

HOW STRONG WAS THE BUNDESBANK?

A CASE STUDY IN THE POLICY-MAKING OF
GERMAN AND EUROPEAN MONETARY UNION

MARTIN KARL GEORG HEIPERTZ

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Abstract

The orthodox view of the role of Germany's central bank during the last decade of the previous century is one of a strategic defeat against the political forces that pushed for monetary union in Germany in 1990 and in the entire European Union less than two years later. Being overpowered in the first instance, commentators see the Bundesbank as weakened and doomed to fail in the big struggle over EMU. That view is wrong. It is based on false assumptions that have been created in the press and that have been uncritically received by an, at times, less-than-vigilant academic world. The chief misunderstanding was to assert outright opposition to both projects on behalf of the Bundesbank in the first place, thereby misrepresenting the competences, interests and role of a central bank even as strong and independent as the Bundesbank was. By attempting to reveal its real intentions and positions, the author wants to show that the ECB's model actually achieved almost all of its aims in this critical period for the future of Europe's monetary constitution, our present today.

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1. Introduction

A very common view of the strength and role of Germany's central bank during the last decade asserts that it was not as strong and independent an institution as hitherto thought. The alleged resistance of the Bundesbank to German Economic, Monetary and Social Union (GEMSU) and European Monetary Union (EMU) supposedly supports this view. Many commentators, particularly in the United Kingdom, leave no doubt that the Bundesbank was fundamentally opposed to both of these projects. David Marsh (a leading commentator on the Bundesbank) wrote in 1992 that 'the project (of EMU) is the object of intense Bundesbank distaste' and that the Bundesbank 'during the 1990s ... (was) fighting for survival.'¹

Marsh and other journalists created a tale of resistance and defeat, which prompted the Bundesbank to respond: 'Several press articles have recently created the impression that the Bundesbank has been insufficiently involved in the negotiations over the state treaty with the GDR.'² An example of the articles referred to are remarks on the 'world-wide insecurity and re-evaluation with respect to the ... independence of the Deutsche Bundesbank' under the title 'damage to the Bundesbank image', arguing that it had been a 'de-mystification' and a 'shock to see how the Bundesbank has been disciplined by the government from one day to the other'.³ Another article read 'guardians of the currency are annoyed at attacks by rumour-kitchen in London' and quoted the Bundesbank declaring that 'it is absurd and completely untenable what is being made of this in London once again',⁴ referring to a speculation about German interest rates and a possible resignation of

¹ D. Marsh. *The Bundesbank. The Bank that Rules Europe* (London: William Heinemann Ltd, 1992), p. 13 and p. 27.

² Deutsche Bundesbank, Pressenotiz, Frankfurt, 31 May 1990.

³ K.C. Engelen, 'Das Bundesbank-Image hat Einen Knacks Bekommen' in *Handelsblatt*, 28 February 1990.

⁴ *Handelsblatt*, 2 March 1990.

Bundesbank President Pöhl. The article continues that ‘President Pöhl has given up his resistance against monetary union surprisingly fast.’ As a result of the misleading press coverage, Pöhl regretted that a ‘wrong image’ of the Bundesbank had been projected in public.⁵

From journalism, the saga spread into academia. Ellen Kennedy, for example, writes about the Bundesbank’s ‘apparent loss to the federal government in February 1990 over monetary union’⁶, Heidrun Abromeit mentions how Chancellor Kohl overruled the Bundesbank⁷ and Ian Derbyshire declares that ‘considerable pressure had been exerted upon the Bundesbank by Chancellor Kohl, including the veiled threat ... to overturn its independence.’⁸

The argument sounds plausible and contains some truth at its core, which is that the Bundesbank continuously voiced concern about the inflationary risks involved in both projects and that it put its weight behind a solution that would minimise these dangers. Its constructive criticism, however, has been misrepresented as outright opposition. This shows a serious misunderstanding of the powers, interests and role of the Bundesbank. The argument derives its conclusion of a weak Bundesbank from the assumptions that Germany’s central bank was fundamentally opposed to both projects and that its original institutional strength would have implied the power to prevent them. I aim to present the actual positions and preferences of the Bundesbank and the extent to which it succeeded in implementing these. This will show that the assumptions are false and the argument therefore lacking in soundness.

2. The Institution

Central banking is practical in that it teaches how to use a power of influencing events.

Sir Ralph Hawtrey, *The Art of Central Banking* (1932)

The Deutsche Bundesbank was founded in 1957 as West Germany’s central bank. Judged by the goal of financial stability and low inflation, it was one of the most successful central banks in the world and as such enjoyed highest esteem internationally and at home. Under its auspices, the

5 Minutes of Bundesbank meeting, 31 May 1990, quoted in D. Marsh, op. cit., p. 219.

6 E. Kennedy, *The Bundesbank. Germany's Central Bank in the International Monetary System* (London: Pinter Publishers Ltd, 1991), p. 109.

7 H. Abromeit, ‘The Chancellor and Organised Interests, in S. Padget’ (ed.), *Adenauer to Kohl. The Development of the German Chancellorship* (London: C. Hirst & Co. Ltd., 1994), p. 175.

8 I. Derbyshire, *Politics in Germany. From Division to Unification* (Edinburgh: W & R Chambers Ltd, 1991), p. 160.

Deutsche Mark (DM) became a symbol for stability and economic success, rose to the rank of the world's second reserve currency and represented the benchmark for currencies in Western Europe.

Studying the Bundesbank is particularly insightful for the political culture of the Federal Republic; it shows how institutions structure the terms of deals they strike among each other in a way that gives them maximum leverage to influence the outcome in their favour. The way in which the Bundesbank was able not to prevent but rather to influence the outcome of GEMSU and EMU shows not only its strength as an institution but gives an excellent demonstration of how policy is made in the Federal Republic of Germany.

2.1 Legal Framework

Germany's constitution, the *Grundgesetz*, simply states in section 88: 'The Federal Government shall establish a central bank and bank of issue as a federal bank.' The Bundesbank was founded with the enactment of the Bundesbank Act, which was passed as an ordinary law. This means that its provisions could be altered by a political majority any day and were safeguarded in the end only by the continued support of public opinion, which made it dangerous but not impossible for the government to act against the central bank.

2.1.1 A Creature of the *Rechtsstaat*

The Federal Republic defines itself as a state under the rule of law. An example for the way in which it regulates its practices in legal terms was by binding the central bank to operate in a quasi-constitutional manner. The norm of monetary stability represented a prescribed principle; the legal context was its normative order. Bundesbank structure and autonomy were the main components of this legal environment, which also provided the justification for its actions. Any debate about the institution and its decisions arose over the appropriateness of the means to achieve its end, not over the stipulations of the law.

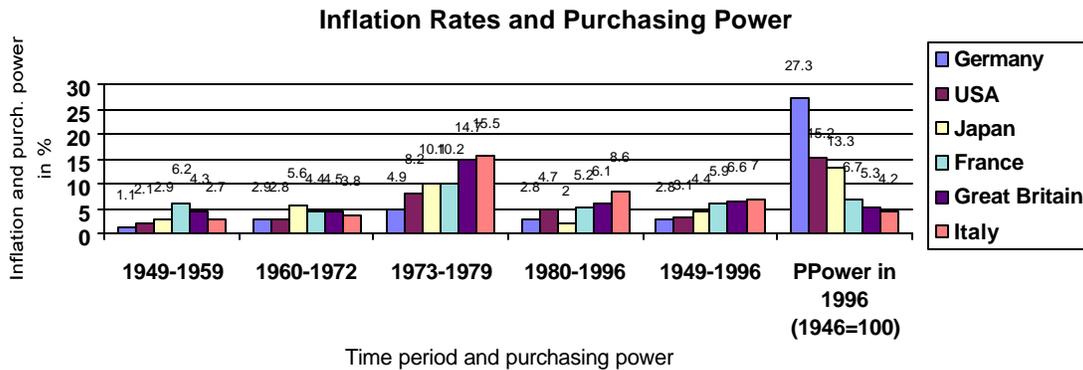
2.1.2 *Stabilitätspolitik* as Means and End

After two bouts of hyperinflation, the Germans developed a common aversion against even low levels of inflation. This *Stabilitätskultur* in combination with central bank autonomy made the pursuit of inflationary economic policies almost impossible. The legal mandate, in section 3 of the Bundesbank Act, read: 'The Deutsche Bundesbank regulates the amount of money in circulation and

of credit supplied to the economy using the monetary powers conferred on it by this Act *with the aim of safeguarding the currency...*⁹

‘Safeguarding the currency’ is clearly not the same as ‘stability’, and the stability of an economy is usually not equated with zero inflation, but the Bundesbank consistently interpreted its task to imply a crusade against inflation. It has never accepted a trade-off between inflation and other goals of macroeconomic policy but saw sound money as the precondition for low unemployment, stable growth and balanced trade. Helmut Schlesinger, then Vice-President, declared forty years after the introduction of the DM: ‘The Bundesbank (takes) steps to help the economy when it (can) do so without endangering the value of money.’¹⁰ The bank stressed the redistributive nature of inflation in eroding the value of private savings and, correspondingly, the publicly beneficial equity aspect of low inflation.¹¹ Germany’s rate of inflation is comparatively low, which implies a relatively moderate erosion of the DM’s purchasing power since 1946.

Figure 1. International Comparison.



Source: Deutsche Bundesbank, quoted in Deutsche Bundesbank, Fünfzig Jahre Deutsche Mark. Notenbank und Wahrung in Deutschland seit 1948, (Munchen: Beck, 1998), p.311.

There is widespread consensus that the German stability record is at least partially attributable to the Bundesbank. The manner in which it autonomously interpreted its legal mandate of ‘safeguarding the currency’ as fighting inflation was quasi-judicial and similar to the way in which a court interprets the law. Its consistency and success in doing so were the results of independence and power.

⁹ Italics by author.

¹⁰ H. Schlesinger, ‘Kontinuitat in den Zielen, Wandel in den Methoden’, in W. Filc, L. Hubl and R. Pohl (eds.), *Herausforderungen der Wirtschaftspolitik* (Berlin: Duncker und Humboldt, 1988), p. 73.

2.1.3 Independence and Power

The Bundesbank was exclusively responsible for monetary policy, free from government instructions, autonomous over its budget and legally prohibited to extend credit to the government. Its independence, combined with the support of public opinion, gave the Bundesbank the power to resist pressure from the government or other political forces in the pursuit of what it held to be the appropriate monetary policy.

Asked about the real source of Bundesbank power, former President Pöhl referred to Stalin's ironic remark, 'how many divisions has the Pope?'¹² He implied that the ultimate resource was its reputation and standing with the public, not the provisions of a federal law.

2.1.4 A *lex imperfecta*

The Bundesbank Act was an incomplete law, a *lex imperfecta*, in its provisions for confrontational interaction between Bonn and Frankfurt, implying an automatic dramatisation and escalation of conflicts. This invariably used to draw in public opinion and was only to be resolved by a publicly achieved compromise or, in the extreme case, by legislation.

