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DIW Berlin — Deutsches Institut für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
T +49 30 897 89 -0
F +49 30 897 89 -200

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Publishers
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Dr. Ferdinand Fichtner
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Translation
HLTW Übersetzungen GbR

Layout and Composition
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Press office
Renate Bogdanovic
Tel. +49-30-89789-249
presse@diw.de

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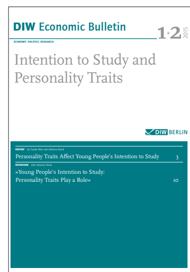

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NEXT WEEK IN DIW ECONOMIC BULLETIN

Energy-Intensive Industries

Lessons for Europe from German Monetary Union

By Marcel Fratzscher

Precisely 25 years ago, on July 1, 1990, German monetary union came into force. On the same day, capital controls in Europe were abolished, creating the basis for European monetary union and the euro. These two historical events fundamentally changed Germany and the rest of Europe. Both German and European monetary union were and still are being heavily criticized and debated. Was the design of German monetary union wrong? Was it a mistake to adopt the euro? Particularly in terms of finding a solution to the current European crisis, it is important to understand what lessons Europe can take from German monetary union.

This came into force on July 1, 1990. It came as somewhat of a surprise and was implemented very quickly. Although the last elections in the GDR and the events of March 1990 pointed to reunification, many economists and politicians were very critical of German monetary union. The aim was to unite East and West Germany, two countries with completely different political systems and economic structures. One approach, favored by many in 1990, was gradual economic unification, the objective being to keep the turmoil of high unemployment and major social uncertainty to a minimum.

However, it turned out differently. Political pressure and pressure from a great many GDR citizens led to the decision to introduce German monetary union on July 1, 1990. In addition, the average exchange rate of 1.6 East German marks to one D-Mark led to fierce debate among politicians, economists, and also between the West German government and the *German Bundesbank*. As Karl Brenke's article in this issue of *DIW Economic Bulletin* illustrates, the political intention was to stop the mass exodus of East German citizens by rapidly and irreversibly implementing German unification, particularly given the unstable foreign economic situation.

Today there is broad consensus that this approach to German monetary union contributed to the swift collapse of the GDR's economic structures. After monetary union, many East German companies could not compete with Western companies; their production costs in D-Marks climbed steeply. Unemployment and underemployment increased rapidly in the former East Germany and many people had to completely rebuild their lives. Achieving the promise of "blossoming landscapes" in East Germany within just a few years turned out to be an illusion.

However, this painful and difficult adjustment process in the former East Germany is not in itself proof that German monetary union took place too quickly and with the wrong exchange rate. The relevant question is

whether the transition process to monetary union might have been more successful and occurred more smoothly using a different approach. The answer to this question is a resounding "No."

The crucial point is that the GDR's economic structures already had no chance of surviving—and so it was ultimately only a matter of time as to how quickly they would collapse and be replaced by something new. Who would have bought a Trabant (an East German car) in 1990—despite all the nostalgia—even if the price had been halved due to a different exchange rate in German monetary union?

The strong exchange rate of the East German mark to D-Mark also had the advantage that it gave many citizens in East Germany assets in D-Marks which served to mitigate the social hardships and high level of uncertainty or provide substantial support through consumer spending in the initial years. Not only did West German producers of consumer goods benefit, but so did the East German economy because many goods, for example, and most services, could only be traded locally.

Consequently, there was a considerable catching-up process in East Germany up until the end of the 1990s which allowed many people to find work again. Disposable income per inhabitant in eastern Germany grew to 82 percent of the western German level. Although the economies have converged substantially since then, it would be unreasonable to expect complete parity of income and productivity across various regions. There are also still considerable regional differences in western Germany, for instance, between the north and the south of the country, which have diverged further in recent years. There are regions in eastern Germany, such as Leipzig, Dresden, and Berlin, which have clear strengths in individual economic sectors and are not only market leaders in Germany but internationally.

Overall, monetary union in Germany has been a success story. It was the right decision to implement it quickly because the GDR's economic structures at the time could not be saved. And it was right to set a relatively high exchange rate. Ultimately, this meant massive fiscal transfers from West Germany to East Germany. As a result, demand in East Germany stabilized and created an important anchor for stability.

In many ways, today's Greece is comparable to the GDR of 1990. The two main problems in both countries were/are the inefficient government institutions and an economic structure incapable of competing internationally. In the GDR, the first of the two problems was solved by reunification, which saw the institutional structures of West Germany transferred to East Germany.

Another major similarity between the then GDR and modern Greece is the vast majority of citizens calling for a common currency. At the time, East German citizens also wanted the D-Mark as soon as possible. The same applies to Greek citizens today: more than 70 percent want to keep the euro and not revert back to a national currency.

However, there is something else they have in common—the unrealistic and contradictory promises of politicians that suggest to the population that it is possible to create "blossoming landscapes" in a just few years without the country having to undergo painful reforms. There is little difference in the election promises made by the West German government in 1990 and by the Greek government today.

One important difference is that German monetary union included a fiscal union and high financial transfers from West to East Germany—around 1,500 billion euros according to DIW Berlin's calculations—whereas such fiscal transfers are much lower within the euro area. These German-German transfers certainly played a major role in the development of eastern Germany. However, it would be wrong to assert that the only beneficiaries of German domestic transfers were in (the former) East Germany. It was mainly western German companies that benefited from these transfers. They were able to make themselves more competitive within Germany and internationally due to the high investment subsidies. These transfers should not only be seen as going from west to east but also as transfers from taxpayers to companies.

In contrast to the GDR in 1990, Greece has chosen the option of a gradual adjustment process. There were virtually no institutional reforms in Greece in the decades before joining the European monetary union in 2001. Institutional reforms have only been initiated since the introduction of the euro and the two rescue packages from the European Union and the International Monetary Fund in 2010. In terms of improving government institutions, reunification had the same impact on the GDR as European integration is having on Greece today—although this transition is proceeding much more slowly in Greece.

With regard to competitiveness and economic structures, Greece still has the majority of the adjustment process yet to come. The problem for Greece, much the same as in the GDR, is less about international demand for goods and services that are, however, too expensive, and much more about a simple lack of products and services that are in demand internationally—apart from tourism. As a result, a weaker currency would do little to help Greece today.

This shows that the euro is not Greece's problem. A Grexit, an exit from the euro area and depreciation of the new currency would, therefore, not solve either of Greece's two main issues. On the contrary, a Grexit would lead to the insolvency of the Greek state and also many businesses and citizens. It would cause the Greek economy to collapse, with a sharp rise in unemployment and major social turmoil. It would therefore not make the urgently needed reforms of Greece's government institutions any easier but in fact, more difficult. And a Grexit would not lead to an economic renewal of the country but to many more years of economic decline.

