mind that the committee was not chaired by a directly elected politician — but was drawn up by representatives, and that the governors of the central banks were much more closely involved from the outset, which was less true in the case of the Werner Plan. The aim was to allow the central bankers to play a much more important role. There is also the fact that Jacques Delors was a particularly influential figure and particularly capable of carrying on from what Mr Werner had achieved under his own chairmanship. But the real reason why the Werner Plan fell through and the Delors Plan did not had to do with international monetary relations. The Werner Plan did not fail in Europe: the Werner Plan failed because of the collapse of the Bretton Woods system, on the one hand, and the onset of the first oil crisis; and the ten years during which the monetary issue marked time — I would say from 1975 to

1985 — were characterised by different responses to that crisis on the part of individual states. On the one hand, there were the countries that wanted to finance the crisis, as I said, and on the other, the countries which were convinced that what was needed was to adjust economies to the crisis. It was only when this parenthesis was closed, when France and Germany were once again looking in the same economic direction, with the abolition of excessive deficits, and were convinced that budget deficits did not create sustainable growth and that, vis-à-vis the rest of the world and above all the United States, Europe had to close ranks in monetary matters to better withstand the effects of a crisis; it was only when that foundation stone of economic consensus had been put back in place, after President Mitterrand changed the course of his economic policy in 1984, mainly at the insistence of his Finance Minister, Jacques Delors, that in 1985 Germany once again agreed to think in terms of a European economic and monetary capability; and it was that foundation stone of consensus, plus the trust which Delors had gained in Germany by reformulating French economic policy, which made progress possible. I have to say, however, that progress was very slow: it was after the Delors Committee, and a number of other stages remained to get through.

III. The role of Luxembourg and Luxembourgers in European integration. National interests and common interests at stake

[Elena Danescu] What is your feeling about how the European Monetary System functioned in the 1980s and what, in your opinion, triggered the effective practical steps taken towards economic and monetary union — the Franco-German motor, or were there other factors involved?

[Yves Mersch] I would say that the successive devaluations created an awareness of the devastating effect of the absence of monetary coordination in Europe and a realisation that you could do away with all the customs barriers but as long as there were barriers between currencies it was impossible to achieve a single market. As a young civil servant I was able to follow the first devaluations that took place within the snake. We followed the snake in the tunnel, then in the European Monetary System, and let me tell you that, as a member of the Monetary Committee, I spent many nights and weekends on the successive revaluations, devaluations and monetary adjustments, which manifestly did nothing but endanger the functioning of the whole of Europe. You mustn't forget that even the agricultural market was threatened by the devaluations and monetary movements, and it was therefore absolutely necessary to escape from the monetary chaos we had got ourselves into with a system of floating exchange rates. The European Community and the Treaty of Rome had been established in an environment of fixed exchange rates, so Europe was unable to adjust right away to the new international paradigm of floating exchange rates and could not find an immediate response. And that lack of response put the whole European integration process at risk. That was the main reason why the largest countries, those most directly concerned, realised that it was necessary to clamp down on monetary movements, otherwise the whole Community *acquis* was in danger. But a clamp-down required a common vision and, as I said, visions differed greatly at certain times. I recall participating in working groups in which the option of a planned economy in Europe was discussed quite openly — as well as budgetary and economic 'fine tuning' — and it was held that administrative decisions could not only correct market forces — as we do today — but replace them. At that time Europe was very close to choosing a different path from that of a market economy. It was only when a consensus again emerged in favour of a market economy — a social market economy, of course — that the idea of completing economic integration by adding a monetary component could be taken up again.

[Elena Danescu] In 1989 you were Director of the Treasury, and you were appointed personal representative of the Minister for Finance in the negotiations on the Treaty of Maastricht. How did

that appointment come about, and what were your areas of responsibility?

