Political Aspects of the Bundesbank: Did the German Central Bank Have the Final Say on German Monetary Union and European Monetary Union?

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As the euro area's debt and banking problems increase, so has the role Germany plays in euro area policy-making, as the European Central Bank attempts to reassure markets. Flannery Dyon provides a fascinating insight into the influence of the Bundesbank, the German Central Bank, in shaping both German and European monetary policy.

Introduction

> "There was just a moment of chaos when the D-mark took over East Germany on July 1st: a crowd of 10,000 gathered in East Berlin's Alexanderplatz and banged on the doors of Deutsche Bank, which as a publicity stunt chose to open at midnight. But the Prussian discipline prevailed. The Bundesbank had advised East Germans to save, not spend, their new notes. The East Germans obliged by drawing much less than the Bundesbank had expected. The feared spending boom was not to be."

In just a few sentences The Economist's Berlin correspondent (1990) manages to describe the mixture of excitement and apprehension that accompanied the first hours of the German Monetary Union (GMU), which was accomplished on July 1st 1990, preceding the formal German reunification that would take place on October 3rd of that same year.

The achievement of GMU was an essential step in completing formal German Reunification, which had been one of the main foreign policy goals of the Federal Republic of Germany since its creation in 1949. The East Germans also saw in the Deutsche Mark (DM) a symbol of the economic success and high standard of living West Germany had enjoyed, of which they also hoped to benefit from.

However, these hopes were equally matched by the uncertainty of unified Germany's economic future, as very little data and knowledge existed regarding the actual economic state of the German Democratic Republic (GDR), and also because there was huge debate with regards to how the 'Mark der DDR' (Mark of the GDR, or 'Ostmarks') should be converted.

As the monetary institution of the Federal Republic, and due to its independent status, the Bundesbank ('Federal Bank') played a key role in determining the modalities of GMU and in managing the monetary consequences. However, reunification also had international effects - the DM was tied to the European Monetary System (EMS) and Germany had been part of the project for a European Monetary Union (EMU).

The Bundesbank has always been driven to protect both price stability and its independence - two of its main characteristics -; and in order to do so it has played a political game with the federal government by using its influence on the German public and its international reputation to determine key aspects of both GMU and later on EMU. This was at times a risky game, as the independent status of the Bundesbank is determined by an all too revocable law - and modifications to this status have almost been ratified by both the Bundesrat ('Federal Council') and the Bundestag ('Federal Parliament'). We are interested in discussing the role the Bundesbank played in both GMU and EMU and how its philosophy and its Stabilitätskultur ('culture of stability') determined the modalities of these two unprecedented events. It is a remarkable occurrence that a Central Bank should exert such influence outside of its own realm of expertise, which is why we argue that the political dimension of the Bundesbank is what protected its Stabilitätskultur.

The Emergence of the Bundesbank and its Monetary Thought

Knowledge of the historical context is paramount to understanding the genesis and philosophy behind the Bundesbank's policies. In its official publication on its scope of tasks, legal framework and history ('Die deutsche Bundesbank: Aufgabenfelder, rechtlicher Rahmen, Geschichte'), the Bundesbank goes back extensively on the monetary institutions that preceded it.

Germany's monetary institution has been known as the Bundesbank since 1957 and has been the sole monetary policy agent in the Federal Republic of Germany (FRG) since then. However, the Reichsbank ('Imperial Bank') – the monetary institution from 1871 to 1945 – had a profound impact on monetary thought in Germany. Its board members were appointed by the Kaiser ('Emperor'), and later the Reichspräsident, so that it was not independent.

During the first half of the 20th century, Germany experienced two world wars, hyperinflation, high unemployment, devastation, fascism, and loss of sovereignty. Inflation is associated with those disastrous events, and that is why the law giving the Bundesbank its purpose speaks of protecting the currency. Indeed central bank independence means that monetary policies are not subject to a time-consistency problem.