Some critics of the euro, particularly in Germany, argue that the euro area is not an "optimum currency area" and therefore the euro would not work for its 19 very different member countries. The flaw in this argument is that there is no optimum currency area—according to this logic, a German-German monetary union ought never to have taken place because East and West Germany were economically very different in 1990, as the current 19 member countries of the euro area are today.

The second point often made by euroskeptics is that a common currency can only work with political union. This argument, too, is inaccurate. A single currency requires an economic convergence process and close coordination of economic policy with common rules. However, this does not require strong centralism with economic policy decisions taken only at the political level. Germany, in particular, with its strong federal structures, highlights how important the principle of subsidiarity is, so that, as far as possible, decisions are taken by those affected.

A third point—made especially by German euroskeptics—is that other Europeans do not abide by the common rules and, therefore, a common currency cannot function. But this argument is also unconvincing. Of course, in a monetary union, it is important to establish common rules and implement them, too. The compelling conclusion, however, is to create a mechanism for making regulations binding, not to abolish monetary union.

The argument is also questionable, since many German euro-critics suggest it is only southern Europeans who do not abide by joint regulations. First, it was Germany that was one of the first countries to break the 2003 Stability and Growth Pact. Second, joint regulations are also frequently circumvented and broken in Germany's federalism. Examples include agreements in the Solidarity Pact II, according to which incoming funds are to be used exclusively for investment in the states of the former East Germany. With the exception of Saxony, no state has adhered to it so far. Moreover, some of the German states, including Berlin, Bremen, and Saarland, and many local authorities today are in much more debt than was originally planned and regulated for. Hardly anyone, however, would question German monetary union because Germany's federalism does not always work smoothly and joint regulations are not always adhered to.

The same applies to the euro area and the euro. A sustainable and successful common currency does not require centralization and political union but simply close economic policy coordination with strict joint regulations. Nevertheless, two things must be ensured. First, there must be an economic convergence process within the monetary union (without requiring economic equality), so that monetary policy and other economic policies can function symmetrically. Second, a successful monetary union requires all economic players to behave in a manner that does not cause systematically occurring negative effects and costs (externalities) for other members of the monetary union.

What would a coordinated policy and joint regulations for Europe and the euro look like? Six elements are crucial. First, the European internal market needs to be consolidated further and fully completed. Although there are no longer formal barriers in many areas, Europe must more strongly and proactively promote cooperation between different regional and national stakeholders. A main priority in this area must be to complete the planned Capital Market Union (CMU) in the coming years. This requires reducing the national fragmentation of financial markets and financial institutions so that more funds can be invested across national borders. This increases efficiency and, above all, reduces concentrated risks. This factor is also important to keep the UK in the European Union, a country that is a significant partner for Germany on many economic policy issues.

Second, the banking union must be finalized. Europe is already on the right track here but has yet to implement the resolution mechanism for insolvent banks. A banking union is important so that financial institutions can operate throughout Europe and globally and risks can be understood and minimized, not only from a national but also from a European perspective.

Third, the euro area needs a fiscal union with clear and joint regulations which is ultimately an insurance union. In order to strengthen and make credible joint regulations such as the Fiscal Pact and the Stability and Growth Pact, the euro area should establish a joint finance minister who has clear rights to intervene in national budgets in cases where national governments do not respect the joint regulations. This should in no way be interpreted as a loss of sovereignty but merely as jointly exercising fiscal sovereignty in extreme situations. An

insolvency procedure for countries should also be introduced whereby governments can no longer receive aid from the European rescue mechanisms without first getting private creditors to participate in the costs with a credible and significant "bail-in."

A successful monetary union does not have to be a transfer union. Even within strongly federal countries, such as the US or Germany, the importance of fiscal transfers is limited. Every monetary union will always have large regional differences without these necessarily calling in to question the meaningfulness of the union. Rather, the euro area should become more of an insurance union, in which unexpected positive or negative shocks in individual regions or countries are borne jointly through market mechanisms. To achieve this, the completion of the Capital Market Union, the internal market, and the banking union are essential. This can also complement and strengthen joint unemployment insurance without this leading to a permanent transfer mechanism between countries.

The fourth element of a sustainable monetary union is coordinated structural policy with the aim of also making individual regions competitive and therefore keeping regional differences in check—see also proposals made by the five European Presidents (EU Council, EU Commission, Parliament, Eurogroup and the ECB). However, great care must be taken here because each country has its own economic and institutional structures, so a uniform structural policy hardly seems sensible. Common objectives in terms of competitiveness—which already exist through the EU's "Macroeconomic Imbalances Procedure"— should therefore be agreed upon without wanting to compensate for differences between national policies.

Fifth, monetary policy must be able to act independently again in order to concentrate exclusively on its mandate. The political vacuum in fiscal policy, financial stabilization, and structural policies during the European crisis led to the ECB having to take on an unusually large number of tasks which pushed it to the limits of its capacity to act. This requires having a clearly defined mandate for the ECB anchored in the EU treaties with a precise definition of what actions it is permitted to take under what circumstances.

The sixth and final element of a successful monetary union is for the legitimization of these European integration steps to be strengthened considerably. European integration ought not become a project for the political or economic elite. Rather, it is the responsibility of politicians to seek dialogue with citizens and to convince them of the usefulness, the objectives, and the benefits of European integration and a successful monetary union. Only then can the integration process in Europe succeed. In their article in the present issue of *DIW Economic Bulletin*, Ferdinand Fichtner and Philipp König present the need for political debate on the European integration process in more detail.

After 25 years, no-one today is fundamentally questioning the meaningfulness of German-German monetary union on July 1, 1990. It is one of the most important foundations for the successful integration of East and West Germany and the high productivity of the entire German economy. Europe, and Germany in particular, as one of the most open economies in the world, are now benefiting equally from European monetary union. We are well on the way to laying the foundations for a sustainable monetary union, although we are still faced with some important challenges and we repeatedly experience setbacks, as shown by the current crisis in Greece. Nevertheless, the hope and expectation is that we will no longer doubt the usefulness and benefits of European monetary union in 25 years' time, as is now the case with German monetary union.