[Yves Mersch] Let me say that as soon as I got back from Washington — shortly afterwards — Pierre Werner appointed me to the Monetary Committee of the European Communities, first as assistant to the Director of the Treasury at the time, and then as Director of the Treasury, the latter normally being a member of the Monetary Committee. Having been appointed a member of the Monetary Committee, I took part in all the talks on economic and monetary policy held at the level of Heads of State or Government. I attended all the summit meetings from, I would say, 1984 or 1985 to 1999. I took part in all the meetings of finance ministers, both formal and informal. I was also the government's representative in the Guigou Group, which, following the Delors Report, worked on certain issues that were considered more political. The interesting thing is that half the members of the Guigou Group were finance representatives while the other half came from foreign affairs, so you can see that the issues were considered as much political as economic. When I was appointed Director of the Treasury in 1989, I was quite naturally also appointed as the Ministry of Finance's representative in the negotiations, which had been largely prepared by the Monetary Committee. For me the great thing was the prospect of the Luxembourg Presidency, which was to begin in 1991 and was to initiate the negotiations leading to the Treaty of Maastricht. I personally drafted the first articles of the treaty by hand, after the meetings, at the weekend or in the evening, in my own home. Of course, those preliminary drafts were then shared with others. I had a small working group of half a dozen people with whom I met regularly. But the fact remains that the first Treaty of Maastricht, the first draft, was ready by the end of the Luxembourg Presidency. The Dutch Presidency that followed honed the text and strove to bring matters to a successful conclusion, which it managed to do after more lengthy deliberations. As Director of the Treasury, monetary relations, financial relations, were my main concern. But I was also responsible for state financial investment and the other national aspects of that office.

[Elena Danescu] You have talked about your involvement in the negotiations and then in the drafting of parts of the Maastricht Treaty. What were the specific interests, the vital interests defended by the Grand Duchy of Luxembourg in those negotiations?

[Yves Mersch] I would say that the role of a small country is not to lose sight of the final aim. Because the interest of the smaller countries lies in progress in European integration. Obviously, a small country has fewer vital national interests to defend and, in any case, our role in European integration is to serve as a link between the large countries. So that was the main aim. We did, of course, have a certain number of interests to defend — interests which I would describe as matters of principle. It was a matter of principle for us to preserve the free movement of capital, which is so important for our continuation as an important international financial centre. That also meant defending the principle of a market economy unimpeded by administrative decisions. I recall that at the time, within the Guigou Group, there was already a move to impose the principle of a single tax. I fought to have the word tax changed to compulsory levy, which includes social security, since the difficulties resulting from Europe's ageing population were already becoming apparent at the time. Difficulties connected with demography also came under the compulsory levy. So the issue was broadened somewhat, though subsequently submerged. That's just a little anecdote — it wasn't a big discussion — simply to show you that, from time to time, Luxembourg also has a special interest to defend. But that should never take precedence over the common interest, because in Community affairs Luxembourg has always played the role of honest broker, and you can't be an honest broker if you have too many special interests to defend.

[Elena Danescu] In the numerous negotiations, political discussions and think tanks in which you

took part, what were the most sensitive issues and the moments of greatest tension, particularly with regard to the Intergovernmental Conference on Economic and Monetary Union? I have in mind the debate about the independence of the European Central Bank and Ecofin as a *sui generis* government.

[Yves Mersch] Well, I would say the statutes and role of the European Central Bank were not the subject of deep disagreement. I think it was above all the British who had reservations at the time and argued for the primacy of politics over independence. But the main protagonists agreed that the final objective was a statute similar to that of the German Central Bank. So I don't think that gave rise to tensions that risked ... or left a strong impression. Yes, the issue of economic government was discussed, and perhaps at the time we were happy with a 'light' arrangement that in hindsight seems to have been too light. It is clear today that we are agreed on the need to strengthen economic government. But economic government doesn't mean a counterweight to the European Central Bank. It means preventing divergences arising between the different economies. How can you pursue a single monetary policy if you have diverging rather than converging economic policies? Perhaps we were too inclined to believe that market forces would compel governments to pursue converging policies, and that didn't happen. The point of divergence, I would say, mainly concerned the issue of intervention. In France, for example, industrial policy is part of the political culture. In Germany the term 'industrial policy' is disliked: it is equated with interventionism, state control, etc. So in my view the divergences were primarily historical differences between countries, and concessions or compromises had to be found in order to arrive at a single text. That's why some people say it was a bad treaty, from a purist point of view. And that's probably very true. But it was a treaty between nations, a treaty full of compromises and wordings that helped to surmount temporary difficulties but failed to resolve the fundamental differences. In the final analysis, a monetary union is bound to be imperfect unless it is accompanied by greater political union. There was no readiness for political union, so that left all the risks of a monetary union unaccompanied by steps towards greater political governance — albeit perhaps in other areas — that would have strengthened and cemented solidarity among nations. A currency, as President Trichet likes to put it, is a community of fate. It is solidarity of fate. With a single currency, either we all stand together or we sink together. So far, the ten years of the single currency show that it has indeed acted as a cement between nations, and the latest decisions prove that once again.

[Elena Danescu] What is your assessment of the role of the Grand Duchy of Luxembourg in European integration and, more specifically, in the process of economic and monetary integration?