Based on the contested ground between government and central bank, the Bundesbank voiced its concern on matters beyond its mere monetary domain of competence and was able to extend its influence *de facto* into areas that were *de iure* not within the domain of a central bank. This pattern contributed to an exaggerated image of its true competences and the reach of its institutional power.

2.2 Games of Strategy

For the Bundesbank, 'the setting of monetary policy (was) greatly shaped by the political environment.'¹³ Former Minister of Economics Schiller described the relation between government and central bank as one where 'different roles, critical dialogue, co-operation and independence

11 H. Tietmeyer, 'The Bundesbank: Committed to Stability', in S.F. Frowen and R. Pringel (eds.), *Inside the Bundesbank* (New York: St. Martin's Press, 1998), p. 3.

12 Quoted in D. Marsh, *op. cit.*, p. 25.

13 J.B. Goodman, *Monetary Sovereignty. The Politics of Central Banking in Western Europe* (New York: Cornell University Press, 1992), p. xi.

belong together'.¹⁴ In the absence of clear-cut rules, the Bundesbank engaged in strategic interaction with other institutions in its pursuit of stability policy. This situation was characterised by roughly defined and overlapping domains of jurisdiction involving two or more institutions and political actors, each of whom tried to influence the outcome of the ensuing bargain in its favour.

2.2.1 Domains of Jurisdiction

In theory, the political leadership set general economic policy goals – in particular the course of fiscal and external economic policy – whereas all monetary issues were left to the central bank. In practice, the division of powers in Germany's economic constitution was a constant matter of struggle. Tension between loyalty and independence is reflected in the Bundesbank Act itself, which in section 12 obliges the bank to 'support the general economic policy of the Federal Government' and in section 3 simultaneously states that the central bank 'shall be independent of instructions from the Federal Government'. Despite the influence the government had over the Bundesbank in terms of nominating senior officials, attending meetings of the Central Bank Council (CBC) and suspending Bundesbank decisions for two weeks, it could not impose its monetary preferences on the central bank. Furthermore, it had to accept the way in which the Bundesbank made use of its right to be consulted on economic policy, often in the form of unasked-for advice, and it had to take into account the effects of the bank's monetary policy on its electorate. Budgetary policy and annual wage rounds were examples for the way in which the Bundesbank influenced decision-making outside its proper domain.

Together with the public sector, employers' organisations and trade unions, it was involved in a system of strategic containment of inflationary wage settlements, issuing threats and announcements before the wage bargaining process or decisions on government expenditure.¹⁵ The government in its budget decisions as well as the wage-round partners were in the position of a Stackelberg leader, taking the reaction function of the Bundesbank into account: A rise in the fiscal deficit or too high wage settlements would lead to higher interest rates in order to counter the inflationary pressure. As

14 K. Schiller, 'Speech for the Inauguration of Bundesbank President Dr. Klasen', published in *Bulletin des Presse- und Informationsamtes der Bundesregierung* (Bonn: 16 January 1970, no.7), p. 62.

15 D. Soskice, 'Wage Determination: the Changing Role of Institutions in Advanced Industrialised Countries' in *Oxford Review of Economic Policy* (1990, vol. 6., no.4), pp. 1-23.

game theory suggests, credibility is crucial for strategic announcements in sequential games. Based on prior performance and a history of consistently implementing announced strategies, the Bundesbank was a highly credible institution and hence able to set the terms of the bargain between employers and unions. According to the game theoretical model, the players in the wage bargain as well as the fiscal authorities practised restraint in the first round in anticipation of punishment interest rates in the second for imprudent settlements.

2.2.2 Bundesbank Strategy for Two Monetary Unions

Monetary union between two or more currencies is the establishment of an irreversibly fixed exchange rate, which is equivalent to and can be followed by the introduction of a common currency. The Bundesbank presided over two monetary unions, one between the Federal Republic and the former German Democratic Republic (GDR), and the other between eleven EU member states. In both cases it was concerned about the risks these decisions entailed for the stability of the DM. These concerns lead to a number of critical comments that have often been misinterpreted as full-scale opposition. However, despite its reputation for power and influence, it is a drastic exaggeration of the competences of a central bank to expect the Bundesbank to have been able to prevent rather than to influence the processes of monetary union in Germany and Europe. Its strategic aim was to ensure the continued primacy of stability policy, nothing more and nothing less. In the next chapter we investigate its role in the GEMSU process.

3. German Economic, Monetary and Social Union (GEMSU)

Our independence depends on our ability not to overstep our limits.

Helmut Schlesinger, *Bundesbank President (1992)*

GEMSU meant the comprehensive introduction of the economic and social system of the Federal Republic to the former GDR prior to political unification. It extended the DM currency area to East Germany. The political usage of an economic instrument, which is what GEMSU amounted to, naturally caused a great headache to the ‘guardians of the DM’, which was a popular synonym for the Bundesbank. But the Bundesbankers were Germans and democrats as well as central bankers. Some disliked the project and voiced their concerns about it - but they did not try to stem the flow of events. What happened during those hectic weeks was a tremendous exercise of German-style compromise-oriented bargaining, and the Bundesbank got a bargain largely on its terms.

3.1 Chronology and Implications of GEMSU

3.1.1 The DM Goes East

Box 1. Chronology of GEMSU events

- 9 November 1989: Fall of the Berlin Wall
- Worsening economic crisis in the GDR triggers public debate about monetary union
- 25 January 1990: Federal Minister of Finance Waigel and Bundesbank President Pöhl independently reject monetary union as too early
- 6 February 1990: Pöhl meets East German Central Bank Governor Kaminsky, both reject monetary union; Federal Chancellor Kohl unilaterally announces offer to negotiate on monetary union
- 7 February 1990: Federal Cabinet decides to offer monetary union to GDR
- 9 February 1990: Pöhl promises support
- 13 February 1990: West and East Germany found common commission for the preparation of GEMSU
- 18 March 1990: General Elections in the GDR
- 1 July 1990: Enactment of the State Treaty and completion of GEMSU

3.1.2 Political Implications

GEMSU was the decisive domestic step towards reunification on Western terms and understood and willed as such by the population in East Germany. The opposition movement in the GDR snowballed into a mass protest against the communist regime during October 1989. Its initially modest demands grew increasingly far-reaching, from economic and political reforms to the abandonment of the entire system and reunification.

After the fall of the Berlin Wall, Chancellor Helmut Kohl positioned himself at the head of the unity movement in both states. His decision for swift GEMSU was propelled by three factors: First, the wish to achieve political union as fast as possible, second, to counteract the urgent problem of migration and third, to win the general election in the GDR. Kohl took advantage of the hopeless economic situation in East Germany and decided to act with GEMSU when the then-Prime Minister of Baden-Württemberg, Lothar Späth, returned from a visit in the GDR on 1 February 1990, reporting to Kohl that the GDR was ‘finished’ and that party secretary and head of state Hans Modrow saw ‘no way out anymore’.¹⁶

Speedy monetary union had an important external aspect, given the perceived urgency of the international situation, which led to the fear that time was running out. There was much talk about a

¹⁶ Quoted in M. Görtemaker, *Unifying Germany 1989-1990* (New York: Macmillan Press, 1994), p. 89.

unique ‘window of opportunity’ and it was clear that the European states were only tolerating the process because they had to, even more so the Soviet Union. Quick monetary union was seen as the appropriate instrument to push the process of unification beyond the point of no return. In retrospect, signing the treaty on GEMSU, the first democratically elected GDR Prime Minister de Maizière observed that ‘monetary, economic and social union (made) the unification process irreversible.’¹⁷

The official reason for GEMSU was the urgent problem of East-West migration after the fall of the inner-German border. In early 1990, roughly 2000 persons per day permanently migrated from East to West, the trend having accelerated from the total of 344,000 citizens who left only in 1989. The severity of this problem is underlined by the fact that most of these people were highly skilled and under the age of 35 – a brain drain that upset demographic patterns in both German states. The devastating state of East German morale showed itself in the slogan ‘If the DM comes, we’ll stay here – if it doesn’t, we’ll go there’ and hours of shouting ‘DM now!’ It was generally perceived, also by the Bundesbank, that ‘if one does not offer a positive perspective to the people in the GDR, it is to be feared that migration will not only continue but rather accelerate.’¹⁸

Finally, GEMSU was crucial in winning the GDR election for Kohl’s party, the Christlich Demokratische Union (CDU). An opinion poll on 6 February 1990 predicted 59% for the Social Democratic Party (SPD), 11% for the CDU, 3% F.D.P. (Liberal Party) and 12% PDS (ex-Communist Party), another poll on 12 March 1990 showed a prospect of 44% for the SPD and left the CDU with 20%. The SPD seemed invincible not only in the GDR but also in a possibly reunified Germany thanks to its strong majority in the East. It seems no coincidence that Kohl promised a 1:1 exchange rate of East Marks into DM for private savings on the day following the gloomy election forecast. Once the electorate identified the CDU with rapid introduction of the Western currency at a favourable rate, victory was attained with 48% for the CDU-led coalition.

The decision to proceed with GEMSU was taken for political reasons and in disregard of the economic implications and the concerns voiced from the Bundesbank and independent experts. The political benefits were reaped at the cost of worsening the economic conditions of East Germany and hampering its recovery more than necessary, a trade-off that Gawel terms a *sacrificium intellectus*

17 Quoted in M. Görtemaker, op. cit., p. 153.

18 K.O. Pöhl, Bundesbank Press Conference on 9 February 1990, Frankfurt.

oeconomicae.¹⁹ It seems fair to say that ‘political opportunism ... has been the enemy of coherent economic strategy.’²⁰

3.1.3 Economic Implications

The scholarly debate on monetary union distinguishes between ‘monetarists’ who see monetary integration as a possible precursor and engine for economic and political integration and ‘crowning theorists’ who demand full economic convergence and political integration prior to or at least parallel with monetary union. A common currency in the latter view should be the ‘crown’ of the process of integration and should not be abused as an ‘economic cart before the political horse.’²¹

Most economists agree that the problems of the East German economy were caused by the shortcomings of a command economy, but that the terms of GEMSU were aggravating and its costs ‘the price of political judgements and priorities.’²² The devastating state of the GDR economy was not fully realised until unification due to the fact that the gravity of the problems had been concealed by deliberately false official statistics, according to which the GDR was the tenth largest OECD economy. However, it was clear from January 1990 onwards that the captive markets of COMECON, representing about 70% of GDR foreign trade, were about to break away. The export shock came on top of insurmountable problems with low productivity, technological backwardness, uncompetitive products, supply shortages and innumerable inefficiencies. The severe situation and the imminent collapse of the supply side in Eastern Germany contrasted with a very healthy Western economy, boasting a strong currency with low levels of inflation, a balanced budget, a high level of household saving and an expected growth of 3.75% in 1990 and even 4% for 1991.

Concerning the transition from a planned to a market economy, economists are divided between a step-by-step approach on the one side and shock therapy on the other. Shock therapy was actually applied to a varying degree in all transitional economies of the former Soviet bloc. It expressively favours the ‘creative destruction’ (Schumpeter) of the existing and unviable industrial base during a

19 E. Gawel, *Die Deutsch-deutsche Währungsunion: Verlauf und Geldpolitische Konsequenzen* (Baden-Baden: Nomos Verlagsgesellschaft, 1994), p. 37.