Marcel Fratzscher is President of the German Institute for Economic Research (DIW Berlin) | mfratzscher@diw.de

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Prof. Marcel Fratzscher, Ph.D., President of the German Institute for Economic Research (DIW Berlin)

FOUR QUESTIONS TO MARCEL FRATZSCHER

»There Are Many Analogies Between the GDR in 1990 and Greece Today«

1. Professor Fratzscher, German monetary union came into force 25 years ago on July 1, 1990. On the same day, capital controls in Europe were removed, laying the foundations for a European monetary union and the euro. What lessons can Europe learn from the German monetary union? In 1990, there was considerable criticism because German monetary union was implemented so rapidly. In hindsight, I think that this was the right step to take as, ultimately, a common currency in the form of the D-Mark was a key prerequisite for establishing new industries and maintaining and creating employment, and therefore crucial for the integration of East Germany. This is one of the lessons learned from the German experience: a common currency can provide not only stability and growth, but it is also an important stimulus for deeper integration. Second, it was also essential to complete this process of integration quickly. Even today, in Europe, we continue to debate whether important reforms should be implemented swiftly or carried out gradually over a period of many years. With the former East Germany, rapid implementation was a success. Within the first ten years, eastern Germany gained considerable ground and income per capita rapidly grew to 82 percent of the western German level. The third lesson is that regional differences are inherent in a monetary union. There are significant disparities between the individual member states of the European monetary union and, despite Germany's strong common currency in the 1990s, there were also massive differences, not only between eastern and western Germany, but also between the north and south of the country.

2. Was or is the euro the pacesetter for European integration? To a certain extent, the euro is a product of the process of integration which began very slowly in Europe in the 1950s. The euro continued this process. In Europe, we now have a banking union and joint supervision of major banks. This would not have been possible without the euro. The banking union brought considerable advantages in its wake, as did other measures resulting from the introduction of the euro, such as the harmonization of industrial standards. The euro has brought numerous benefits for many countries, not least for Germany. So the answer is that the euro is both a product and a driver of integration. Clearly, it is not possible to have a common currency at the beginning of every process of integration but a common currency can provide added impetus and have extremely important economic benefits.

3. Ultimately, East Germany's economy had no chance of surviving. Can we draw parallels with Greece? There are many interesting parallels between the GDR in 1990 and Greece today. These two countries have or had no functional institutions; nor were their economic structures capable of surviving long term. Interestingly, another similarity is that, in the past, politicians made significant promises to the population which were impossible to keep. In East Germany, at the time, we pledged "blossoming landscapes" but it took substantially longer before the promise of such economic prosperity was actually fulfilled. The Greek government is doing exactly the same today by pledging the world yet, at the same time, knowing that such promises are impossible to keep.

4. What does Europe have to do to stabilize the monetary union? Europe does not need a political union but we do need reforms in various areas: first, the completion of the banking union including the joint supervision of banks. We still have some way to go here. Second, we need a capital market union so that, for example, it becomes easier for German banks to lend abroad and German companies to invest in other countries. Third, structural policy needs to be aligned with a view to securing a certain level of competitiveness for all countries. Fourth, we need a fiscal union that consists of joint binding rules to ensure that, when it comes to spending policy, all member states behave in a manner that does not impact negatively on their neighbors.

Interview by Erich Wittenberg

A Critical Retrospective: German Monetary Union

By Karl Brenke

Twenty-five years ago, East Germany adopted the deutschmark as its currency. In terms of East German economic development, monetary union proved to be a disaster. With virtually no warning, East Germany's few productive factories and businesses were exposed to free market competition; industrial production collapsed in a way unparalleled in history. Nevertheless, for political reasons, introducing monetary union at the start of the process of system transformation was almost unavoidable. Given the insecure foreign policy situation, the aim was to seize the chance of reunification and push through monetary union to create an irreversible fait accompli. Moreover, this move was intended to put a brake on the massive exodus of people from East Germany. Admittedly, it also buttressed the widespread illusion among the East German population that a strong currency would facilitate fast-track income parity on West German levels. This illusion, however, also encouraged excessive wage hikes which only served to intensify the shock of alignment in summer 1990, complicate economic renewal in eastern Germany, and increase the financial costs.

Fall of East Germany and SED's Helplessness

Germany's monetary, economic, and social union came into force 25 years ago—and it was completely unexpected. The East German Socialist Unity Party (SED) and the state leadership had planned to dedicate 1989 to a series of festivities to mark the 40th anniversary of the German Democratic Republic (GDR). Not even in their wildest dreams could they have imagined that East Germany would no longer exist just one year later. Even in the West, it was inconceivable that the GDR could collapse like a house of cards—especially since a large percentage of the population supported the prevailing policies.[1]

The impetus for change came from abroad. The *perestroika* movement in the Soviet Union had a strong impact on the political climate in East Germany. The first expression of the ruling regime's loss of authority came in the shape of protests over the evident rigging of the local election results in May 1989. That summer, thousands of East Germans determined to leave the country occupied West Germany's embassies in Prague, Warsaw, and Budapest. In September, when Hungary opened its borders, people from East Germany could cross there to the West. Simultaneously, steadily growing crowds swelled the "Monday demonstrations" calling for political freedom and the freedom to travel. In mid-October, Erich Honecker, SED leader and East Germany's head of state, was forced to resign. The Berlin Wall fell on 9 November.

In the fall of 1989, East Germany's economic problems were becoming increasingly obvious. Previously, there was only a suspicion of such problems based on the

1 The ruling Socialist Unity Party (SED) alone in East Germany had almost 2.3 million members, equal to one in six of the adult population. The figure for support is even higher taking into account members of the parties in political alliances with the SED. In addition, there were a variety of mass organizations, some with very large numbers of members—for example, the Free German Youth (FDJ) movement, the Young Pioneers Organizations, the Free German Trade Union Federation (FDGB), and Combat Groups of the Working Class (*Betriebskampfgruppen*).

growing obsolescence of the production plants. However, these problems were never openly discussed. Instead, the political leadership denied and repressed them.[2] In a nutshell, East Germany had lived far beyond its means.[3] A growing proportion of its economic resources was used for consumption, and no funds ploughed into the investments necessary for upgrading production facilities; it was a "social policy of capital erosion."[4] Rather than export income and loans from abroad utilized for acquiring plant equipment as initially foreseen by the party line of the "unity of economic and social policy," these were spent on purchasing consumer goods such as, for instance, foodstuffs.

In the debate in the fall of 1989, East Germany was presented internationally as hopelessly indebted.[5] By the end of 1989, external financial obligations, surging in the period after 1985 due to growing export deficits, had reached 49 billion *Valutamark*.[6] Moreover, the state had significant liabilities to its own banking system.[7] Although it may seem reasonable to doubt the theory of East Germany's total overindebtedness,[8] the country would hardly have been in a position to act on its own to reduce its debt burden to a viable level. In view of the country's poor economic performance, significant cuts in consumption would have been inevitable, placing an enormous pressure on the government to justify any go-it-alone policy.

The GDR governments led by Krenz and then Modrow in the months following Honecker's resignation hoped to preserve the country's independence by reforming the economy. The drive toward greater economic efficiency was to comprise three main pillars: a shift away from rigid state planning, greater economic autonomy for production facilities, and more performance-related wages. In addition, growing numbers of private enterprises were also to be permitted. However, state ownership of property was to remain the central form of ownership.[9] According to its statutes, the renewed SED party sought to realize "socialism [...] beyond the profit economy, exploitation, and bureaucratic administrative socialism." Nevertheless, virtually no reforms were initiated; the East German leadership seemed paralyzed.[10]

High Migration Levels

With the general population continuing to have little faith in East Germany's independent economic future, more demonstrations were held again. Now, though, there were new slogans calling for German reunification.