In 1945, as the Americans administrated a quarter of post-WWII Germany, they were confronted with the volatility and weakness of the Reichsmark, thus initiating the Währungsreform ('currency reform') of 1948, which then spread to the zones administrated by the UK and France. Within each federal state a Landeszentralbank ('state central bank') was set up, and in March 1948 the Bank deutscher Länder (BdL) was created to govern them. This highly decentralized central bank resembled the Federal Reserve System. In June 1949, the DM became the official currency of what would, a few months later, become the FRG. The BdL remained subject to the directives of the Allies (excluding Russia). It was only in 1957 that the FRG founded an entirely independent central bank, the Bundesbank, and gave it one clear purpose: to protect the currency ["mit dem Ziel, die Währung zu sichern" (Bundesbank, 2006:26)]. 1957 is also the year that the Treaty of Rome was established, which founded the European Economic Community, thus a correlation link could be ascertained.

Nevertheless, the Bundesbank's independence could be challenged if the Bundesrat and the Bundestag revoked this law. This is an important element in order to understand the at times fragile relationship between the Bundesbank and the federal government.

However, since the Bundesbank has been established, the DM has been a strong, reliable and very stable currency, associated with the 'Wirtschaftswunder' ('economic miracle') of the 1950s and '60s in the minds of the German population. The stability that followed from 1957 to 1990 - with exception of the oil crises of 1973 and 1979 – sharply contrasts with the former volatility of the currency during the '20s and '30s.

The European Monetary System and the Build-up to the Reunification of 1990

Since 1949, the German federal government has been involved in two major foreign policy endeavours: the European Integration process and the 'Ostpolitik'.

The former led to participation in the EEC, the common market, and in various attempts at creating a monetary union. Although the Government was keen in asserting the FRG as part of Europe and in furthering peaceful relations with its neighbours, as well as in regaining a respectable place on the stage of world politics (Kaltenthaler, 2002), we can argue that a strong motivation for this openness to the West could have been the possibility to benefit from more trade and improve exports.

However, as talks of a European Monetary Union (EMU) surfaced throughout the 60s, the Bundesbank was strongly against it, for it involved letting go of monetary authority – and endangering price stability.

The FRG was already part of the Bretton Woods system until its collapse in 1971, which meant that the Bundesbank was struggling to keep inflation low internally whilst being tied to a fixed exchange rate system. It seemed that the Bundesbank did not want to take part in another fixed exchange rate system, whereas this was what the European integration process seemed to tend towards.

At this point we can identify two coalitions: a 'foreign policy coalition' and a 'monetary stability coalition'. The foreign policy coalition, which is made up of the Chancellery and the Foreign Ministry, pushes towards more European integration, whereas the monetary stability coalition, which safeguards the stability of the DM, is led by the Bundesbank and the Finance Ministry (Kaltenhalter, 2002).

In a sense they can both be thought of as lobbies, so the Bundesbank shaped negotiations and influenced decisions on a European level, for it had the German public opinion on its side, and other European leaders, namely France, could not consider an EMU without the German giant. There had been a European snake before, which imploded due to the oil crisis in the '70s and the impossibility for other European institutions to follow the Bundesbank's policies and the strong DM. In 1978, another attempt at an EMU was initiated. Although negotiations between government representatives started by considering a European 'basket of currencies', so that there would be symmetry, pressure from the Bundesbank and the monetary stability coalition led the European Monetary system (EMS) launched in 1978 to have the DM act as the anchor currency. (Indeed the German Dominance Hypothesis has been proven even though it should be considered carefully (Kirchgässner and Wolters,1993; Gardner and Perraudin, 1993). The other European central banks had to ensure that their currency remained within a certain relation-value to the DM. Thus an asymmetric European fixed exchange rate system was created. "The burden of policy adjustment in the system was asymmetric; Germany led, the others had to adjust in order to follow" (Kaltenthaler, 2002:80)

While the FRG was integrating itself into the West, it was also opening itself up to the East. The second major foreign policy endeavor of the FRG was the Ostpolitik - the attempt to normalize and appease relations with the GDR. After decades of European integration and increased diplomatic relations to the east, the fall of the Berlin Wall on November 9th 1989 would not only mark the end of the cold war but also disrupt the course of German-German and German-European relations. Reunification was on the horizon, and the next logical step was German Economic and Monetary Union.

German Monetary Union and the Bundesbank's Stand

The GDR, although being the eastern block's country with the highest GDP per Capita, was a drastically different country from the FRG. Not only was its Ostmark considered to be 'funny money', with very low purchasing power, its banks offered none of the financial assets that were available in the West. So achieving monetary union meant overcoming these two challenges. Furthermore, the Bundesbank had access to very little data regarding the GDR and the unpredictability of events made the introduction of the DM in East Germany risky (Hagen, 1993).