[Yves Mersch] You are asking me to say nice things about my own country, which I'm always happy to do. But I prefer to let foreigners talk about the very important role which I believe Luxembourg representatives have always played in the integration of Europe, especially in economic and monetary affairs. We began by discussing Pierre Werner, and he was succeeded by a line of distinguished figures who have worked on the European integration in that field. Look at the number of eminent Luxembourgers who have held high office at European level, in the European institutions. That is to some extent a recognition of the important part played by people from this country in European integration, especially where economic and monetary aspects are concerned.

[Elena Danescu] You worked in the United States at the Monetary Fund and the United Nations. What were the main lessons you learned from your American experience?

[Yves Mersch] On the one hand, on the economic and financial level, it was my experience in the

United States that helped me understand the functioning of a market economy purer than the one I had known in France in the 1970s. On the financial side, it also enabled me to discover the emergence of the financial phenomenon in relation to the real economy, which crystallised with the growth of the free movement of capital, which had not been widespread after the Second World War and was beginning to establish itself more and more, especially after the collapse of the international monetary system based on the gold standard and then on the dollar. So I took part in the emergence of a new paradigm in economic and financial affairs — the paradigm of floating exchange rates, which followed the paradigm of fixed exchange rates. I was thus able to gain a good knowledge both of the old system of fixed rates and the new system of floating rates. Having known both systems well is also an advantage in discussions about the future. The same applies to Paris, incidentally, where I studied planned economies in depth. That was a great help at the time when the socially managed countries, countries with centrally planned economies, were being liberated. It enabled me to be much more active in regard to those transition economies, in explaining the transition from a planned economy to a market economy. From the economic and financial viewpoint, that was the benefit I gained from my stay in the United States. In terms of governance, the most important thing for me was that, coming from a small country that perhaps already had a European outlook, it broadened my horizon and gave me a worldwide perspective. It was world governance that I experienced in economic and financial affairs at the World Bank and the International Monetary Fund, since I sat, as a backbencher obviously, on the executive boards of both those institutions. At the UN I was able to participate in world governance on a more political level, but again within an economic framework, since I dealt mainly with economic issues, especially development aid. It was the time of the discussions on the Development Decade, and during that period I was able to establish numerous contacts with national delegations taking part in the deliberations. I encountered the same people time and again throughout my career, and that also helped me realise the importance of putting Luxembourg on the world map and of maintaining numerous contacts at the level of international institutions. For a small country, that is the only way to make such contacts, since bilateral networks are much too rich and demanding of human resources that are not available to a small country like Luxembourg.

IV. The Belgium-Luxembourg partnership in monetary Europe. Agreements, tensions and clashes

[Elena Danescu] That experience was put to good use from 1981, when you became an advisor at the Ministry of Finance in charge of international financial and monetary relations. During that period of worsening iron and steel crisis and social unrest in Luxembourg, there were also severe monetary tensions in the Belgium-Luxembourg Economic Union. In the search for a lasting solution, Pierre Werner called on experts who concluded that a purely national monetary system was viable. Do you recall what medium-term measures the Luxembourg Government envisaged? And — my last question on this point — what were the international implications of that monetary crisis for Luxembourg?

[Yves Mersch] It was indeed with the onset of that crisis that I entered the inner circle, as it were, of those who prepared the decisions on the matter in Luxembourg. I was the assistant of Raymond Kirsch, who was Director of the Treasury at the time. I had my own views on economic and monetary matters, formed on the basis of the experience that I had accumulated during the few years I had spent in the United States, as well as in France. It was becoming obvious that the economic policy pursued in Belgium, which was accompanied by a single monetary policy for both countries, did not necessarily suit Luxembourg. We in Luxembourg were aware, for example, that the growing budget deficits could not continue and that a return to budgetary orthodoxy was necessary. And I must say that Mr Werner was a man particularly attached to budget equilibrium.