20 T. Lange and G. Pugh, *The Economics of German Unification* (London: Edward Elgar Publishing, 1998), p. xiv.

21 *New York Times*, 09 February 1990.

22 T. Lange and G. Pugh, op. cit., p. 8.

period of unavoidably worsening the state of the economy until external and internal investment have sufficiently picked up and support growth to regain and surpass the former level of productive capacity and hence achieve transition in a rapid, comprehensive and uncompromising way. This involves the prompt introduction of the institutions and rules of a market economy, such as a freely convertible currency, which means the rapid opening to foreign competition and investment. In contrast, the step-by-step approach sees a freely convertible currency the final step of transition.

East Germany was treated with shock therapy, which is what GEMSU was about in economic terms. The immediate introduction of the DM and the high rate of conversion implied a substantial increase in the real costs of production, above all wages, and 'creatively destroyed' all uncompetitive elements of the industrial base, amounting to nothing less than 92% of East German employment, a figure much higher than the bleakest predictions. The supply side virtually imploded within weeks, causing a contraction of economic activity with a relative magnitude that was unprecedented in modern history.

This still makes economic sense under the condition that the first phase is accompanied by large subsidies in order to ensure continued high-skill employment, thereby preventing the development of a low-wage, low-skill region. However, the attainability of this aim depends on subsequent wage constraint as the key to self-sustaining development, allowing productivity to catch up with Western standards at increasing levels of employment. The wage level in Eastern Germany was sufficiently low at only 50% of the Western standard at the time of economic union but a subsequent rush to wage equality was negotiated by West German trade unions and employer associations who cared more about preventing an area of low cost competition in East Germany than the disastrous long-term unemployment resulting from their settlements.

The Eastern currency was not convertible, black market trading occurred at roughly 10:1 against the DM, official trade being based on a 4.4:1 conversion rate. It was evident that any rate higher than 4:1 would have serious consequences for the competitiveness of East German industry. On the other hand, the higher the conversion rate, the more purchasing power would be given to recipients of financial flows and consumers with household savings, which made the conversion rate the decisive and most disputed issue. The negotiated rate for financial flows was 1:1 without prior wage-price reform, the rate for stocks was set at 2:1 with 1:1 allowances for small private savings. The resulting composite rate was an average of 1.83:1, which came close to the Bundesbank proposal of 1.9:1.

The asymmetry in the conversion of financial stocks between the general rate of 2:1 and the 1:1 rate for small deposits lead to a disparity between assets and liabilities on the balance sheet of the East German credit system (deposits are part of a bank's liabilities). This disparity caused equalisation claims of 26.4 billion DM, which the state had to compensate. The 2:1 conversion of financial stocks increased the DM money supply M3 by 15%, which was slightly more than anticipated but implied no significant inflationary potential since the additional economic capacity of East Germany meant a 10% increase in total GDP.

The fact that the conversion of stocks was of a much larger magnitude and was of substantially greater economic significance than the flow conversion (but paradoxically gained almost no attention) shows quite openly the degree of economic ignorance on the part of public opinion. The common view, also in the scientific literature, that the central bank was overruled or even suffered a 'defeat at the hands of the government over the conversion rate'²³ is not justified and can often be traced back to an incorrect representation of these figures in the form of taking the 1:1 rate for financial flows and small savings as the average rate.²⁴ Misunderstandings such as these contributed to the myth that the Bundesbank had suddenly lost its power, being reluctantly forced into GEMSU.

3.2 The Puzzle

The Bundesbank seemed to have sounder arguments than the government and criticised Kohl's nonchalant decision in favour of GEMSU and the way in which a mystified perception of the DM fostered naive and optimistic expectations of the consequences. The popular but misleading parallel with the currency reform of 1948 (when savings were substantially devalued instead of revalued as in 1990) fuelled empty hopes for a new 'economic miracle'. Unlike many politicians and public opinion, most economists and the Bundesbank agreed that monetary union was economically hazardous. Why then was it possible that the opposition to GEMSU was eroded so quickly? How did Kohl achieve an outcome that was significantly tilted towards political considerations and against the advice of expert opinion and, above all, despite the concerns of the independent central bank?

23 W.Carlin and D.Soskice, 'Shocks to the System: the German Political Economy under Stress' in *National Institute Economic Review* (159, January 1997), p. 70.

24 See, for example, T.Lange and J.R.Shackleton, 'Germany in Transition: An Introduction' and G.Pugh, 'Economic Reform in Germany', both in T.Lange and J.R.Shackleton (eds.), *The Political*

3.2.1 'A Fantastic Idea'

Former President Pöhl disliked monetary union and was personally highly critical about reunification.²⁵ In interviews and public statements responding to the debate, he consistently stated that monetary union would be premature and rushed and called it 'fantastical ideas' to talk about introducing the DM in the GDR.²⁶ He repeated his conviction on 6 February 1990 in Berlin after talks with the East German Central Bank Governor and the Economics Minister, both of which had conveyed the impression on him that they 'categorically declared not to be prepared to accept the far-reaching consequences of introducing the DM.'²⁷ Pöhl was as surprised as everybody else that Kohl announced on the same day that he was prepared to negotiate about monetary union. Pöhl did not believe that East Berlin would consent to the loss of sovereignty by accepting the DM as the national currency and repeatedly stressed that it was the responsibility of the GDR to create the preconditions for monetary union.

Pöhl's view was that of the majority of experts. The real problems were seen not in the lack of a convertible currency but in the low productivity of the economy, the lack of capital, the low quality of the capital stock, the absence of competition and the omnipresent state monopoly. At first sight, only a sudden weakening of the Bundesbank and a crucial loss to the government seem to reconcile its resistance with the fact that it loyally implemented the project.

3.2.2 Chancellor Democracy and Bundesbank Defeat?

What happened in the early months of 1990 seems to be nothing less than a case study of policymaking in the German chancellor democracy, a 'shining example of the possibilities for political leadership.'²⁸ Kohl had not been seen as a particularly energetic political leader prior to 1989 but suddenly seemed to live up to Bismarckian heights of political finesse. He was aware of Pöhl's sceptical stance and pre-empted any chance for the popular Bundesbank to subvert public opinion.

Economy of German Unification (Providence: Berghahn Books, 1998), p. 5 and p. 134 or D. Marsh, op. cit., p. 33.

²⁵ Interview with the author in Frankfurt, 6 December 1999.

²⁶ 'Das Muß Doch Die DDR Entscheiden. Interview mit Karl Otto Pöhl', in *Die Zeit* (Hamburg, 26/01/1990).

²⁷ K.O. Pöhl, Declaration for the Federal Press Conference, 9 February 1990.

²⁸ W. Bergsdorf, 'West Germany's Political System under Stress', in D. Grosser (ed.), *German Unification. The unexpected Challenge* (New York: Berg Publishers, 1992), p. 97.

He knew that the government in East Berlin stood with its back at the wall and successfully deployed the DM as the Federal Republic's best trump card in absorbing the bankrupt GDR. By sidelining the central bank, he succeeded in pushing for an economically risky course in favour of its political benefits. Apparently, the Bundesbank did not like the project but was subsumed and overrun in the course of Kohl's tactical moves and the instrumentalisation of the popular desires in East Germany.

But this version is wrong...

3.3 The True Story

The usual explanation of Bundesbank defeat in the chancellor democracy is based on a distorted picture of the Bundesbank as it has been created in the press²⁹ and has subsequently been fed through into the academic literature and mainstream opinion.

The argument as such is logically valid, but the premise is false. The argumentative edifice rests on an exaggerated and mythological portrayal of the Bundesbank as 'the bank that rules Europe' and which in 'the next battle of Europe... (fights) not by force of arms but by the power of German money.'³⁰ Marsh's caricature becomes even more grotesque when he writes that 'the Bundesbank has replaced the Wehrmacht as Germany's best-known and best-feared institution... (holding) sway across a larger area of Europe than any German Reich in history.'³¹ Monetary policy, just like corporate mergers, football matches and song contests is, in the British press, the continuation of war by other means.

It comes as no surprise that the comparison of a central bank with an army leads to exaggerated expectations of the former competences and powers. Nevertheless, the Bundesbank is a federal institution, bound by and responsible before the law, autonomous over monetary policy but ultimately obliged to loyalty to the political leadership. It had neither the power nor the intention or even the motive to prevent the GEMSU project. Its co-operation with the government disappointed some who held a wrong image of the institution and those who still clung to their false opinion misinterpreted its loyalty as weakness.

29 See introduction for examples.

30 D. Marsh, op. cit., p. 10.

31 Ibid.

3.3.1 Key Actors and Their Positions

Mr Pöhl was not the Bundesbank and a biased selection of his semi-official negative statements about GEMSU does not represent the line of the central bank in an adequate way, especially his frequently cited comment that GEMSU was a ‘disaster’.³² Pöhl interpreted Kohl’s offer primarily in the light of the elective pressure and judged Kohl to be a ‘pure opportunist’.³³ His own view of the revolutionary events of 1989 and 1990 as an ‘unstoppable avalanche’ and an ‘emotional and nationalistic swell’³⁴ are characteristic for those who have never accepted the concept of unified Germany. This perception, of course, was not representative for the whole CBC. A contrasting private position was held, for example, by former member of the Directorate Johann Wilhelm Gaddum who was responsible for the task of implementing GEMSU and establishing the central banking system in East Germany within a couple of weeks. He explained that such an effort was possible only with enthusiasm and conviction about the righteousness and historic importance of the endeavour.³⁵

But these opinions were private and not those of public officials. The professional and official attitude of the central bankers was concerned with the implications of GEMSU for the stability of the DM and not the political or patriotic desirability of the project. During a television interview on the day of Kohl’s announcement, Pöhl rejected the idea that the Bundesbank would be able or would even attempt to resist against the pressures for monetary and economic union: ‘This is not for the Bundesbank to decide. It is a political decision.’³⁶ Pöhl gave a press conference in reaction to the government proposal on 9 February 1990, which is the authoritative source on the Bundesbank position. He stated:

32 K. O. Pöhl, Speech before the Economic Committee of the European Parliament (Brussels: 19 March 1991).

33 Interview with the author in Frankfurt, 06 December 1999.

34 Ibid.

35 Interview with the author in Mainz, 23 March 2000.

36 H. J. Friedrichs, Interview with Pöhl in ‘Tagesthemen’, ARD, 6 February 1990.

It is self-evident that the Bundesbank and myself as Bundesbank President, but also as a (German) citizen, feel obliged to loyally support such an important decision of the Federal Government... The competency lies without a question with the Federal Government and the Bundestag... The Federal Government has the responsibility, not the Bundesbank... It is our duty, in accordance with the Bundesbank Act, to advise the government on questions of monetary nature. We are also obliged to support the economic policy of the Federal Government as far as this is reconcilable with the task of stability policy.³⁷

The Bundesbank acknowledged the political urgency of the project, in particular with respect to the migration problem, but was mainly concerned about the risks of completing a monetary union without a firm political structure. The justification for this concern is proved by the fact that Moscow only consented to political reunification two weeks after GEMSU had gone into effect. Because the scenario of divergent political control over the same economy in a completely unclear international setting ‘would have been a catastrophe’, Pöhl accused Kohl of ‘playing Vabanque’.³⁸ The necessity of pursuing monetary union only as part of a sensible strategy for political unification was one of his priorities: ‘And only in this context, as a step towards the unification of Germany, is such a proposal justifiable with all its far-reaching implications.’³⁹

But once the government had decided to proceed with GEMSU, the Bundesbank followed suit and put its weight behind a solution according to its terms. Its principal aims, in order of priority, were:

Box 2. Bundesbank conditions for GEMSU

- Exclusive validity of the Bundesbank Act and of Bundesbank decisions in the GDR's monetary affairs
- Administrative presence of the Bundesbank in East Germany
- Liberalisation of the financial markets and opening to West German and foreign credit institutions
- Limitation of public debt in the GDR
- 2:1 conversion of stocks (excluding small private savings)

Source: Deutsche Bundesbank, Entschließung des Zentralbankrats (Frankfurt: 29 March 1990).