This lack of faith played its part in fueling a major wave of migration, although those leaving were also drawn by higher incomes in West Germany. In November 1989, the month when the Wall came down, 73,000 people left East Germany for the West, with another 59,000 leaving in December. In the first three months of 1990, almost 50,000 people emigrated every month (see Figure 1).[11] The size of this exodus was reminiscent of the period before the Wall went up, with large numbers leaving East Germany by August 1961 when the border to West Berlin was sealed (see Figure 2). Furthermore, after the Wall had fallen, a significant and growing proportion of East Germans also began commuting to jobs in West Germany and West Berlin, although there are no figures available on the precise number.

From the perspective of East German economists and social scientists, the key labor market problem of the *Wende* (the fall of the Wall and change in regime) was the loss of the labor force through the flood of migration and commuters to the West; their view of events did not include the possibility of a steep rise in unemployment

2 On October 7, 1989, in his ceremonial address to mark East Germany's 40th anniversary, East German leader Erich Honecker noted that since the country had been founded, it had developed "an economy with a modern structure and great economic potential." He added that it "is characterized by dynamism and growing efficiency." The speech also contained the promise that thanks to the use of microelectronics, productivity in East Germany, already "among the ten most productive industrial nations in the world" was set to see a future increase even greater than before. See "Durch das Volk und für das Volk wurde Großes vollbracht," Ceremonial address by Erich Honecker, General Secretary of the Central Committee of the SED and Chairman of the Council of State of the GDR, *Neues Deutschland*, October 9, 1989 (Translated by Allison Brown: http://www.germanhistorydocs.ghi-dc.org/pdf/eng/Chapter14Doc_14.pdf).

3 For an overview of the debate, see K. Brenke, "Die Jahre 1989 und 1990: Das wirtschaftliche Desaster der DDR - schleichender Niedergang und Schocktherapie,"*Vierteljahrshefte des DIW*, no. 2 (2009).

4 P. Hübner, "Industrielle Manager in der SBZ/DDR. Sozial- und mentalitätsgeschichtliche Aspekte,"*Geschichte und Gesellschaft,* no. 24 (1998).

5 See G. Schürer, G. Beil, A. Schalck, E. Höfner, and A. Donda, "Analyse der ökonomischen Lage der DDR mit Schlussbetrachtungen," prepared for the Politburo of the SED's Central Committee, October 27, 1989 (duplicated manuscript).

6 See G. Schürer et al., p. 5. The *Valutamark* was primarily a statistical unit of account in East German foreign trade, though the basis for its calculation was kept secret. For 1989, one can assume that a *Valutamark* was worth approximately four East German marks. See U. Ludwig, R. Stäglin, and C. Stahmer with the assistance of K-H. Siehndel, "Verflechtungsanalysen für die Volkswirtschaft der DDR am Vorabend der deutschen Vereinigung," *Beiträge zur Strukturforschung*, no. 163 (1996).

7 Amounting to 123 billion East German marks in 1988. See G. Schürer et al, p. 4.

8 See German *Bundesbank*, *Die Zahlungsbilanz der ehemaligen DDR 1973 bis 1989* (Frankfurt a. M.: 1999).

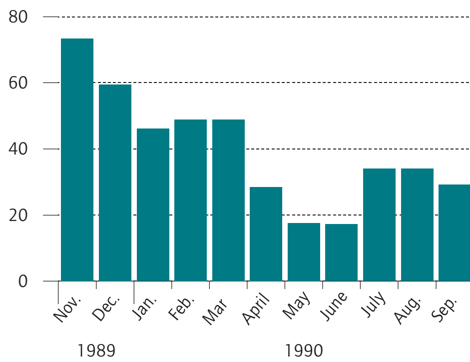
9 See, for example, G. Gysi, "Wir kämpfen für die DDR, für soziale Sicherheit, für Stabilität und Frieden," *Materialen zum außerordentlichen Parteitag der SED-PDS* (Berlin: December 1989).

10 Aside from a law on forming joint ventures between state-owned businesses and western investors.

11 These were the figures given by the East German administrative bodies. The exodus may well have been larger since not everyone leaving East Germany informed the responsible authorities of their intentions.

Figure 1

Emigration from the GDR to the Federal Republic of Germany 1989/90
1,000 persons



Sources: Statistical office of the GDR; Gemeinsames Statistisches Amt der neuen Länder.

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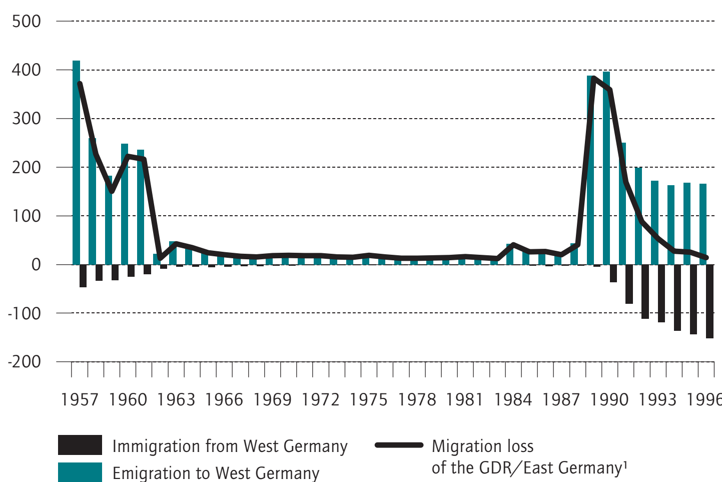
The lack of faith in the economic future fuelled a major emigration wave.

Figure 2

Emigration from the GDR/East Germany and Immigration to the GDR/East Germany
1,000 persons



1 Incl. East Berlin.

Source: Federal Statistical Office.