He was deeply convinced that a country the size of Luxembourg could not afford deficits, and that the country's independence was at stake. So he was greatly committed to reducing the growing deficits brought about by the iron and steel crisis. We therefore began talks that culminated in tripartite decisions taken jointly by the unions, the employers and government, including a decision to suspend cost-of-living indexing that resulted in a wage reduction. Wage reduction was the logical economic response to the rise in energy prices at the time. If another country levies a tax on the rest of the world, that tax cannot be financed and offset by money that has not been generated. It was a situation rather similar to what we are experiencing today. So Luxembourg implemented a general wage reduction — in other words, an internal devaluation. Meanwhile, our partner in the economic and monetary union was unable to impose the necessary internal devaluation — the responsible attitude on the part of the unions that was required in order to achieve a temporary reduction and relaunch the economy on a sounder footing with a view to stronger growth in the medium term. And so, faced with this situation, the Belgian Government carried out an external devaluation. It devalued its currency, which was the common currency. The result was, of course, to put Luxembourg in a situation of super-competitiveness, so to speak, but needlessly, since we had already effected our reduction and adjustment internally. Understandably, therefore, the situation gave rise to some discussion. The question arose for the first time — for the first time, I would say, since the Second World War — because Luxembourg had always been in a situation in which the economic and monetary policy pursued by Belgium served our interests. Until the mid-1970s, when Belgium, in response to the first oil crisis, chose to finance its deficits while Luxembourg, along with countries like Germany, the Netherlands and others too, chose to adjust. Today, 50 years on, we can see that adjustment is the only viable response to an external shock and that financing leads only to permanent structural deficits that undermine social well-being with longer-lasting effects than an adjustment at the beginning of the crisis. Prime Minister Werner was fully aware of these facts at the time — his economic thinking was what I would describe as orthodox, since it favoured adjustment — and he saw that events were leading to a situation in which Luxembourg had to pay interest rates on its currency — which was also the Belgian currency — that were higher than necessary. The high interest rates put a brake on investment and undermined the will to attract new investment to Luxembourg. The diversification policy already being promoted at the time was held back to some extent by the monetary policy which Belgium had to pursue in order to continue to attract foreign investors in its national currency. Because there was the beginning of a loss of international confidence in the currency. And that loss of confidence in the currency was also hampering the emergence of our own financial centre, even though many banks at the time did not draw up their balance sheets in national currency but in the currency of the country of origin, and despite the fact that we, that is the Werner Government, had even adopted special measures to compensate banks for currency exchange losses. So the question of monetary independence was definitely on the table, and Mr Werner gave the matter serious thought. I should mention that I myself took part in the debate, for example by publishing a book on Luxembourg's ability to have an independent currency of its own. There were, I must say, arguments for and against. In the end, the Prime Minister decided to maintain the economic and monetary union, but he did so, it seems to me, with a heavy heart, because he could see that the risks were, after all, rather high and that our preparations, both institutional and cultural, as it were — that our institutions were not prepared for such a brutal change of paradigm, and that it was better to make long-term preparations. That is why, I believe, the government ultimately maintained the union with Belgium, while deciding to make preparations for the future to cope with any recurrence of the situation.

V. The Banque centrale du Luxembourg, a new institution in the framework of EMU

[Elena Danescu] Was that when the idea of a Luxembourg monetary institute arose?

[Yves Mersch] The measures taken were, I would say, at least threefold. First, at the institutional level, we had created at least the embryo of a monetary authority. We still didn't want to call it a 'monetary authority'; we agreed on the term 'institute'. But, at least, certain persons were to be employed there to monitor monetary affairs from day to day and to participate alongside Belgian representatives in international bodies where monetary issues were discussed. Whereas, until then, such representation had been largely left to Belgium. Secondly, the monetary institute also asked banks to try to separate in their accounts receivables in Luxembourg currency from those in Belgian currency. Because one of the problems with separation was that the banks would have had huge problems with their balance sheets, because the banks weren't prepared for it either. So we tried to impose on the banks greater transparency in regard to holdings and receivables in Belgian francs and Luxembourg francs. Thirdly, the government negotiated with Belgium a doubling of the limit on the issue of currency units authorised by Belgium at the time, so that Luxembourg could issue its own banknotes. Because, in the event of separation, it would have been difficult to have the necessary banknotes available — even though certain steps had been taken, all in the greatest secrecy, to print and store old notes for distribution in the short term. So a number of measures had been envisaged, and serious consideration was given to adopting a separate policy and a separate currency at the time. There was one more factor, I believe, that prevented Mr Werner from taking the plunge. That was the European dimension. I think he always kept one eye on European integration, and he would have seen it as a step backwards on that road if the only existing monetary union in Europe were unable to continue, at a time when the resumption of European integration in the monetary field was being mooted in discussions between Chancellor Schmidt and President Giscard d'Estaing. But that was a little later, in the 1980s. At the time, therefore, we were already witnessing the emergence of a first stage — the resumption of a kind of European monetary system. But it has to be said that, with the change of administration in France and the beginning of President Mitterrand's first seven-year term, those first years also saw greater divergence in the economic thinking of France and Germany. And as long as France and Germany did not share a consensus on economic policy, there could not be any single monetary construction in Europe. That situation lasted until 1985, when a new rapprochement in economic thinking took place. By 'economic thinking' I mean 'economic adjustment', the avoidance of deficits and budget deficits, the pursuit of what we call an orthodox economic policy.