Its *conditio sine qua non* was to get sole responsibility for and autonomy over GDR monetary policy, the other points being of secondary importance.

37 K. O. Pöhl, Federal Press Conference (Bonn, 9 February 1990).

38 Interview with the author in Frankfurt, 6 December 1999 – ‘Vabanque spielen’ is a German proverb for an extremely risky course at high stakes. A probably unintentional parallel is that Hitler was accused by Göring to be ‘playing Vabanque’ during the Czechoslovakian crisis.

39 K. O. Pöhl, Federal Press Conference (Bonn, 9 February 1990).

The Federal Government was originally in favour of a prudent and economically sensible step-by-step approach, formulated by Economics Minister Helmut Haussmann (F.D.P.) as a three-stage programme for gradual marketisation and convergence of the GDR economy prior to monetary union. The political debate about immediate monetary union was triggered by a proposal of the opposition on 19 January 1990. The SPD hoped that monetary and economic union would reduce the pressure for political unification, a major miscalculation. At first, government politicians reacted negatively. Finance minister and leader of the Christian Social Union (CSU) Theo Waigel declared that monetary union with the GDR would be 'dangerous and a completely wrong signal'⁴⁰ and that such a step would come far too early.⁴¹ However, this strong rejection was watered down over the following days in favour of introducing the DM in East Germany rather sooner than later: 'If the people in the GDR want to go along this brave road, we are not going to stand in their way.'⁴² By then, Kohl had taken over on the issue and decided to make the best of the mounting pressure of popular demands, economic distress and the rising tide of migration. His closest ally in the clandestine preparation of his initiative was Foreign Minister Hans Dietrich Genscher (F.D.P.). After secretly winning Waigel's support, Kohl announced his offer on 6 February 1990.

Pöhl attended the cabinet meeting on the following day and recalled that 'in the beginning, everybody was of my opinion.'⁴³ However, he acquiesced and Kohl ensured the unanimous support of his ministers. Financial support for the GDR was made part of the offer to negotiate on monetary union. As a reason for its decision, the government referred to the 'dramatically deteriorating situation in the GDR' and presented the offer as an 'appeal to the people in the GDR to help with the construction of a new economic system and not to leave the country'.⁴⁴ The Bundesbank had virtually a free hand in the negotiation and implementation of GEMSU. As for the conversion rate, the 2:1 proposal of the Bundesbank was originally endorsed by the government but became subsumed in the election campaign when the SPD developed a strong stance for a general 1:1 rate as a concession to its working class support in both parts of the country (working for more purchasing power in the East

40 *Münchener Merkur*, 20 January 1990.

41 'Waigel: Für eine Währungsunion ist es zu früh' in *Frankfurter Allgemeine Zeitung* (Frankfurt, 26 January 1990).

42 'Zur Diskussion einer Wirtschafts- und Währungsunion mit der DDR erklärt der Bundesminister der Finanzen, Dr. Theo Waigel', Federal Ministry of Finance (Bonn, 2 February 1990).

43 Interview with the author (Frankfurt, 06 December 1999).

and less wage competition for the West). In his decision to react with a 1:1 proposal for flow conversion and small deposits, Kohl again found initial support only with Genscher but soon managed to bring his cabinet into line. In the election, he benefited strongly from the deep rift between the SPD and its chancellor candidate, Oskar Lafontaine, who was one of the few outspoken political opponents of GEMSU. In sum, Kohl successfully instrumentalised the popular demands and desires in East Germany for his unification policy, riding high on the uncontrollable dynamism of the grassroots movement towards unity, freedom and capitalist-style consumption.

Heading the rapidly disintegrating GDR, the government in East Berlin faced immediate economic and political collapse but reacted with irritation to Kohl's surprise offer. A decision was postponed until the general election, which had to be brought forward to 18 March 1990 due to the urgency of the problems and the increasingly perceived lack of legitimacy of the *ancien régime*. After the change of power, the new government strove for German unity but insisted on a general 1:1 exchange rate for stocks and flows and an independent central bank for the GDR. Its central bank declared that a nominal devaluation of savings would have intolerable social consequences, which ignores the fact that they were substantially revalued in real terms by the West German offer.⁴⁵

3.3.2 The Bargain

The Bundesbank as an institution did not negotiate directly with the government of the GDR but its position was extremely well represented in the West German delegation, not least because of the participation of senior Bundesbank staff as expert advisors and negotiators on behalf of the government. Frankfurt and Bonn were undoubtedly in a stronger position than East Berlin but conceded on some points, mainly in order to prevent the accusation of imposition and in consideration of the demands of the people in East Germany. Hans Tietmeyer, then member of the Bundesbank Directorate, recalled that 'in fulfilling its political responsibilities, the Federal Government departed from the Bundesbank's recommendations on individual points such as the selection of the conversion rate for current payments.'⁴⁶ In his recollections of the negotiations,⁴⁷

44 Federal Press Conference, 07 February 1990.

45 'Erklärung des Direktoriums der Staatsbank der DDR' in *Presse- und Informationsamt der Bundesregierung, DDR-Informationen* (Bonn: 3 April 1990).

46 H. Tietmeyer, 'The Bundesbank: Committed to Stability', in S.F. Frowen and R. Pringle (eds.), *op. cit.*

Tietmeyer describes how the confidential statement of the CBC on a 2:1 conversion leaked to the public and provoked a storm of protest in the GDR, which had more influence in achieving a concession than the demands by East Berlin.

However, it cannot be overstated that despite setbacks on minor issues, the treaty fulfilled all essential conditions of the Bundesbank with a small deviation from the central bank's proposal on the conversion rate. Instead of the 1.9:1 average rate envisaged by the Bundesbank suggestions, a rate implying a 1.83:1 average was agreed upon. Many commentators exaggerate the Bundesbank concession, such as Marsh writing that 'the central bank had ... seen how its monetary wishes could be overridden by the force of political expediency'⁴⁸ and wrongly interpret it as a sign of substantial weakness. GDR demands for monetary autonomy were put forward in vain and only led to a non-voting seat for the GDR Minister of Finance at CBC meetings. Apparently, 'the GDR delegation agreed to this solution only after an ultimatum by ... Tietmeyer.'⁴⁹ In sum, the Bundesbank got much more than it conceded and none of its principal conditions remained unfulfilled.

3.3.3 The Bundesbank as Strong as Can Be

The CBC issued *ex post* a press note in response to the incorrect newspaper coverage of the Bundesbank's role:

The Deutsche Bundesbank has from the start intensely participated in the negotiations with the GDR. The President of the Bundesbank attended all-important discussions in ministerial and cabinet meetings and had the opportunity to present his point of view. With the consent of the Central Bank Council and on request of the Federal Chancellor, the Member of the Directorate Dr. Hans Tietmeyer headed the delegation of the Federal Republic during the expert talks. The Vice-President of the Bundesbank was a member of the official negotiating commission. Other Members of the Directorate also participated in the negotiations ... The decisive condition of the Bundesbank has been fulfilled in the state treaty: The Bundesbank is exclusively and unrestrictedly responsible for monetary policy in both German states. Central Bank Council decisions are also valid in the GDR from 1 July onwards... The contracting parties have largely accepted the (conversion) proposal.⁵⁰

47 H. Tietmeyer, 'Recollections of the German Treaty Negotiations of 1990', in S.F. Frowen and R. Pringle (eds.), op. cit.

48 D. Marsh, op. cit., p. 245.

49 M. E. Streit, 'Die deutsche Währungsunion' in Deutsche Bundesbank, *Fünfzig Jahre Deutsche Mark. Notenbank und Währung in Deutschland seit 1948* (München: Beck, 1998), p. 691.

50 Deutsche Bundesbank, Pressenotiz (Frankfurt: 31 May 1990).

The Bundesbank was as strong as one could possibly have expected from a central bank. It was critical about the project but loyally supported the government course and achieved an outcome that was optimal from its point of view under the given conditions. In the words of then Vice President Schlesinger, ‘the Gordian Knot was cut with the sword of a political decision, probably not exactly at the appropriate place’,⁵¹ but the Bundesbank was highly successful in negotiating the terms and implementing the results of the process. The fact that GEMSU frustrated an unrealistic picture of Germany’s central bank does not alter the fact that ultimately, the episode tells a story of strength and success for the Bundesbank.

4. European Monetary Union (EMU)

L'Europe se fera par la monnaie ou elle ne se fera pas.

Jacques Rueff

1 July 1990 was not only a crucial step on the road to German reunification but also for the process of European integration, marking the beginning of the first stage of EMU. EMU compares to GEMSU like a marathon to a sprint, and both monetary unions differ substantially from each other. However, a similarity is the misrepresentation of the Bundesbank’s preferences and its position in both processes, which has been continued in parts of the academic literature on the subject.

It seems plausible that the Bundesbank should have fought against losing its powerful role in Europe, but it accepted the necessity and benefits of the project, respected its political nature and the primacy of political decisions and contributed decisively to its success. In the outcome we see a proof of strength, not weakness of the Bundesbank: EMU entry conditions were as rigorous as they were politically acceptable and, above all, the European Central Bank (ECB) is largely a clone of the Bundesbank and, if anything, even more independent than its Frankfurt model. As Rehfeld writes, ‘it was not up to the Bundesbank whether but how EMU was formed.’⁵²

51 H. Schlesinger, ‘Die Währungspolitischen Weichenstellungen in Deutschland und Europa’ in J. Siebke (ed.), *Monetäre Konfliktfelder der Weltwirtschaft* (Berlin 1990), p. 21.

52 A. Rehfeld, ‘Europäische Währungspolitik im Spannungsfeld von Nationaler Souveränität und Europäischer Integration’ (dissertation at Tübingen University, 1995), p. 106.