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The size of the exodus was reminiscent of the period before the wall was constructed.

during economic reconstruction.[12] The various suggestions on how to "safeguard the labor supply" included setting up "wage compensation funds" to finance the mandatory conversion of wages from deutschmarks to East German marks for those commuters working in the West. Such a move was intended to make this cross-border commuting less attractive. In addition, the proposal of generally limiting the free movement of workers was also discussed.[13] None of these measures were practically or legally viable, however.[14]

Policy-Makers Opt for Monetary Union

Monetary union between the two Germanys was first posited in the political arena in mid-January 1990 as a means to slow the exodus to the West.[15] The West German government willingly adopted the suggestion as its own, presenting it publicly on February 6. Since the deutschmark was associated with economic prosperity and a higher standard of living, the idea of monetary union strongly resonated with the general population in East Germany. Such an association was evident in a popular slogan chanted at the demonstrations: "*Kommt die D-Mark, bleiben wir. Kommt sie nicht, gehen wir zu ihr*" (If we get the Deutschmark, we'll stay here! If not, we'll move over there!). The announcement of monetary union may well have also been a decisive factor in the mid-March East German elections for the unicameral *Volkskammer* which returned the Ost-CDU (Christian Democratic Union of East Germany) and its allies as the clear winners. In the polls prior to the election, the Ost-CDU was seen as trailing. Yet the party's victory was also a vote for the deutschmark; an "independent East Germany" was no longer a real option. Immediately following the elections, the monthly figures of those leaving the country dropped by half.

12 See L. Hummel, E. Sachse, and V. Thiel, "Vorschläge zur gemeinsamen Beratung mit dem DIW," January 17, 1990 (duplicated manuscript). In winter 1989–1990, at the initiative of East German social scientists and scholars, a working group on the labor market was formed with DIW Berlin members.

13 Hummel et al, "Vorschläge."

14 The proposals were incompatible with West Germany's constitution. According to the Basic Law (*Grundgesetz*), every citizen of East Germany was already a citizen of the Federal German state; under these proposals, East German citizens would have been even worse off than citizens of other EU member states. As a result, there was no way of stopping the mass migration of the labor force from East to West Germany. At most, migration into the social system could be decreased. See K. Brenke, V. Meinhardt, F. Stille, J. Volz, H. Vortmann, and G. G. Wagner, "Auswirkungen der Öffnung der innerdeutschen Grenze auf den bundesrepublikanischen Arbeitsmarkt," *DIW Discussion Papers*, no. 5 (1990).

15 It was proposed by the social democratic SPD politician Ingrid Matthäus-Meyer in a solo action which had not been agreed with the executive of her party. See I. Matthäus-Meyer, "Signal zum Bleiben," *Die Zeit*, January 19, 1990.

Economic Debate over Monetary Union

The announcement of monetary union came as a complete surprise. On the very same day the West German government first proposed monetary union, the *Bundesbank* issued a statement that any such move still lay in the distant future. The vast majority of economists and social scientists shared the *Bundesbank*'s view that monetary union could not take place ahead of a program of fundamental economic reforms in East Germany.

In February 1990, an open letter by the (then West Germany's) Council of Economic Experts attracted particular notice. In this, the Council laid out a road map which began with dismantling the planned economy price system with its subsidies and excessively weighted prices, resolving the problem of accumulated excesses in the money supply and purchasing power due to the scarcity of goods, creating a financial system capable of meeting the demands of a market economy, and introducing a series of other reforms—not least the sweeping privatization of state-owned companies.[16] Initially, there was to be a fixed exchange rate for the East German mark, with convertibility phased in gradually—and as quickly as possible.[17] The Council also reasoned that monetary union would clearly highlight the gap between East German incomes and those in the West. Since monetary union was tied to the illusion of quickly achieving parity with western living standards, this was expected to trigger a series of excessive pay increases.[18]

DIW Berlin similarly argued for East Germany's statehood and separate currencies. The exchange rate of the East German mark could be linked to the deutschmark, but with the rate set as low as possible—the proposed rate was five East German marks to one deutschmark.[19] Thus, the argument continued, export trade could successfully assert itself in competition, while the low exchange rate would attract the foreign investments so urgently needed. The convertibility of the East German mark should only be established at the end of the reform process. Moreover, it was essential to ensure that pay increases were related to increases in productivity. Finally, on the political level, the DIW saw a confederation model as a possibility.[20]

There were also economists and experts advocating a swift move to monetary union, however. Economist Hans Willgeroth, for example, saw the monetary union treaty as itself already providing an adequate regulatory basis.[21] This, he argued, not only excluded government financing through the printing press, but would, above all, establish tolerably reliable price signals on a deutschmark basis; thus, investors would not be exposed to exchange rate and convertibility risks which, in turn, would have a favorable effect on the level of interest rates. In Willgeroth's view, whether the currency was convertible or not was immaterial, since prices and incomes would in any case have to be aligned with productivity. Alternatively, if a separate currency were maintained, this would lead—for instance, in cases of excessive pay increases—to massive depreciation. The associated increase in import prices would result in expanded inflation within the country, amounting to an indirect adjustment in real wages. In a monetary union, Willgeroth argued, increasing prices in the wake of excessive wage rises would produce a drain on purchasing power. The falling demand and growing unemployment would then force an adjustment in nominal wages.

The Question of the Right Conversion Rate

Admittedly, rather than puzzling over when monetary union should be introduced or whether it should be introduced at all, the public debate largely focused on the appropriate conversion rate for the East German mark to deutschmark. The general population in East Germany expected the rate to be one to one, and showed a marked lack of enthusiasm for any other option such as, for instance, the possible rates put forward by the *Bundesbank*.[22] The East German government indicated a similarly strong resistance to any rates deviating from conversion at par.

With regard to the conversion rate debate, two aspects were particularly significant. First, there was a concern over monetary stability, not least in the *Bundesbank*, worried that the additional money and build-up of con-

16 "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Brief des Sachverständigenrates vom 9. Februar 1990 an den Bundeskanzler," (letter from the German Council of Economic Experts to the German Chancellor), in *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Auf dem Wege zur wirtschaftlichen Einheit Deutschlands. Jahresgutachten 1990/91,* (Stuttgart: 1990), 307.

17 "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Zur Unterstützung der Wirtschaftsreformen in der DDR: Voraussetzungen und Möglichkeiten. Sondergutachten vom 20. Januar 1990," (special report by the German Council of Economic Experts on support for economic reforms in the GDR: prerequisites and opportunities), in *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Auf dem Wege zur wirtschaftlichen Einheit Deutschlands. Jahresgutachten 1990/91*, (Stuttgart: 1990), 289.

18 "Brief des Sachverständigenrates": 308.

19 DIW Berlin, "Reform der Wirtschaftsordnung in der DDR und die Aufgaben der Bundesrepublik. Stellungnahme einer deutsch-deutschen Arbeitsgruppe," *DIW Wochenbericht,* no. 6 (1990): 68ff.