[Elena Danescu] Mr President, you have just started your third term of office as President of the Central Bank of Luxembourg. You have been a member of the Governing Council and General Council of the European Central Bank from the outset. As a participant and witness to this institutional construction, how was the Central Bank of Luxembourg established and what did it add to the institutional landscape of the Grand Duchy?

[Yves Mersch] First of all, after the first monetary mishap in the Belgium-Luxembourg Economic Union in 1982, we saw that Luxembourg could not afford to ignore monetary issues. But we thought the solution perhaps lay with Europe and, if Europe progressed fast enough, we could spare ourselves a painful and politically costly scission with Belgium. In 1991–1992, during the negotiations under the Netherlands Presidency, I asked for the inclusion in the treaty of an article stipulating that Luxembourg set up a central bank. Our central bank was thus established not by national legislation but pursuant to an obligation imposed by an international treaty. Admittedly, when our Belgian colleagues saw that article in the making, they tried to have it removed from the treaty and requested that it be deleted. The matter was referred to the higher, political level. And I have to say that the Belgian Finance Minister at the time was Philippe Maystadt, who is now President of the European Investment Bank, and he, together with Jean-Claude Juncker, said no, it was good that Luxembourg be fully represented in the future European bodies and that, if we didn't have a central bank, some people might say: 'But Belgium should represent both countries!' That was contrary to the philosophy behind the renegotiation of the Belgium-Luxembourg agreement

resulting from the talks held by Pierre Werner in the early 1980s. So that's how the Banque centrale du Luxembourg came to figure in the treaty. I should also mention that in 1993 Europe experienced strong monetary upheavals, with devaluations. When the second stage was called into question, we were torn in different directions. There were times when we asked ourselves whether we could wait until the introduction of monetary union to create a central bank. And we discussed certain measures to be taken in the event, for example, that Belgium was unable to continue functioning as a unitary state, and what the solution would be for Luxembourg, and I must say that this time we were much better prepared.

[Elena Danescu] How did this institution-building work out at national level? What were the bank's relations with the Luxembourg Government, the Ministry of Finance and Parliament, and how has the balance of the bank's various internal responsibilities evolved since then?

[Yves Mersch] I admit I had perhaps underestimated the impact of the creation of the new institution. And in Luxembourg, which had not had a central bank since 1872, many people had forgotten what the existence of a central bank implies. There were ministers who dared to suggest that the central bank could operate with a staff of three. Now, the treaty said quite clearly that decisions were to be taken at the central level, but that the implementation of decisions — the preparation of decisions, that is — and their implementation, and relations with the national banking system, were to be carried out by the national central bank. As a real bank, therefore, we must also prepare decisions, assume our responsibilities for research, etc., the issue of currency, and everything else involved in the operation of a central bank. And there was little understanding of this in Luxembourg. What is a central bank, what does it mean? Secondly, I realised that we are a country in which decision-makers, in thinking about institutions, are above all influenced by France. Which means there are strong reservations about the independence of institutions. Now, a central bank is a part of the Executive that is rendered independent of the Executive, and the counterweight should be control by Parliament or by public opinion. That is why we are frequently present in public opinion and seek contact with Parliament. But that was unknown in Luxembourg. To this day many people persist in saying: 'But you are an administration!' Well, an administration is placed under the supervision of a minister, and it is the minister who is answerable to Parliament. It took several years for this new phenomenon to be perceived and then accepted. It is, I would say, accepted by the political class today, but in the beginning the politicians said that this institution, which was critical of the government, was working for the opposition and would therefore be treated as part of the opposition. And that is what they used to do. Then, when the government and ruling coalition changed, they understood the nature of the institution but continued to be critical. It was only very gradually that they realised it had its own role to play in the country's institutional environment, and we greatly improved relations with politicians of all parties. I appear regularly before Parliament when invited and report to it, and we give numerous press conferences, always holding to our own course — that of keeping our country on the path laid out by the European Union. And that is also the best course for national policy. That is what inspires us, and it took some time to get there. It is also a fact that banking supervision constituted 90 % of the function of the Luxembourg Monetary Institute, and that six months after the creation of the central bank, banking supervision was removed from its remit. Two years ago we recovered part of the banking and liquidity supervision function, but we are still not at the point to which the international consensus has returned. This separation is rather dangerous. In the beginning it served to protect the new institution in case there should have been a bank crash or a bank in trouble, which could have undermined public confidence in the new institution. Ten years on, that argument no longer applies. Today, as opinion polls show, we enjoy much greater public confidence than most other institutions. I won't reveal the figures, but the public knows and accepts the central bank as an independent institution and appreciates, above all, its independent attitude to other institutions.