4.1 Chronology and Implications of EMU

4.1.1 Monetary Integration in Europe

The project of monetary union is almost as old as the post-war process of integration itself. Its roots date back to the first attempts at better economic co-ordination in the Treaty of Rome, leading to a European Currency Agreement and the European Payments Union for mutual convertibility in 1958. The decline of the Bretton Woods System and a rising awareness of the insufficiency of the status quo prompted an initiative of the European Commission in 1969, which led to the Werner Plan. Already envisaging a federal structure for European monetary policy, total financial liberalisation and irreversibly fixed exchange rates, the Werner Plan was ahead of its time and failed to find sufficient support on the national level. But several financial crises finally precipitated the end of Bretton Woods and induced the EC in 1972 to an agreement on internal exchange rate management ('the snake') and the setting up of the European Monetary Co-operation Fund. This system was, however, still unable to provide joint responses to external currency movements and was generally felt to be insufficient.

In 1978, the European Monetary System (EMS) was designed as the monetary component of a Franco-German expansion programme. The Bundesbank was not enthusiastic because fixed European exchange rates would constrain German monetary policy but Fratianni and von Hagen exaggerate when they claim that 'the Bundesbank never quite accepted the EMS.'⁵³ The system imposed a set of standard obligations on its members and functioned increasingly under the involuntary hegemony of the Bundesbank. As Grahl writes, 'disinflation via the DM became the common macroeconomic strategy of all Western European countries.'⁵⁴ The inequality of the balance of power in the system became evident in mid-1992, when most currencies were either drastically devalued against the DM and forced to fluctuate within 30% margins or left the exchange rate mechanism (ERM) altogether. The crisis ensued from the asymmetric shock that German unification meant for the system and the fact that the Bundesbank was unwilling and without the mandate to define a European response strategy instead of its domestically oriented reaction. The EMS was a

53 M.Fratianni and J.von Hagen, *The European Monetary System and European Monetary Union* (Oxford: Westview Press, 1992), p. 18.

54 J.Grahl, *After Maastricht - A Guide to European Monetary Union* (London: Lawrence and Wishart Ltd., 1997), p. 81.

prolonged digression from the road to monetary union, but it achieved convergence in inflation rates and thereby contributed to the conditions that made the 1990s appear to be the right time for EMU.

France in particular was very dissatisfied with its lack of influence under the existing regulations and proposed a fundamental reform. Germany had more to lose than anybody else did by giving up the DM - and it could live most happily with the existing EMS. EMU therefore became the test case for reunited Germany's commitment to Western Europe.

Box 3. Chronology of EMU events

- January 1988: French Finance Minister Balladur criticises EMS and argues that ‘rapid pursuit of the monetary construction of Europe is the only possible solution’⁵⁵
- February 1988: German Foreign Minister Genscher reacts with a memorandum on a common central bank as the ‘economically necessary completion of the European Internal Market’⁵⁶ and proposes a council of independent experts on EMU
- 1988/89: The Committee of Central Bank Governors and independent experts convene under Commission President Delors and comment on EMU (‘Delors Report’)
- June 1989: EC summit at Madrid accepts EMU design of the Delors Report
- December 1989: Strasbourg conference on EMU
- 1 July 1990: Beginning of stage I
- December 1991: Maastricht conference results in treaty on EMU
- 1992/93: EMS crises
- 1 November 1993: Maastricht Treaty becomes effective
- 1 January 1994: Beginning of stage II, foundation of European Monetary Institute (EMI)
- 1 June 1998: Foundation of European Central Bank (ECB)
- 1 January 1999: Beginning of stage III

4.1.2 Political Implications

As with GEMSU, the primacy of the political holds for EMU. The project was initiated, supported and opposed out of political motivations and its value or danger has predominantly been perceived in political dimensions. EMU means that monetary policy is no longer in the domain of governments or national central banks but is almost exclusively the task of the ECB. But it is arguable whether monetary policy was really subject to the governments of sovereign states since 1978: The EMS imposed a voluntary but none the less effective prescription of monetary policy by the German

55 E.Balladur, ‘Europe's Monetary Construction’, Memorandum to the Ecofin Council, Ministry of Finance and Economics, Paris, 8 January 1988.

56 H.-D.Genscher, ‘A European Currency Area and a European Central Bank,’ Memorandum to General Affairs Council, Ministry of Foreign Affairs, Bonn, 26 February 1988.

central bank – hence EC states did not really lose control through EMU but actually regained some by acquiring influence over the ECB and - even more important – as much influence as Germany.

The German position was different, both as the anchor for the EMS and because it was not the government but the central bank that would have to give up monetary sovereignty. These reasons make it appear almost inevitable for the Bundesbank to oppose the EMU project. But even the Bundesbank was beginning to lose its famed autonomy over monetary policy long before EMU due to the technical and structural revolution and liberalisation of the global financial system, which had significantly reduced the influence of central banks in general (as the crises of 1992 and 1993 powerfully demonstrated). The Bundesbank realised that EMU ‘offers the most realistic prospect of reasserting social control over internationalised economic forces’,⁵⁷ and that the alternative to EMU in the long run might not be Bundesbank control over European monetary policy but no public control at all.

An additional explanation for German readiness to renounce formal sovereignty over monetary policy is that the absence of nationalistic approaches to concepts like sovereignty has been firmly established in the roots and the self-understanding of the Federal Republic and that it has always been combined with a tradition of regularly and immediately passing on newly regained sovereignty to a supranational level. The German public was worried about losing the stable DM for an unstable euro, but not about transferring sovereignty. Only the failure to understand this particular perspective could lead one to expect the Bundesbank to fight EMU on the grounds of battling for sovereignty, such as the French or British government would have done at its place.

Political union as a frequently cited implication of EMU is hard to define and represents a process on a continuous rather than discrete scale. Nevertheless, concrete spillover-effects from the monetary field into other areas have been taken very seriously in the public debate. Reversing the causality in accordance with the crowning theory of monetary integration, the Bundesbank demanded more political integration prior to monetary union. For many observers, the fixed schedule of monetary integration and the decoupling from political union repeated the GEMSU experience of putting an economic cart before the political horse. Progress on economic integration without a parallel advance in the political sphere is seen to bear the risk of endangering the success of EMU by making it

57 J. Grahl, *op.cit.*, p. vii.

subject to potentially centrifugal political tendencies. The Bundesbank accepted that monetary union could precede measures of political union, but it was particularly concerned about the dangers of divergent fiscal policy for the stability of a common currency and did not tire of mentioning the mantra that ‘monetary union is an irrevocably sworn confraternity – all for one and one for all.’⁵⁸ A fundamental Bundesbank criticism of the Maastricht Treaty was that it did not ‘reflect an agreement on the future structure of the envisaged political union and on the required parallelism with monetary union.’⁵⁹ President Tietmeyer expressed an even stronger version of this sentiment: ‘EMU is impossible without political union’.⁶⁰ However, the Bundesbank has never been precise on its definition of political union.

The last and least concrete political implication of EMU is that the euro is expected to take over the role of the DM as the world’s second reserve currency, now being backed by a much larger GDP. This could mean a gradual Americanisation of European external monetary policy in the sense that the EU can afford less fear of exchange rate volatility and a more assertive posture in international finance. By joining its forces and having essentially created a system of three world currencies (euro, yen and dollar), Europe might have found the best answer to the challenge of financial globalisation. Given the successful G7 co-operation in dealing with financial crises during the 1980s, a G3 structure could regain some of the lost stability and rationality in the functioning of global finance, redressing the balance of power between markets and authorities thanks to concertation of the latter. So in terms of benefits for the political economy of Europe, it is clear that the Bank would have had good reasons to support the project.

4.1.3 Economic Implications

Economic aspects were of secondary importance for the EMU project and the potential benefits alone would possibly not have justified or enabled the effort in the first place. Furthermore, the debate about economic costs and benefits is not conclusive. The lack of substantial economic reasons in favour of monetary union shows its predominantly political character.

⁵⁸ Deutsche Bundesbank, Monthly Report (Frankfurt: September 1990), p. 27.

⁵⁹ Deutsche Bundesbank, Monthly Report (Frankfurt: February 1992), p. 51.

⁶⁰ H.Tietmeyer: 'The relationship between economic, monetary and political integration' in A.Bakker, H.Boot, O.Sleijpen and W.Vanthoor (eds.), *Monetary Stability Through International Cooperation - Essays in Honour of André Szasz* (Dordrecht: Kluwer Academic Publishers, 1994), pp. 21-30.

Based on the macroeconomic theory of optimal currency areas, there is little ground for monetary union in the EU.⁶¹ The only actually observable optimal currency area in Europe is one made up of Germany, Austria and Benelux, countries that achieved a very high degree of convergence and *de facto* represented a DM trading block. The Bundesbank was prepared to extend this optimal area to France, Britain and Denmark and argued for a ‘Two-Tier Europe’, which meant a monetary union among the advanced countries of the EC only. Pöhl stated that ‘it makes no sense to say we want no two-speed Europe but very soon a monetary union.’⁶² His proposal is said to have been discussed in bilateral discussions between France and Germany, and Crawford is wrong to assert that the French side never supported the idea in public.⁶³ The Banque de France remarked in 1990 that ‘given the diversity that exists in the economic conditions ... it would probably be wise to offer some countries a transitional period.’⁶⁴

Box 4. Convergence criteria

- No devaluations of the currency and maintenance of the respective ERM margin for at least two years before EMU
- A rate of inflation not higher than 1.5% more than the average of those currencies with the lowest inflation at least one year before EMU
- Interest rates no more than 2% above the average level of the countries with lowest inflation at least one year before EMU
- A budget deficit that is declared ‘not excessive’ by a qualified majority in the European Council of Economics and Finance Ministers (Ecofin)

But the strong preference of the Bundesbank for a two-tier union was not backed by a veto right on the process. The best outcome the Bank could achieve under these conditions was a demanding set of entry conditions for EMU, which would allow only for a high-class membership. The agreement was sufficiently tough to place all odds against a universal union by 1999. (Which occurred nevertheless, partially due to laxness in the interpretation of the budget criterion.) The Bundesbank’s motivation behind the uncompromising stance on convergence was its serious concerns about

61 See, for example, the discussions in M. Crawford, *One Money for Europe? The Economics and Politics of EMU* (New York: Macmillan Press, 1996), J. Grahl, op. cit. and D. Gros and N. Thygesen, op. cit.

62 K. O. Pöhl, interview in ARD-Wochenmagazin (26 October 1990).

63 M. Crawford, op.cit., p. 321.

64 J. Neher, 'France backs Pöhl on union' in *International Herald Tribune* (New York, 15 June 1990).

inflationary pressure coming from the weaker countries. The Maastricht Treaty corresponded to the need for convergence and laid down a set of economic benchmarks that would ensure a sufficient co-ordination of the economic cycle, the convergence criteria:

The last condition was held in very imprecise terms against German wishes, but was later interpreted as a public debt level below or at 60% of annual GDP and a rate of current fiscal deficit of 3% of annual GDP. The interpretation by Ecofin left room for some degree of discretion and laxness to enable the beginning of stage three in 1999. These criteria and their interpretation caused most of the disagreement during the Maastricht conference.

A surprisingly uncontroversial implication was the principle of full independence of the European System of Central Banks (ESCB) and the ECB, one of the essential Bundesbank conditions, which has also been enshrined in the Maastricht Treaty.⁶⁵ Following the Bundesbank example, national central banks are not allowed to accept instructions from their respective governments. The ECB Statute can only be changed by a unanimous decision of the council of ministers. Neither the European Parliament nor the Commission has power over the ECB and central bank financing of budget deficits and credits to the EU are banned. Another source of independence is the long terms of office and the impossibility of renomination for the members of the executive board. These measures make the ECB at least as independent as the Bundesbank was.