Deciding on the conversion rate between the Ostmark and the DM was particularly problematic. Prior to GMU, East Germans could convert their Ostmarks for DMs at a 10:1 conversion rate on the black market, reflecting the vast gap between the two economies. A 1:1 parity rate would destroy all possible East German competitiveness, and the finance minister at the time, Theo Waigel, as well as the president of the Bundesbank, Karl Otto-Pöhl, warned that a hasty monetary union could lead to lasting damage to the East German economy. (Welt am Sonntag, 2004).

Regardless of this, politics took over. The Bundesbank had repeatedly managed to impose its own interests (as we've seen in the case of the EMS), but it had been able to do so because of its popularity with the German public. As Germans protested against the projected conversion rate of 2:1, they held signs saying "Wir sind ein Volk, 1:1" ('We are one people: 1:1'). The Federal Government and the Bundesbank could hardly go against the spirit of reunification, proving that both are almost equally dependent on public approval. Especially concerning savings and social benefits, one could not make disparities so blatantly obvious in such newly formed union.

Ultimately it was decided that wages and rental payments would be converted at 1:1 rate, as well as savings deposits. Other savings would be converted at a 1:1 rate but only within a certain limit (up to 2000 DM for under 14 year olds, up to 4000 DM for the people between 14 and 58 years old, and up to 6000 DM for the people over 58). The general exchange rate was set at 2:1. (Collier Jr). Although the Bundesbank regarded the conversion rates as a political success, it did declare that the 'actual favourable savings rate was 1·8:1' (2006).

These politically influenced decisions had numerous implications; mainly there was the fear that there would be a huge surge in spending in East Germany, which would lead to inflation. The large amount of capital investment in East Germany also created some inflationary pressure. The Bundesbank anticipated this, and thus rose interest rates at this time (This would, in turn, have an effect on the EMS, as we will see later.).

Aside from the monetary issues, reunification demanded huge fiscal transfers (nearly 170 billion DM in 1992 alone, see Renzsch, 1998) and necessitated the privatisation of East German companies – which proved to be problematic due to the contention of ownerships. The government could not print money in order to finance reconstruction, and the Bundesbank would of course not let it do so. The influential German labour unions put East German and West German wages on par with one another, although productivity and the ability to work in an entirely different economy were vastly different. East German companies could not compete, with wages being too high and West German products invading the market (unemployment in East Germany remains particularly high nowadays).

The Ramifications of GMU on a European Scale

The consequences of German reunification were not only internal. In 1991, R. F. Owen already feared the consequences a DM appreciation might have on the EMS, and on the possible EMU.

The rise in interest rates by the Bundesbank, the high levels of both public and private demand for capital, the fiscal expansion and the increased attractiveness of the DM as an investment currency led to an appreciation of the DM (Sinn, 1996; and Hagen, 1993). This had severe implications for the EMS. Indeed an appreciation of the DM meant that the other countries in the EMS fell under a lot of stress, even more so than previously. If the anchor currency in a fixed exchange rate regime appreciates, the other currencies have to resist devaluation pressure and artificially increase interest rates and forgo economic growth (Sinn, 1996).

> "The rise in the German interest rate had important consequences for Europe, as it led to a crisis in the European Exchange Rate mechanism (ERM) that preceded European Monetary Union. The higher German interest rate meant that the Deutschmark required a revaluation with the ERM, or equivalently, the devaluation of other ERM currencies. France and other countries attempted to maintain the existing exchange rates, fearful of a loss of deflationary credibility. But in 1992 speculative attacks forced several countries to devalue, while the United Kingdom and Italy left the ERM."
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> (Hunt, 2006:15)

This is what happened in France, for example (Kaltenthaler, 2002). Many could not keep up and had to exit the system and devalue their currencies. On Black Wednesday, 16 September 1992, the UK pound devalued, followed by the Italian lira. Even though the Bundesbank had previously offered to revalue the DM within the system, a political decision of defending the existing rates (Sinn, 1996) meant that there was no stopping the capital flows, thus leading to the breakdown of the system.