[Elena Danescu] What do you think will be done about the separation of banking sector supervision in the medium term? Is the legislation under review, or is a redistribution of responsibilities between the bank and the supervisory commission called for?

[Yves Mersch] Let me repeat, Luxembourg cannot afford to be at odds with dominant trends and with developments in other countries. If all other countries are once again strengthening the central bank's supervisory role, Luxembourg cannot stand aside and claim to be cleverer than everyone else. That applies both to indexing and to the separation of supervision. The fact remains that we sometimes take a little more time to do what we know we have to do. And sometimes, too, it can be a question of individual personalities. But I'm convinced that in the long term Luxembourg will be institutionally comparable with our large neighbours.

[Elena Danescu] The Banque centrale du Luxembourg is not a member of the Bank for International Settlements, which is a key forum for cooperation between central banks. Is that a choice on the part of the central bank?

[Yves Mersch] Certainly not. We have been seeking membership for many years. We had the possibility in the 1990s, but Belgium always claimed to represent both countries. And when both countries had a central bank, Belgium denied that it had done so: they might have said something along those lines but they had never put anything in writing. In the 1980s, I think, the monetary institute approached the BIS with a view to membership, but the institute did not push the matter hard enough. I have been trying to achieve full membership for ten years now but without success, partly because of the attitude of the world's largest economy, which believes that European countries are over-represented on international bodies and now prefers to give a voice to new countries, emerging countries and countries closer to that major world economy.

VI. The BCL and the international financial centre in Luxembourg

[Elena Danescu] At the present time you are involved in deliberations on the consolidation of the Luxembourg financial centre, which has become the foremost international centre of private banking in the euro zone, the second investment funds centre after the United States, and one of the world's ten most important financial centres. How have its pillars, the stock market and Cedel in particular, helped to promote the various stages of Economic and Monetary Union?

[Yves Mersch] Here again, I believe that the various financial players act in the interests of the Luxembourg financial centre if they pursue a policy of openness to foreign countries and promote the expansion of the continent of Europe, thus helping to include not only Luxembourg but Europe itself in the globalisation process. The two institutions you mention, the stock market and Clearstream, are major players in the international arena. In view of their contribution, they deserve that, in return, the authorities should endeavour to support the activities of two such visible and much appreciated players in the international arena.

[Elena Danescu] How do you see the future of the financial centre, especially in view of the major challenges for the preservation of gains, and what weaknesses need attention?

[Yves Mersch] The crisis will bring about profound changes to the banking system. And the banking system in Luxembourg will also change. If we want to maintain economic activity in the interests of the country, we shall have to go along with international developments. International developments are twofold. At the institutional level, new institutions are being created, for example the Systemic Risk Council which is to be established under the auspices of the central bank, with the governor of the central bank as the country's representative, in charge of macro-prudential oversight. That aspect was neglected before the crisis. Secondly, alongside the institutional developments, there is regulatory adjustment. The crisis was brought about by heedless risk-taking on the part of the banking sector. The new regulations will limit risk-taking. That means there will be less risk, but also less profit: so the financial sector will not make the same profits as in the past. And that, of course, means that it is impossible not to adjust, since certain financial institutions will see no point in pursuing activities that have ceased to be profitable. Concentration will take place, and will also affect Luxembourg's financial centre. The financial centre will therefore have to diversify its activities and concentrate on the most profitable new niches. These developments in the banking industry will require new regulations and legislation, which will increasingly have to be determined centrally at European Union level. A greater promotional effort will be needed, to which the government has also given its backing. So ten years from now the financial centre will be very different from what it is today. Quite possibly there will be fewer players. A great deal will depend on the reaction of national governments to the international system being put in place, and over-reaction may of course lead to a loss of activity in our financial centre. But an appropriate reaction may result in Luxembourg again being seen as an attractive centre for new activities. So we are at a crossroads. Political action is extremely important; not only national political action, but also the reaction of neighbouring countries. If neighbouring countries adopt the wrong measures, Luxembourg might be able to take advantage of that by adopting the right measures. Unfortunately, today it is impossible to say for sure what path will be taken. I can see possibilities for enlargement as well as the dangers of adopting the wrong measures. And I also hear proposals that would spell the end of the financial centre in the long term. Fortunately, they have not yet been implemented.