There exists no conclusive cost-benefit analysis for EMU in economic terms, mainly because of the uncertainties involved, but the benefits seem to slightly outweigh the costs for most countries. The most obvious economic benefits accrue from a substantial reduction in transaction costs (roughly 0.5% of EU GDP). The necessity of risk premia on non-DM currencies falls away, which implies lower interest rates for the participants, except Germany. On top of that, indirect gains are expected to arise from improved transparency, the removal of price distortions, an increased volume of trade and a higher stock of capital, gains that were conservatively estimated to occur at levels between 1.2 and 2.4% of EU GDP. Further benefits were expected to arise from a reduction in uncertainty, especially with respect to investment, and from exchange rate stability, which is probably the only economic advantage of EMU that applies to Germany as well. Microeconomic costs of 20 billion euro are expected to arise mainly from technical aspects of the currency introduction, which is

65 Articles 104, 107.

equivalent to only nine months of the estimated economic benefits.⁶⁶ Macroeconomic costs of transitional nature arose for those countries that had difficulties in meeting the convergence criteria, but more significant is the permanent loss of the instrument of exchange rate devaluation in the event of an asymmetric shock. Despite the arguably limited effectiveness of this option, the long-term cost of EMU is that fiscal policy and real effects, above all in the labour market, will have to make up for it. Hence on economic grounds, the Bundesbank had no reason to assign a high priority to EMU.

4.2 The Puzzle, Part II

The Financial Times wrote in 1989: ‘Europe already has a central bank. Its name is the Bundesbank and it is located in Frankfurt.’⁶⁷ With this scenario in mind, Marsh logically commented on Maastricht: ‘If EMU ever became a reality, the Bundesbank would be the principal loser.’⁶⁸ Given the Bundesbank’s leadership position in the EMS and its influence on the German government, how was it possible that EMU came about at all? Once again, weakness and defeat seem to be the only explanations one can find for the contradiction between its stated preferences and critical remarks on EMU on the one hand and the fact that it happened on the other.

4.2.1 ‘Nothing will come of EMU’

The Bundesbank, understandably, was not as keen on the project as the Commission or the French government. Pöhl remarked with respect to the Delors Report: ‘We can live very well with the status quo.’⁶⁹ Tietmeyer stated shortly before the beginning of the Maastricht conference that ‘United Germany has much to lose in the forthcoming reordering of European currencies, namely one of the most successful and best monetary constitutions in the world.’⁷⁰

According to Marsh, the Bundesbank decided to sabotage the project instead of fighting it openly: ‘If the bank could not bring down EMU from outside, it had to try to disable the edifice from within.’⁷¹ In this light, one is bound to interpret any positive comments of the Bundesbank on EMU as shrewd tactics and any criticism as proof of resistance. One is also obliged to view the ECB

66 Statistics quoted in M. Crawford, *op.cit.*, pp. 172-186.

67 *Financial Times*, 6 October 1989.

68 D. Marsh, *op. cit.*, p. 235.

69 *Ibid.*

70 H. Tietmeyer, speech (Frankfurt: 6 November 1991).

statute and even more the convergence criteria as conditions that were deliberately formulated too tough to be achieved, which places the entire German contribution under the premise that the Bundesbank set EMU up to fail. The survival saga then culminates in the allegedly deliberate collapse of the ERM in the EMS crises of 1992 and 1993.

4.2.2 Versailles without War?

EMU did not fail and, central to its achievement, France and the other participants accepted the Bundesbank's maximalist conditions for it, thereby taking the cards out of its hands. Following the sobering setback of 1992 and 1993, intensive efforts secured the fulfilment of the convergence criteria. EMU went ahead without anything the Bundesbank could have done about it. Paris was keen to portray Maastricht as a major bargaining success against Germany and the Bundesbank, and the word went around in France that it amounted to a 'Versailles without war'. But did the Bundesbank really fight a total war and was it humiliatingly defeated?

4.3 The True Story

'Nothing will come of EMU' is an incomplete quote of what the real strategy of the Bundesbank was, in the words of former Bundesbank Director Otmar Issing:

For a long period, we said nothing would come of EMU... Then we saw that if we remained on the sidelines, we would be confronted with difficulties. So we decided to advance to the head of the movement, with the aim of making the Bundesbank's position clear at a European level.⁷²

The true story is about a deal that was struck predominantly between France and Germany, a deal, in which the German concession was to participate at all and in which the French had to concede on most of the subsequent issues. If we want to measure the strength of the Bank, we should evaluate the outcome of the Franco-German bargain, not the fact that it occurred.

4.3.1 Key Actors and Their Positions

To reduce the presentation to the positions of France and Germany is certainly an oversimplification. On each of the issues there were different constellations of countries supporting either side, but France and Germany were clearly identified as the focal points of opposing schools of thought on

71 D. Marsh, *op. cit.*, p. 245.

72 *Ibid.*

central banking. Paris found its most loyal ally in Rome, whereas the Netherlands consistently supported the Bundesbank, providing a convenient opportunity to occasionally frame common positions as ‘Dutch’ proposals. The deal was about national interests. The EC periphery, including Italy, was mainly interested in obtaining a stable currency and its benefits (above all, low interest rates). Other countries already enjoyed monetary stability and belonged to the unofficial DM trading area – for these it was natural to follow if the DM was going to merge into the euro. Britain and Denmark for domestic reasons were preoccupied with securing a possibility to opt-out, which they did. London participated in the negotiations but essentially tried to divert and slow down the project. Pöhl recalled that Thatcher was personally very disappointed that he and the Bundesbank would go along with EMU⁷³ – which partially reflects and partially explains the wrong evaluation of the process in Britain. Thatcher’s hope that Pöhl was going to fight the project and the interpretation of his ‘failure’ as weakness are characteristic for the wrong image of the Bundesbank in Britain. But the main discourse before, during and after Maastricht took place between France and Germany.

Having pegged the franc to the DM at the cost of enormous foreign exchange interventions throughout the late 1980s, the French government under Mitterrand realised that it had gained a stable currency but lost its influence over monetary policy. With a European central bank and French officials among its directors, combined with the introduction of some sort of economic government also subject to influence from Paris, the French hoped to end German hegemony and still maintain a low rate of inflation. EMU was a French project in this sense, combined with the ambition to alleviate US dominance in the world’s financial affairs and to achieve a reform of global financial relations. On the technical side, France tried hard to ensure a maximum degree of political influence and wanted to transform the Ecofin into an ‘economic government’ and to endow the EMI with central bank competency.

At the beginning of the bargaining process, French commentators saw Pöhl’s design for the future ECB as being ‘nothing possibly more remote from the ideas of the French Ministry of Finance, which affirms the pre-eminence of political power over the ‘technocrats’...’⁷⁴ As late as September 1992, President Mitterrand was still advocating a French-style monetary union and argued that ‘of course

73 Interview with the author (Frankfurt: 6 December 1999).

74 D. Gervais, ‘Poehl Plaide pour une Banque Centrale Européenne "Indépendante"’ in *La Tribune de l’Expansion* (Paris: 18 January 1990).

European monetary policy would not be left to technicians, it would be under political control... It is politicians and not the technocrats who decide on economic policy, of which monetary policy is the application.⁷⁵ The French side gradually realised that the Germans were prepared to concede monetary sovereignty but absolutely rejected political influence. They became less enthusiastic about the project to the extent that it developed truly supranational character and political independence. The mounting scepticism in France manifested itself in the close outcome of the 1992 referendum.⁷⁶

The Germans in general and the Bundesbank in particular were usually suspected of paying only lip service to EMU while in reality being opposed to it. However, according to the *Frankfurter Allgemeine Zeitung* in 1989, 'the Bundesbank is not against a realisation of the economic and monetary union envisaged by (Delors') three-stage plan.'⁷⁷ There is no piece of evidence based on which Minford could be justified to write that the Bundesbank 'has argued implicitly against the advisability of the whole project.'⁷⁸ Above all, it knew its limitations and that 'the question of whether EMU is to be established is a political decision.'⁷⁹ The private opinions of the central bankers were a different matter, but the official attitude was to comment the process critically without obstructing it and to demand very tough conditions without opposing EMU if these were met.

As an internationally negotiated agreement, the Bundesbank was less directly involved in the bargain compared to GEMSU. However, its relation with the German government was extremely close and, through its advisory function, it was able to clearly imprint its positions on the negotiating strategy of the German delegation. The Bundesbank confirmed that it 'participated intensely as an advisor in the preparatory work on formulating the treaty. The recommendations of the Bundesbank concerning all major technical issues and problems were duly taken into account by the Federal Government in

75 F. Mitterrand in 'Aujourd'hui l'Europe', TF1 (Paris: 3 September 1992).

76 Which yielded only a 51% majority in favour of the Maastricht Treaty and contributed to triggering the EMS crisis.

77 *Frankfurter Allgemeine Zeitung* (Frankfurt, 28 October 1989).

78 P. Minford, 'The Single Currency - Will it Work and Should We Join?' in M. Baimbridge, B. Burkitt and P. Whyman (eds.), *The Impact of the Euro* (London: Macmillan Press, 2000), p. 75.

79 Deutsche Bundesbank, *Monthly Report* (Frankfurt: February 1992), p. 51.

reaching its political decisions. They are reflected in important clauses of the EMU Treaty.’⁸⁰ The CBC noted in December that it ‘agreed with the Federal Government on all important issues.’⁸¹

Bundesbank scepticism was centred on the readiness of other countries not only to renounce their monetary sovereignty but also to accept a German-style outcome. It underestimated the extent to which they were prepared to do precisely that. Its negative attitude can have two sources, which are hard to distinguish in their effects. The first source is an economic motivation and based on the Bundesbank’s concerns about inflationary risks entailed in EMU. The second is more political and sees the Bundesbank’s efforts, interpreted as attempts to prevent EMU, as those of an institution battling for its continued existence and power. Former Chancellor Helmut Schmidt was one of the proponents of this view, arguing that ‘in reality, the gentlemen at the Bundesbank ... have a very simple motive for rejecting (European) monetary union: They do not want to become a dependent branch of another central bank which is even more independent than they are today.’⁸² But one important finding of this thesis, based on discussions with decision-makers, is that we should view the economic motive as by far the more dominant, leading to the Bundesbank’s insistence on an independent ECB. In addition, senior officials seem to have had a good chance of being taken over by the ECB (which involved a substantial pay rise without a change of location): Of the 748 members of ECB staff in 1999, 204 were Germans, 71 of which came from the Bundesbank.⁸³ Given that a substantial proportion of these 71 were to be found in the higher floors of the Bundesbank, we have one more reason not to assign too much significance to the political argument.