WThe asymmetry in the system had been the source of frustration for all participants, especially France. The Franco-German duo that seemed to have led the European integration process was put under strain due to the EMS, which was exacerbated by the German Reunification. A unified Germany could mean a further delay in talks of a symmetrical EMU. But the French were one of the four initial administrators of defeated Germany in 1945 – and still had some hold over German politics, and especially German borders. Their participation, as well as the USA's, the UK's and Russia's, was needed in order to finalize German unity. Article 7 of the Two-plus-Four Treaty clearly states:

> "(1) The French republic, the Union of Soviet Socialist Republics, the United Kingdom of Great Britain and Northern Ireland and the United States of America hereby terminate their rights and responsibilities relating to Berlin and to Germany as a whole. As a result, the corresponding, related quadripartite agreements, decisions and practices are terminated and all related Four Powers institutions are

> dissolved.
> (2)The united Germany shall have accordingly full sovereignty over its internal and external affairs."

The French threat of withholding this signature was to a certain extent what precipitated the intergovernmental conference on EMU (Sinn, 1996), as though, in a way, EMU had been bargained against German unity. There was also a belief that German unity could be more easily accomplished within an integrated Europe.

All these events precipitated EMU, and while it was the government that signed the official documents, the Bundesbank would not easily forgo its authority over price stability in Germany. An EMU could not exist without Germany, and the German public was siding with the Bundesbank. The government had to negotiate according to the terms the Bundesbank requested. They needed a guarantee that an EMU would not be influenced by the inflationary tendencies of other European countries, and so that the European Central Bank (ECB) remained independent.

> "The Kohl government faced a Bundesbank and Finance Ministry committed to shaping EMU according to their preferences. That meant an EMU that first and foremost had price stability as its goal. The best way to accomplish this was to replicate the institutions of the Bundesbank and its price stability at the European level. The Bundesbank's position was backed by the banking and industry organizations that also wanted to avoid EMU becoming a way to reinflate Europe. The Bundesbank had German public opinion on its side, which feared that EMU would replace the strong Deutschmark with a new weaker European currency. This meant that in the IGC negotiations, the German representatives pushed for and achieved an EMU which conformed, to a very large extent, to the Bundesbank and its allies' institutional preferences"
>
> (Kaltenthaler, 2002:81)

There is a vast array of literature that compares the Bundesbank and the actual ECB (notably Debrun, 2001; and Chortareas, 2003), pointing towards the fact that both institutions not only resemble each other, but are in fact 'related'.
A counter-argument to the possibility of board members being influenced by their respective governments is the theory of a 'trickle down' effect, in which the independent status of the ECB seeps down to the national central banks,

making them adverse to influence from their government (The Economist, 7-13 July, 1990).

Because we have observed the ways in which the Bundesbank influenced the EMU negotiations, the convergence criteria for EMU and the design of the ECB seem to be more logical. The convergence criteria to achieve before the actual EMU as laid out in article 109j of the Maastricht treaty were as follows:

> "- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
>
> - the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6);
>
> - the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
>
> - the durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in the long-term interest rate levels."

These criteria almost all seem suited to the German economy and the objectives of the Bundesbank. However, it could be argued that as the exchange rates were fixed and the conversion to the Euro occurred in 1998, the DM was still suffering from the after effects of German unification (Sinn, 1996). After the creation of the Maastricht Treaty, which also laid out the mission and statute of the ECB, there was a fear amongst the monetary stability coalition in Germany that because other countries had a tendency for budget deficits, a future bail-out would be needed from the ECB; which is why the Bundesbank, along with the then finance minister, Theo Waigel, pressured the federal government into presenting the project for the Growth and Stability Pact, which was implemented in 1997. This event resonates with our current financial crisis, as the role of the ECB has come under scrutiny, and many have wondered whether it would become a lender of last resort.

Conclusion

By exploring the singular position and philosophy behind the Bundesbank's policies, we have in turn highlighted the political aspect of this institution. This political dimension has affected many decisions that were made with regards to GMU and EMU. We also indicated the similarities between the Bundesbank and the ECB, which could lead us to question whether the ECB has also had to manoeuvre the political environment it is in to defend its policies.

Moreover, we can also see that cultural and historical traumas affect economic thoughts and convictions profoundly, and monetary policy has not been sheltered from either politics or cultural specificities.

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