VII. The euro zone, the Stability and Growth Pact and economic governance after the Treaty of Lisbon

[Elena Danescu] Since the adoption of the Maastricht criteria, which were considered indispensable for Economic and Monetary Union, there has been recurrent debate about whether they are realistic. That also applies to the budgetary orthodoxy required by the Stability and Growth Pact, whose strict rules were relaxed in 2005 under the threat of a crisis due to the excessive deficits of Germany and France. It is known that both the agreement of 1996 and that of 2005 were reached thanks Luxembourg's mediation between Germany and France, in which you were closely involved. What points of divergence and rapprochement between the German and French positions did you have to deal with? And how has the balance of forces evolved in the present circumstances?

[Yves Mersch] Well, as I said earlier, the Maastricht Treaty was a treaty between nations that was based on compromises. It was therefore only to be expected that after the treaty was ratified some parties would try to put their own construction on it, an interpretation that was not quite the same from country to country. So the discussion continued. It soon became apparent that, in the relationship between monetary policy and the rest of economic policy, one aspect was particularly important, namely budgetary policy. In a Europe where budgets account for 40 to 50 % of gross domestic product and are therefore the most important economic factor next to the single currency, there is an absolute need to have rules on budgetary policy in order to avoid divergences that

prevent implementation of an efficient monetary policy throughout a single monetary space. If you don't have such rules, you soon get to a stage where interest rates are too high for the situation in one country and not high enough for the situation in another country. So much for the theory. And although we can quickly reach agreement on the theory, once certain countries began to succumb to deficits, we also realised that the reality of relations between nations is not the same as reality within a single nation. I mean that some brothers are bigger and more equal than others. When the stability pact was violated by the biggest brother, the one who had been the strongest advocate of budgetary orthodoxy was badly placed to defend what he had always defended. That weakness allowed those who in the past had already attributed less importance to respect for budgetary equilibrium to try to relax the rules. The rules were relaxed by the country that held the presidency at the time — that is, Luxembourg. But it also has to be said that it was under the Luxembourg Presidency that the first Stability and Growth Pact — the budgetary linchpin along with monetary union — was adopted. The talks between Chancellor Kohl and President Chirac were particularly tough at the time, but there was a mediator who was trusted by both statesmen. That was Jean-Claude Juncker, who contributed greatly to achievement of the Stability and Growth Pact. I believe it was thanks to that experience, and I was present in Dublin when he stood with Chancellor Kohl and President Chirac in a stairwell — I can still see the scene — explaining, sometimes by translating, sometimes trying to speak English to avoid translation, in order to reach agreement. So he too was in the best position to judge how far the rules had to be relaxed. They were relaxed, but now we can see it would have been better not to relax them. Now we are trying to tighten up again, but we are trying to tighten the rules because this time, perhaps, the countries in trouble carry less political weight. Now we also understand the risk to the European Union and the single currency if we don't have rules governing budgetary discipline. Let me say this: the rules are especially important for small countries. If we don't have rules, the big countries do what they like. If we have rules, they can at least be made to feel guilty if they don't obey them. They have to justify themselves to their own public opinion and to international and European public opinion above all. So it is important for Economic and Monetary Union to have rules, and we have now understood that budgetary rules alone are not enough and we have to go further. Certain states must be prevented from heading in the wrong direction and from going too far down that path. Because they have gone too far, sanctions must be imposed in the budgetary sphere, and it's a bit like an atom bomb. In the case of Germany we have seen that it is quite difficult to apply sanctions so it's better to try to take swift and stronger preventive action. And to have sanctions that are more automatic and don't require a political decision. That's the whole point of the present discussions in the working group chaired by President Van Rompuy, in which all the Member States are also taking part. The aim is to have rules that don't apply only when it is too late and the deficits are too great, but to have, in addition, a stronger preventive arrangement and try to prevent divergences arising. That means that certain states must put an end to practices that are incompatible with Economic and Monetary Union, such as, for example, wage indexing in this country. I've said it time and again: the system as we apply it today it is not compatible with price stability. We can maintain a certain degree of adjustment of wages to inflation — that's quite obvious — but the system we have here in Luxembourg is not compatible because it projects past inflation into the future. It is a perpetuation of inflationary expectations which is incompatible with the definition of price stability. All this will probably be the subject of future discussions, and I hope those discussions will result in the strengthening of all the systems involved, which is what I mean by a strengthening of economic governance. That doesn't mean opposing the central bank: it means supporting the action of the central bank in such a way that monetary policy becomes more efficient and does not have to react so strongly in order to correct certain deviations. The less monetary policy is required to react, the better it will be for the sustainable economic development of the whole euro zone.

[Elena Danescu] So will the euro support fund you mentioned earlier be an efficient instrument for improving the budgetary management of countries that seek to draw on it?