The Bundesbank acknowledged the economic benefits of EMU for Germany - which were less than for any other country but significant for the export industry. In addition to that, it saw EMU as a way to spread the effects of the DM-dollar volatility onto the EC economy. EMU was perceived as superior in this respect than the EMS with its lack of institutionalisation, credibility and irreversibility. The development of the financial markets meant a loss of monetary control for national authorities, which lowered the opportunity cost of EMU and increased its benefit as an answer to global liberalisation. The Bundesbank knew that the favourable conditions of the ERM could not have been

80 Deutsche Bundesbank, Monthly Report (Frankfurt, February 1992), p. 51.

81 Deutsche Bundesbank, Central Bank Council Press Conference (Frankfurt: 19 December 1991).

82 H. Schmidt, 'Der zweite Anlauf, die letzte Chance' in *Die Zeit* (Hamburg, 5 April 1996), p. 4.

83 Figures from Deutsche Bundesbank, Public Relations Office, Frankfurt.

continued indefinitely. Pöhl stated in 1990 that ‘in the long run, it is surely not in the German interest to supply the anchor currency forever.’⁸⁴ In this respect their motivation mirrors that of the USA to abandon Bretton Woods in 1971. More stability in the German currency’s external value would also mean a reduction of the proportion of exports that were exposed to exchange rate volatility down from 40% to the US level of 10% by removing the export character from intra-European trade.

Hence the Bundesbank position on EMU was one of general support combined with scepticism, concern for stability and strong preferences on monetary and institutional features. It preferred narrow and high-class membership and pointed out the need for parallelism with political union. Its *conditio sine qua non* was the nature of the ECB: The new bank had to have a monopoly over money creation in the euro-zone, independence from political influence and a legally prescribed and unambiguous commitment to price stability. In addition and conducive to these goals, the Bundesbank placed continued and strong emphasis on a strict interpretation of the convergence criteria. It stressed the importance of the budgetary criteria and the correlated need for fiscal discipline across the union in order to maintain stability. As secondary goals, Germany with Britain and the Netherlands opposed French ambitions to form an economic government out of the Ecofin. They also rejected a premature setting up of the ESCB in stage two, which would have diluted the Bundesbank’s sole responsibility for monetary policy. Lastly, the Bundesbank saw problems in article 109 of the Maastricht Treaty, which allows the EU to enter into exchange rate agreements with other currencies.

4.3.2 The Bargain

Germany proved and ensured its continued commitment to the West by renouncing sovereignty over its currency and its monetary hegemony in favour of a common currency. The price its partners had to pay for this fundamental concession was the acceptance of German conditions in most of the terms of the outcome, both of the Maastricht Treaty and on subsequent decisions.

In the run-up to Maastricht, the Report on Economic and Monetary Union in the European Community (Delors Report) proved to be of singular importance. Central bankers and independent experts instead of the Commission drafted it. Pöhl recalled that, after initial frictions, a consensus

⁸⁴ 'Bundesbankpräsident Pöhl vor der ECU Banking Association' in (Frankfurt: 26 October 1990).

along Bundesbank lines emerged relatively easily⁸⁵ and remarked with respect to the independently drafted statute for the future ECB that it had to be regarded as ‘a small miracle that this ‘European Bundesbank Law’ has been accepted even by governments of countries without independent central banks.’⁸⁶ The Bundesbank was certainly surprised to see how keen the French were on the project and that they seemed willing to make the most unexpected concessions. Over the disagreement on convergence criteria, the provisions of the Delors Report slipped into the treaty without much controversy. Through its stance for an independent central bank it pre-empted the decision that monetary union was to be achieved in conservative terms. It defined a markedly a-political base for the process. The ECB statute as drafted by the central bankers under Pöhl's chairmanship was incorporated virtually unchanged into the treaty and corresponded closely to the detailed views that he had presented at the opening meeting.⁸⁷ The report did not set a timetable but provided the outline for the three stages and listed the institutional changes necessary for their implementation.

The fact that the Bundesbank participated intensely and from the beginning in the crucial phase of the project implied that it would seriously discredit itself by vetoing the entire process at a later stage. The nature of this commitment was recognised in Frankfurt and opposed by some members of the CBC,⁸⁸ but the majority opinion was to proceed with constructive participation instead of obstruction, which would have entailed the risk of being marginalised. Pöhl, as a cosmopolitan who was beyond even a trace of a suspicion of nationalistic outlooks on monetary policy, was crucial at this stage in winning the support of his colleagues for the constructive course of the Bundesbank.

The question of timing, in particular the beginning of the final stage, was one of the most contested issues and represents a major concession on the German side and the only significant bargaining success for Paris, which gained an invaluable automaticity for the EMU process, without which its prospects would have seemed at least doubtful: The 1999 deadline committed all participating governments to tight fiscal budgets and sometimes painful policy restrictions with respect to the criteria and provided the urge and justification to adopt a lax interpretation of the deficit criterion.

85 Interview with author (Frankfurt: 6 December 1999).

86 K. O. Pöhl, ‘Der Delors-Bericht und das Statut einer Europäischen Zentralbank’, Private Memorandum.

87 K.O.Pöhl, ‘The further Development of the European Monetary System’, *Annex to the Delors Report, EC Publications Office* (Luxembourg 1989), pp. 131-55.

88 Ibid.

The Bundesbank feared the independent dynamism of political goals taking precedence over economic criteria and considered the French urgency for EMU as anathema, stating that ‘the transition to another stage must not be linked to deadlines fixed in advance.’⁸⁹ However, Bundesbank autonomy did not imply the ability to prevent Germany’s political leadership to commit itself to deadlines. The French succeeded in setting 1 January 1999 as the latest date for stage three to begin for those countries that had fulfilled the criteria. The Bundesbank acquiesced, not least because the decision seemed to allow for a two-speed solution. Finance Minister Waigel claimed incorrectly that he had ‘never accepted a deadline, also during the Maastricht negotiations.’⁹⁰ According to Rehfeld, the deadline decision was taken at three o’clock in the morning by the heads of government under exclusion of their financial advisors.⁹¹

A crucial factor for the issue of timing was German reunification. The EMU project was of course older, but the tight schedule and the French insistence on it needs to be seen in the light of European countries, above all France, suddenly taking great interest in limiting German economic leverage enlarged by reunification. It was perceived in Paris that the chance for EMU and German need for goodwill was running out by the end of the century and that an independent ECB was not too high a price to pay. At the same time, Kohl saw EMU as the best way to ensure the continuation of Germany’s commitment to the West.

Subsequent decisions represented almost entirely the fulfilment of Bundesbank demands and preferences. This holds above all for the institutional features of the ESCB and the ECB itself as well as the strong anti-inflation stance of the system. Two important deviations of the treaty from the propositions of the Delors Report were opt-out clauses for Britain and Denmark and the failure to introduce formal controls over national fiscal policies, which induced Germany to press for an agreement on its ‘Pact on Stability and Growth’. Germany’s concerns were summed up by the Bundesbank statement that ‘the ceding of national monetary and exchange rate policy autonomy is acceptable for a stability-oriented country only if its fellow participants do not undermine the

89 Deutsche Bundesbank, Monthly Report (Frankfurt, October 1990), p. 44.

90 D. Schröder and F. Thoma, ‘Die Stabilität der Währung muß oberstes Ziel sein. Interview mit Finanzminister Theo Waigel’ in *Süddeutsche Zeitung* (München, 14 August 1993).

91 A. Rehfeld, op.cit., p. 252.

monetary stability of the union through their economic policies.⁹² The Bundesbank remarked that ‘the agreements on the stability and growth pact have brought about important clarifications and improved the prospects of a stability-oriented budgetary policy course...’⁹³ but the failure to decide in favour of automatic punishment for deviating states was perceived as a setback.

The result of the controversy on convergence criteria was based on a Dutch proposal, which as usual corresponded closely to the Bundesbank position and indicated a two-speed process as desired in Frankfurt. The selection of participants in the treaty formulation was geared more towards the aspirations of the weaker countries however, and was placed in the hands of the Council of Heads of Governments, underlining the political nature of the issue. In December 1992, the Bundestag, Germany’s lower chamber, passed a resolution to resist any attempt to water down the strictness of the convergence criteria. The Constitutional Court also stressed the right of the Bundestag to review coming integrative developments with regard to their consistency with the constitution and demanded the creation of a ‘stability community’.⁹⁴ The combination of this judgement, the Bundestag resolution, Bundesbank statements and increasingly sceptical public opinion ensured the firmness of the Kohl government in the negotiations.

The most difficult topic among the monetary questions was the future use of exchange rate policy and the external aspects of the euro. For the DM, these issues fell into a grey area between the Bundesbank and the government, and a similar solution was achieved for the euro. The German side, with support from the UK and the Netherlands, insisted on and achieved a very limited degree of control for the Ecofin and only in co-operation with the ECB, which opposed French proposals. This solution demonstrated that the plan for an ‘economic government remained an unfulfilled dream of the French.’⁹⁵

The French project of already endowing the second stage with the ECB and parts of its operational capacities only led to the foundation of the EMI without any functions other than the preparation of the ECB foundation and reporting on the progress of convergence. The Bundesbank was pleased

92 Deutsche Bundesbank, Annual Report 1994 (Frankfurt: 1995), p. 103.

93 Deutsche Bundesbank, Annual Report 1996 (Frankfurt: 1997), p. 110.

94 Bundesverfassungsgericht, *Leitsätze zum Urteil des Zweiten Senats* vom 12. Oktober 1993 (Karlsruhe, 1993).

95 A. Rehfeld, op.cit., p. 261.

that ‘the regulations for the transitional phase provide for responsibility for monetary policy remaining at the national level until the entry into the final stage of EMU.’⁹⁶

A less serious but nevertheless controversial issue was the name of the common currency. Proposals dating back to the 1970s included Europas, emus, Franken, mark, Euromark, ecu, of course, and Dellor, the latter being a jocular suggestion by Pöhl, combining Delors’ name with the American currency. Most countries were prepared to live with the ecu as shorthand for European Currency Unit. But it had also been the name of a medieval French currency and sounded much too French for Germans. It also had had a bad press as an *Ersatzwährung*, a substitute currency, which had depreciated against the DM by more than 30% during its existence. The prolonged debate about the name was ended by a compromise reached in the European Council in December 1995, and the euro was born (with the advantage of allowing the entire range of nationally different pronunciations).

Turning to the ECB itself, we see most evidently the impact of German influence. The draft statute provided by the Committee of Central Bank Governors was adopted for the Maastricht Treaty. According to the *Financial Times*, ‘it reflects most fully the position of Germany, the one country that has to be in any EMU. The proposed European Central Bank is, therefore, a super Bundesbank.’⁹⁷ The Bundesbank itself was more modest but acknowledged that ‘the draft ... takes account of German interests in the items relating to the independent status of the ESCB, the primary orientation of monetary policy towards the goal of price stability and the ban on the central bank financing public sector deficits.’⁹⁸ The treaty prescription of an anti-inflationary stance for the ECB is an astonishing tribute to the Bundesbank tradition and a significant concession to its bargaining strength, making its interpretation of the law a legal requirement in itself. The relation between the central bank and other economic decision-making bodies in the EU creates a similar area of co-operative tension, as it had existed between the Bundesbank and the Federal Government. The relative weakness of the Community institutions, however, means an even greater degree of independence.