20 See L. Hoffmann, *Warten auf den Aufschwung* (Regensburg: 1993).

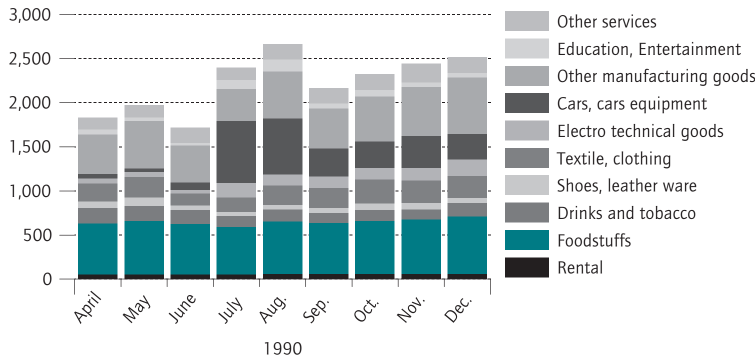
21 H. Willgeroth, "Probleme der deutsch-deutschen Währungsunion," *Zeitschrift für Wirtschaftspolitik*, no. 3 (1990).

22 For bank deposits and loans, the *Bundesbank* favored a conversion rate of two East German marks to one deutschmark.

Figure 3

Monthly Expenditures of Employees Households with Two Children[1] in the GDR resp. East Germany

DDR-Mark resp. D-Mark



1 Without households of unemployed main income earners.

Sources: Statistical Office of the GDR; Gemeinsames Statistisches Amt der neuen Länder; DIW calculations.

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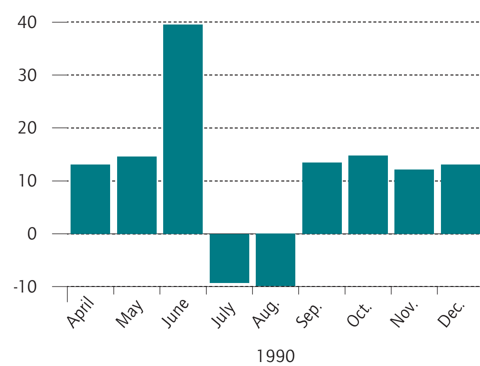
After German monetary union in East Germany the sales of cars and electrical products increased.

Figure 4

Savings Rate of Employees Households with Two Children[1]

In Percent of Household Income



1 Without households of unemployed main income earners.

Sources: Statistical Office of the GDR; Gemeinsames Statistisches Amt der neuen Länder; DIW calculations.

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In September 1990 the savings rate rose again.

sumer needs among East German citizens could trigger a spending spree and fuel inflation. Second, if the conversion rate were set too high, the fear was that this could lead to a *de facto* appreciation, leaving East German companies unable to withstand competition. This, however, raised the question of East Germany's economic productivity, but it was a question without any sufficiently reliable answer. West German government estimates put productivity in East Germany at approximately one third of their level.[23]

In the treaty on establishing the monetary, economic, and social union, it was agreed that flow variables (wages, current state social provisions such as retirement benefits, etc.) were to be converted at par. This rate was justified since, for example, wages were also approximately only around one third of the West German levels.[24] Although, in principle, stock variables (bank balances, debts, etc.) would be subject to a conversion rate of two East German marks to one deutschmark, under a system of age-related tiered amounts, certain percentages of the bank balances were also to be exchanged at par.[25] In practice, the conversion ratio for stock variables was 1.6 to 1.[26] As measured by the production potential—which could only be roughly estimated—the additional money supply for East Germany was approximately 50 percent too high; for the entire currency area, this was 4.5 percent, which was viable under the stability policy.[27]

Shock after Currency Change-Over

Introducing the deutschmark into the territory of East Germany on July 1, 1990 did in fact give a strong impetus to consumer spending—particularly since households there had refrained from making purchases over the previous few weeks while they waited for the much-anticipated deutschmark (see Figure 3). Above all, the sales of cars and electrical products increased, yet this could hardly be called a sustained out-and-out shopping binge since consumer demand fell in September and the saving rate rose again (see Figure 4).

This was a reaction to the economic development. The parts of the East German economy exposed to international competition were proving to be hopelessly inferior to competition from the West. Now within just a few

23 J. Ludewig, *Unternehmen Wiedervereinigung. Von Planern, Machern, Visionären* (Hamburg: 2015), 44.

24 Ludewig, *Unternehmen Wiedervereinigung.*

25 See *Deutsche Bundesbank*, "Modalitäten der Währungsumstellung in der Deutschen Demokratischen Republik zum 1. Juli 1990," *Monatsbericht der Deutschen Bundesbank,* no. 6 (1990).

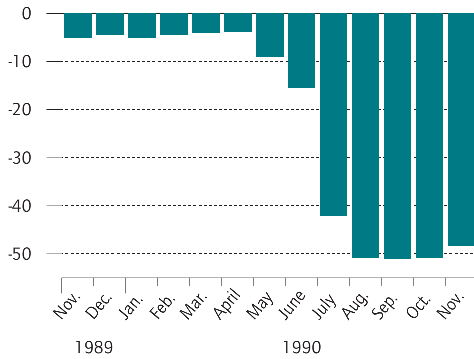
26 P. Bofinger, "Geld- und Kreditpolitik nach der Bildung der deutschen Währungsunion," in *Wirtschaftspolitische Probleme der Integration der ehemaligen DDR in die Bundesrepublik*, eds. H. Gröner, E. Kantzenbach, O. G. Mayer (Berlin: 1991), 152.

27 Bofinger, "Geld- und Kreditpolitik": 163.

Figure 5

Production in Industry in the GDR resp. East Germany

Change Versus Previous Year in Percent



Sources: Statistical Office of the GDR; Gemeinsames Statistisches Amt der neuen Länder; DIW calculations.

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Within just a few weeks industrial production fell by nearly 50 percent.

weeks, industrial production, which had already shown signs of faltering before, fell by almost 50 percent (see Figure 5)—a scenario that is historically unique.[28] Underemployment rose by leaps and bounds. Not only did the number of registered unemployed increase sharply, but so did the number of short-time workers; frequently, short-time workers had no hours to work at all, since there was nothing to do.

Major job creation programs were also launched and, from late 1990, many employees were shifted into qualification schemes which had been quickly set up.[29] Numerous people were given early retirement. The wave of redundancies first hit retired people who were still working and some foreign employees, and neither of these groups ever appeared again in any official labor market statistic. By late 1990, approximately three million people of the previous labor force potential of 9.8 million were either unemployed, placed in labor market policy measures, or pensioned off. The situation on the labor market became even worse the following year. Given the dramatically deteriorating situation on the labor market, the prospects for the future were uncertain, which also explains why there was no sustained consumer binge as had sometimes been expected.[30]

Causes for Collapse

Although converting from a planned to a market economy was expected to lead to the closure of large numbers of production facilities and high levels of personnel adjustment, no-one anticipated the full extent of the collapse after monetary union. The causes for this collapse could have been on the demand side; after all, rather than East Germany undergoing such radical political and economic changes alone, the entire Eastern Bloc was affected—including countries which were traditionally the leading foreign customers for East German products. However, this cannot be the cause of the rapid and dramatic decline in industrial production, particularly in the weeks directly after monetary union. On the contrary, the German federal government provided a massive support program of favorable conditions for those factories and businesses trading with Eastern Bloc partners.[31] Without this support, then, industrial production would have collapsed even more dramatically.