[Yves Mersch] If the fund is seen as a way of Europeanising the lax policy of national governments, then that is certainly the wrong approach. On the other hand, we have seen that, despite all possible measures, as long as the present institutional situation continues there can always be countries that stretch the limits too far and endanger the whole single currency. So I think that, alongside the International Monetary Fund, it can only be a good thing to have an instrument for emergency intervention in the event of a crisis at European level. Especially as this European fund will work closely together both with the Commission and with the European Central Bank. Let us hope it doesn't have too much work to do.

[Elena Danescu] Is it symbolic that the stabilisation fund is being established here in Luxembourg?

[Yves Mersch] I would like to think so, but I would have preferred the front-office operations to be conducted in Luxembourg rather than in France and the back-office tasks to be assigned to a European institution.

[Elena Danescu] How do you see the new role of the Eurogroup, including with respect to enlargement of the euro zone?

[Yves Mersch] I think that once all countries have complied with the European statutes which they accepted on joining the Union, they will be members of the euro zone and Ecofin will be the Eurogroup. The Eurogroup is, by definition, a transitional instrument, since all EU Member States share the aim of becoming members of the euro zone, even if there are derogations for some countries and exceptions for others. Until such time, therefore, I consider the Eurogroup as a good example of how European enlargement should not prevent other countries from moving ahead and, in some respects, as the first case of the reinforced cooperation provided for in earlier treaties. I don't want to exaggerate the opposition between the euro zone and Ecofin, but the fact remains that countries which have a common currency have a much greater obligation to cooperate than countries which keep their own currency as a national instrument — even though the treaty provides that the national instrument in question is not to be used in an interest other than that of the Union as a whole. That provision, however, does not carry any sanctions, so its value is open to question. In the case of the Eurogroup, at least, we see the emergence of economic government and, moreover, the organisation of cooperation with the independent European Central Bank, whose President and Vice-President attend all its meetings. And I would remind you that the President of the Eurogroup is invited to, even if he does not always attend, all the meetings of the European Central Bank's Governing Council.

VIII. The ECB and central bankers in the European integration process

[Elena Danescu] What do you think of the criticisms of the European Central Bank's monetary policy, particularly regarding independence, rates that are too high, and a euro that is too weak or too strong?

[Yves Mersch] I think we were established in order to ensure that our currency is stable and credible. After ten or twelve years of existence, what do we find? Our inflation rate, over ten years, is a little under two per cent. No other currency in the world has had that result. Secondly, interest

rates have never been as low in any of the countries that are members of the euro zone. Even the most orthodox countries like the Federal Republic of Germany had higher interest rates over ten years; not to mention countries that have inspired less confidence on the capital market. So I prefer to let the facts speak for themselves, but I see that despite the facts the same criticisms recur. With regard to independence, I have to say that unfortunately, at the time of the last sovereign debt crisis, the European Central Bank was once again the only institution, apart from the European Court of Justice in Luxembourg, that functioned on a federal basis. It was the European Central Bank that adopted the necessary measures to prevent a real euro crisis and it was our action that convinced the markets. The politicians also reacted, but the European Financial Stability Fund has just become operational now that the worst of the crisis is behind us.

[Elena Danescu] How would you assess the role of central bankers in the European integration process?

[Yves Mersch] In my view, the central bankers made a great contribution to the single currency since their natural prudence ensured that they would only launch a project that was viable. Because it was they who were in charge of the project. If, on the other hand, someone who is not directly responsible is asked to implement policy at a supranational level — if, I mean, the baby had been entrusted at European level to the politicians — I am not sure we would have had the same results. That, moreover, was the whole difference between the Werner Report and the Delors Report, which left a great deal of room for action by the central bankers. Now, the central bankers are not beings from another planet. If you look at the members of the Governing Council of the European Central Bank, I think you will find that a very large majority have long experience of work in national treasuries — in many cases as deputy ministers or directors of the treasury — and that almost all of them have in-depth knowledge of the European institutions because they have worked in those institutions themselves or in intergovernmental working groups. So these are not people without responsibility in terms of commitment to European integration. They are people who have a special responsibility to prevent the formation of speculative bubbles or illusions that are economically unsustainable.

[Elena Danescu] Mr President, we have come to the end of our discussion. May I thank you very much indeed for taking the time to participate in our research project. I leave the last word to you.

[Yves Mersch] I am very happy and pleased about the work you are doing. You spoke of Luxembourg's role. We are a country which is short of human resources and often preoccupied with current affairs. Which means, indirectly, that we do not allocate enough time to historical testimony. May I, therefore, thank you for initiating this project and contributing to something which in Luxembourg, unfortunately, is not always given its full measure. What you are doing is of great importance. Thank you once again.