It is hard to tell whether the insistence of the German side on ECB independence an anti-inflation stance is a result of direct Bundesbank pressure or whether the government itself was not prepared to accept anything other. The best way to understand the Bundesbank role in this issue seems to be a

96 Deutsche Bundesbank, Monthly Report (Frankfurt, February 1992), p. 51.

97 ‘A sensible draft on EMU’ in *Financial Times* (London: 30 October 1991).

game theoretic model, which suggests that the government as a Stackelberg leader had to take fierce resistance into account in case it would deviate from the bank's line on this crucial point. The fact that Frankfurt signalled its acceptance of the Maastricht decisions does not imply that it could not have done anything about them - such as supporting the popular demands for a referendum, for example. Its most subtle line of influence over the government rested on the success in employing the sensitivity of *Stabilitätskultur*, which it had fostered for more than four decades, in exerting pressure in favour of ECB independence.

A technical issue was the range of instruments and targets to be at the hand of the ECB. The Bundesbank claimed that it was 'seeking to ensure that its own tried and tested set of instruments (was) adopted as far as possible.'⁹⁹ They are indeed closely modelled on the Bundesbank. The only significant change was from monetary targets to direct inflation targets, supplemented by 'monetary indicators'. Disagreement arose over the ECB's location. The Economist noted that 'there is a strong feeling that, since the Germans have won almost all the argument, they should not get the bricks and mortar too.'¹⁰⁰ Nevertheless, the choice for Frankfurt was made in October 1993 and is seen as a physical demonstration of the fact that the tradition of the Bundesbank has been handed over to the ECB. President Tietmeyer was pleased and noted that 'the decision for Frankfurt provides good conditions for the independence of the ECB.'¹⁰¹

4.3.3 Crisis and Success

People who expected the Bundesbank to fight the EMU process as agreed in Maastricht were bound to misinterpret the bank's role after the agreement, when it was allegedly attempting to disable the project after failing to prevent it. Most commentators attribute the ERM crises of 1992 and 1993 to the negligence or even sabotage of the Bundesbank aiming to discredit EMU beyond repair. The Bundesbank justified its high interest rates with respect to the existing inflationary pressure and President Schlesinger commented that 'this is not an action targeted against the Maastricht

98 Deutsche Bundesbank, Annual Report 1990 (Frankfurt: 1991), p. 10.

99 Deutsche Bundesbank, Annual Report 1994 (Frankfurt: 1995), p. 101.

100 'EMU-Made in Germany' in *The Economist* (London: 2 November 1991).

101 'Zur Einigung der Europäischen Rates über den Standort des Europäischen Währungsinstitutes' in *Pressemitteilung der Deutschen Bundesbank* (Frankfurt: 29 October 1993).

agreement.’¹⁰² Its evaluation of the effects of the crisis for the EMU process was not devastating at all: ‘The process of monetary integration in Europe need not be disrupted by the temporary widening of the margins of fluctuation.’¹⁰³ From 1990 onwards, the Bundesbank had offered lower interest rates for a general realignment, pressing strongly for such a step in the wake of the crisis. It is not exclusively to blame for the crisis and was also not responsible for the fact that risk premia made interest rates in France, Italy and Britain even higher than in Germany. During a secret meeting in Paris on 26 August 1992, the Finance Ministers of the three countries decided against a devaluation, even at the cost of rising interest rates – for which one could easily blame the Bundesbank. When Grahl writes that ‘the disruption of the ERM is a consequence of German failure to meet (its European) responsibility’,¹⁰⁴ he overlooks that the Bundesbank acted under the legal prescription to safeguard the German currency. It accepted but did not will the collapse of the ERM in its pursuit of price stability for Germany. It might have tacitly welcomed the negative light this threw on a holistic EMU as inferior to its two-tier proposal, but making monetary policy a function of its political preferences is taking the interpretation too far. Nothing other than the necessary realignments occurred via the markets instead of the central banks. Schlesinger wrote on the crisis that ‘that was not a retrograde step on the road to EMU, but rather ensured a more sustainable basis for the further course of monetary integration.’¹⁰⁵ It contributed to a smooth and stable changeover from DM hegemony to the euro and does not provide evidence for a subversion strategy on behalf of the Bundesbank. Hence the episode does not give support to the thesis that the Bundesbank was trying to recover from its alleged defeats over GEMSU and EMU and fought a desperate and final battle for survival.¹⁰⁶

4.3.4 To Clone a Central Bank

The EMU compromise was achieved by Germany giving up its exclusive control over monetary policy and the other countries accepting German-style priority for price stability as a common standard. Overall, the concrete timing of EMU and its tight schedule was the major concession of the

102 Central Bank Council press conference (Frankfurt, 19 December 1991).

103 Deutsche Bundesbank, Monthly Report August 1993 (Frankfurt: 1993), p. 27.

104 J.Grahl, *op.cit.*, p. 91.

105 Deutsche Bundesbank, Annual Report 1992 (Frankfurt: 1993), p. 9.

106 As implied, among others, by D. Marsh, *op. cit.*

German side to France, whereas strict convergence criteria and ECB independence was the price France had to pay.

The Bundesbank was critical but has never stated its opposition to such a compromise, given the condition of price stability was fulfilled. Unlike the massive political will for GEMSU in Germany, overall support for EMU was rather weak across Europe. If it were really true that, as Walter Eltis writes, there was ‘a belief by those who control (the Bundesbank) that the German government is replacing the DM with the euro through an illegitimate political process’,¹⁰⁷ then a combination of such a belief and the existing public dissatisfaction with EMU would have been devastating for the project. Hence it is simply wrong to claim, as Marsh does, that ‘France and Italy have registered a historic victory.’¹⁰⁸ Only a misunderstanding and exaggeration of Bundesbank competences could result in the misguided idea that it was trying to jeopardise the project. Its persistence on the ultimate goal of price stability has often, and sometimes willingly, been misunderstood as outright opposition, which it was not.

President Tietmeyer commented on the Maastricht Treaty that he was ‘pleased with the monetary part of the treaty’ and that ‘EMU meets the most important Bundesbank conditions.’¹⁰⁹ He had good cause for being pleased – comparing the ECB statute with his demands presented at a seminar on central banking¹¹⁰ shows that they have been fulfilled almost down to the letter: commitment to price stability, independence in institutional, functional and personal terms, full control over the instruments of monetary policy, prohibition of extending public credits, integral structure of ECB and ESCB with central decision making, a Bundesbank-like structure, binding rules on fiscal policy restraint, and lastly the completion of the single market, independence for all national central banks and sufficient convergence prior to the establishment of the ECB.

Those who argue that EMU was a sign of Bundesbank weakness are wrong. Its support shows acceptance coupled with the determination to influence structure and functionality of the project.

107 W.Eltis, 'British EMU Membership would Create Instability and Destroy Employment' in M.Baimbridge, B.Burkitt and P.Whyman (eds.), op.cit., p. 146.

108 D. Marsh, 'Bonn Agrees to Surrender the D-Mark' in *Financial Times* (London: 12 December 1991).

109 Both in H. Mundorf, 'Wenn die Vertragspartner der Ratio des Vertrages Folgen, Funktioniert die Union' in *Handelsblatt* (Düsseldorf: 17 December 1991).

Grahl writes that ‘German central bankers seem to have subscribed to the scholastic doctrine that, in order to secure the immortality of the soul, it is necessary to resurrect the body – certainly the ECB could hardly be closer than it is to a physical replication of the Bundesbank.’¹¹¹ But precisely the fact that the ECB is modelled on the Bundesbank to an extent that seems excessive to many non-German commentators is a refutation of the view that Germany’s central bank failed to resist the project out of weakness. Its aim was to influence, not to prevent.

5. Conclusion

It is easy to fall prey to a misconception of the Bundesbank which sees the occurrence of inner-German and European Monetary Union as evidence for the fact that this allegedly so powerful institution in the end lacked sufficient strength to prevent them. The argument runs that despite the fierce resistance it mounted, for example by deliberately causing the collapse of the EMS, the Bundesbank had to give in to the combined pressure of the German government and its European partners. This argument turns out to be based on false premises and therefore is not sound. The false premise consists of a misrepresentation of the Bundesbank’s competences and preferences. The Bundesbank was not fundamentally opposed to German monetary union or to EMU. It was critical of some of the decisions taken in the course of both processes and it repeatedly voiced its doubts and concerns, but it has never seen it in its legally prescribed domain nor in its ability to jeopardise any step towards monetary integration in both cases. Nor did its preferences diverge in the way posited by the argument, which wrongly sees the Bundesbank as diametrically opposed to both projects.

Secondly, the Bundesbank was neither overrun nor excluded from the decision-making processes. It had ample opportunity to influence the outcomes and the results are much closer to its true preferences than many commentators acknowledge. Its fundamental conditions for both monetary unions have been fulfilled to the detail. These were full responsibility for monetary policy in the case of GEMSU and a structural design geared towards monetary stability for EMU.

110 H. Tietmeyer, 'The Role of an Independent Central Bank in Europe' in P. Downes and R. Vaez-Zadeh (eds.), *The Evolving Role of Central Banks* (IMF, Washington: 1991), p. 176.

111 J.Grahl, op.cit., p. 154.

Thirdly, it seems inappropriate to test the institutional strength of the Bundesbank against an exaggerated conception of its domain of jurisdiction. As the central bank of Germany, it was principally responsible for domestic price-stability, and only secondarily concerned with external aspects of the DM under the guidance of the political leadership. The fact that the bank expressed strong preferences in both areas but did not always succeed in the latter does not constitute evidence of weakness in the former.

The allegations of Bundesbank weakness rest on a wrong representation of its position and views, leading to an exaggerated portrayal of its concessions in the bargain. The widespread error, particularly in the Anglo-American literature, goes along the lines of, for example, Carlin and Soskice who argue that ‘these episodes dented the Bundesbank’s reputation since they made it clear that at the end of the day it was not in control of underlying economic policy’.¹¹² The reputation was dented because it was exaggerated, not because the Bundesbank was actually weaker than before. The findings this study suggest a revised picture of this important institution. The Bundesbank was powerful but not omnipotent. Rather than resisting to GEMSU and EMU, it was involved as a critical but constructive partner in their making. Having been the guardian of *Stabilitätspolitik* for half a century, the Bundesbank was politically independent and institutionally strong; strong enough to pass on the torch of sound money to a successor created in its own image, the European Central Bank.

112 W. Carlin and D. Soskice, op.cit., p. 70.

Annex

CBC	Central Bank Council (Bundesbank steering committee)
CDU	Christian Democratic Party
COMECON	Council for Mutual Economic Assistance
CSU	Christian Social Party
DM	Deutsche Mark
EC	European Community
ECB	European Central Bank
Ecofin	Council of Ministers of Economics and Finance
ecu	European Currency Unit
EMI	European Monetary Institute
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EU	European Union
F.D.P.	Free Democratic Party
G3	Group of Three Industrialised Countries
G7	Group of Seven Industrialised Countries
GDP	Gross Domestic Product
GDR	German Democratic Republic
GEMSU	German Economic, Monetary and Social Union
OECD	Organisation for Economic Co-operation and Development
PDS	Party of Democratic Socialism
SPD	Social-Democratic Party

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