With the availability of the deutschmark, the preferences of the East German population changed, often happier to buy goods from the West instead of those produced locally. Since western goods genuinely offered better quality in terms of production, functionality, or design, such a purchase decision may well have been taken on rational grounds. On the other hand, the decision may also have involved irrational grounds, with East German goods merely suffering from their association with a poor image. Be that as it may, ultimately the decisive factor is the consumer's wishes and the price. Productivity is low where the goods produced cannot be sold or are only sold in the low-price segment.

On this basis, then, the causes for the massive slump in production must logically lie on the supply side. Obviously, the conversion rate did not reflect productivity. Numerous publications before and after monetary union were dedicated to the productivity gap between West and East Germany; their estimates vary widely, with pro-

28 Germany experienced a similarly dramatic collapse in industrial production in the early 1930s. The collapse lasted two years—from early 1930 to early 1932. R. Wagenführ, "Die Entwicklung der Produktion," in *Das Wirtschaftsjahr 1932/33. Tatsachen, Entwicklungsbedingungen und Aussichten der deutschen Volkswirtschaft*, ed. F. Raab (Leipzig: 1933), 17.

29 Wagenführ, "Die Entwicklung."

30 Even before monetary union, responses from the vast majority of households taking part in surveys indicated that their spending behavior was not going to change fundamentally after the introduction of the deutschmark. See Institut für angewandte Wirtschaftsforschung, *Kaufrausch nach der Währungsunion*.

31 See DIW Berlin, Institute for the World Economy, "Macroeconomic and Microeconomic Adjustment Processes in East Germany– Third Report," *DIW Economic Bulletin*, no. 39–40 (1991), as well as DIW Berlin, Institute for the World Economy, "Macroeconomic and Microeconomic Adjustment Processes in East Germany—Fifth Report," *DIW Economic Bulletin*, no. 12–13 (1991).

Table 1

Monthly Gross Wages[1] in the GDR by Selected Industries

	Mark			Change in Percent	
	1st half-year 1989	1st quarter 1990	2nd quarter 1990	1st Qu. 1990 versus 1st half-year 1989	2nd Qu. 1990 versus 1st Qu. 1990
Manufacture of chemicals, pharmaceuticals	1,101	1,115	1,283	1.3	15.1
Manufacture of basic metals, metal products	1,119	1,132	1,335	1.2	17.9
Manufacture of construction materials	1,027	1,081	1,230	5.3	13.8
Maschinery, cars, transport equipment	1,088	1,124	1,229	3.3	9.3
Elektrical, elektronical goods, computers	1,055	1,091	1,195	3.4	9.5
Light manufacturing	962	994	1,062	3.3	6.8
Manufacture of textiles	967	994	1,048	2.8	5.4
Manufacture of food products	974	1,032	1,142	6.0	10.7
Electricity and coal mining	1,227	1,228	1,385	0.1	12.8
Water supply, waste	1,013	1,051	1,228	3.8	16.8
Transportation	1,162	1,277	1,334	9.9	4.5
Postal services, telecommunication	968	1,016	1,282	5.0	26.2
Education		1,088	1,174		7.9
Health services		1,250	1,531		22.5
Residential care, social worker activites		944	1,101		16.6
Scientific research and developement		1,320	1,484		12.4
Creative and arts activities		1,084	1,225		13.0
Total		**1,116**	**1,242**	**4.1[2]**	**11.3**

1 Full-time equivalent.
2 Only industries with complete data.

Sources: Statistical office of the GDR; DIW calculations.

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Already before the German monetary union the wages increased.

ductivity in East Germany rated as only 50 percent or even 25 percent of that in West Germany.[32]

Although the productivity lag to West Germany no doubt varied in different sectors, with the gap possibly narrower in services than in the manufacturing sector, only one standard conversion rate could be set. To do justice to the realities across all sectors of the economy, the value of the East German mark ought to have been far lower than the deutschmark. For example, if the rate of 4.3 to 1 is taken as the benchmark, the internal clearing rate used by East German factories and businesses for exports to a non-socialist economic area (*nicht-sozialistisches Wirtschaftsgebiet, NSW*), then monetary union brought a considerable *de facto* appreciation of the manufacturing sector—and this even though the factories and plants active in the NSW export business were certainly not inefficient.[33]

Failed Wages Policy

Moreover, the granting of substantial wage increases even in the run-up to monetary union was overlooked. In the second quarter of 1990, wages in East Germany were 11 percent higher than in the first quarter, and they had also increased prior to that time (see Table 1).

Growth in wages was justified by reference to massive consumer price hikes. In fact, consumer prices fell between June 1989 and June 1990 (see Table 2), possibly as the result of factories and businesses reducing their stock on hand. A selective perception may have fueled this assumption of a general price rise: when there were individual price rises for certain goods, this was generalized to conclude that there was sweeping price inflation. However, prices only rose generally with monetary union, due in part to stronger consumer demand and also to partially abandoning a policy of price distortion.

32 For an overview see, for example, G. Heske, *Volkswirtschaftliche Gesamtrechnung DDR 1950-1989* (Cologne: 2009); Ludwig, Stäglin, and Stahmer, "Verflechtungsanalysen."

33 Sinn and Sinn point out that the conversion rate would have been appropriate in terms of purchasing power. A variety of goods are included in calculating purchasing power: non-tradable manufactured goods, usually labor intensive, where the productivity differences between West and East Germany were most likely relatively slight, as well as tradable goods where the productivity differences were most likely larger. The problem would have been that the productivity lag for tradable goods produced in East Germany would have been below purchasing power parity. G. Sinn and H. W. Sinn, *Kaltstart. Volkswirtschaftliche Aspekte der deutschen Vereinigung* (Tübingen: 1993), 44–5.

Table 2

Devolopement of the Consumer Prices in the GDR resp. East Germany

	All Private Households		Households of Employees[1]		
	June 1990	July 1990	July 1990	January 1991	November 1991
	Index; June 1989 = 100		Index; 1989 = 100		
Foodstuff, drinks, tobacco	96.2	114.0	115.4	119.3	126.4
Clothing, shoes	51.7	57.5	57.5	69.9	72.4
Rental costs, energy	100.0	100.0	100.0	158.6	375.8
Furniture, home appliances	84.8	74.5	74.8	82.4	85.0
Health and body care products	88.5	119.4	119.4	137.7	147.7
Transportation, telecommunication	93.4	85.2	85.2	97.8	111.8
Education, entertainment, cultural activites	88.3	88.5	88.5	117.7	129.0
Others	92.6	99.0	99.0	134.4	135.2
Total	**87.9**	**94.5**		**108.9**	**127.6**

1 Since January 1991 without East Berlin.

Source: Statistical office of the GDR; Landesamt für Datenverarbeitung und Statistik Brandenburg; Gemeinsames Statistisches Amt der neuen Länder; DIW Calculations.

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In contrast to the people's assumptions consumer prices fell before the monetary union.

Consequently, prices for previously heavily subsidized foods increased sharply in July 1990. In 1991, the rents for apartments in particular rose dramatically.

The wage increases before monetary union, though, were just the prelude to a strong and rapid wage drift. In some cases, wage rises had already been agreed for the months after monetary union.[34] This was the case, for example, in the key metal and electrical industry where pay levels rose in two steps by a good 40 percent by early October. This also no doubt gave a further impetus to the decline in industrial production. In fall 1990, the collective bargaining policy passed to the national German unions and employers' associations—which were, however, largely influenced by West German players. In spring 1991, the metal and electrical industry reached an agreement on wages gradually rising to achieve full parity with western German levels by April 1994. But with the employers' associations then put under pressure, this actually came to nothing. As a result, however, some member companies left, but it was far more serious that, due to this wage policy, many of the privatized and newly founded companies did not even join the associations in the first place.[35] The pay agreements did not apply to these businesses; moreover, in 1993, the metal industry employers revoked the planned incremental wage increases to meet levels in western Germany.

The wage drift steadily weakened across the economy as a whole, yet nonetheless consumer prices did not rise as fast as wages until 1995 (see Figure 6). Up until 1992, there was even the absurd situation in industry that wages outstripped economic output.[36] In other words, average factories and plants, many not privatized at that time, made massive losses which, ultimately, were shouldered by the state.

Conclusion

In contrast to European monetary union, an idea first raised in the late 1950s[37] and discussed more or less intensely over the subsequent decades, the monetary union of East and West Germany suddenly and unexpectedly appeared on the political agenda. Furthermore, unlike European monetary union, the objective was not to utilize a common currency to mutually link regions with similar economic systems, but to transform a command economy into a market economy. Yet there was no historical model providing the experience of how to cope with

34 The IG Metall (Industrial Union of Metalworkers) pushed through a flat-rate increase for the metal and electrical industry of DM 250 from July 1 and DM 300 as of October 1, 1990 for each person employed in the industrial sector. See K. Ohl, "Die Ost-West-Tarifangleichung in der Metall- und Elektroindustrie," *WSI-Mitteilungen*, no. 11 (2009): 628.

35 Ohl, "Die Ost-West-Tarifangleichung," as well as DIW Berlin, Institute for the World Economy, "Macroeconomic and Microeconomic Adjustment Processes in East Germany – Thirteenth Report," *DIW Economic Bulletin*, no. 27–28 (1995).

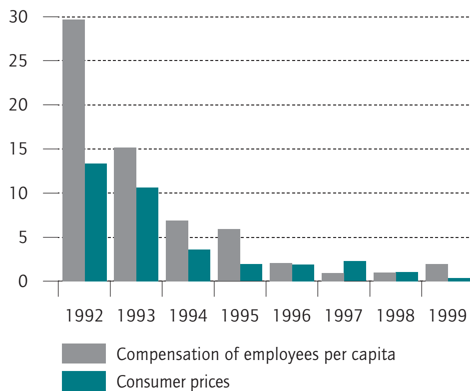
36 K. Brenke, "Eastern Germany Still Playing Economic Catch-up," *DIW Economic Bulletin*, no. 11 (2014).

37 W. Abelshauser, "Die Erblast des Euro - eine kurze Geschichte der Europäischen Währungsunion," *Aus Politik und Zeitgeschichte*, no. 43 (2010): 40.

Figure 6

Development of Wages and Consumer Prices in East Germany

Change Versus Previous Year in Percent



Sources: Arbeitskreis Volkswirtschaftliche Gesamtrechnung der Länder; Federal Statistical Office; DIW calulations.

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Until 1995 wages increased faster than the consumer prices.

the simultaneous transformation of monetary union and the economic system. Here then, rather than seeking to create regional equalization in the course of conventional or desirable economic development,[38] the aim was the economic reconstruction of a run-down region.

In addition, the political sphere was under pressure to slow labor force migration. The large-scale loss of human capital across the territory of the former East Germany would have left economic reconstruction with no viable chance of success; moreover, in western Germany, this flow of inward migration was considered a barely manageable burden.

From the economic point of view, it would have made most sense to tackle the transformation of the system first—which was the approach taken in eastern European EU member states. But in the case of East Germany, this was not an option. In the elections for the *Volkskammer* in March 1990, East Germany's population had voted for a swift move to monetary union. If this had then been postponed, East Germany would have found itself treading on very thin ice, both politically and economically, if not facing total chaos. Although it may seem from this perspective as if the West German government was driven by developments in East Germany, this is not the case. Instead, it was not only forcing the pace of monetary union but also promising that, in the case of German reunification, the former East Germany would soon catch up and thrive, transformed into "*blühende Landschaften*" (blossoming landscapes). The main objective was to seize the chance of reunification as fast as possible on the assumption that, given the unstable situation in the Soviet Union in particular, this window of opportunity would soon close.[39] By quickly establishing monetary union, an irreversible process would be started.

With monetary union, the system underwent transformation through shock therapy. Overnight, East Germany's economy was exposed to competitive forces which, to a large extent, it was quite unable to cope with. The conversion rate of the East German mark to deutschmark was fixed at the wrong level, failing to reflect the economic performance of factories producing goods for transregional trade. To align incomes to output and lay the foundation for a self-generated catch-up process,[40] it would have been necessary to reduce costs and, in particular, cut wages. Although wage cuts might have triggered an increase in labor force migration, the figures for those leaving eastern Germany rose anyway. After monetary union, the outflow from eastern Germany increased again, probably due to growing underemployment, and remained high over the subsequent years as well. However, outward migration no longer reached the levels in the period directly before monetary union.

In wage development, though, the trend was markedly away from wage cuts. Instead, wages rose sharply, with union representatives finding it more than easy to push up pay levels. Before monetary union, their counterparts in negotiations were the heads of state combines who, due to their involvement in the old political system, had to have the interests of their workforces at heart; moreover, they were themselves employees and so also interested in higher wages. Later on, the representatives of the employers' associations influenced by the West then had no interest in lower wages, let alone wage cuts, since efficient production in eastern Germany could have competed with businesses in western Germany. The political sphere was also unable to act against this type of wage policy since the right to free wage determination by employers and employees is anchored in the German constitution. As a result, there

38 As is assumed in older theories of optimum monetary union. According to Mundell, given the high mobility of the factors of production of labor and capital, currency union occurs where, within one currency area, labor and capital flow to an emergent region. See R. A. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review*, no. 4 (1961).

39 See Ludewig, *Unternehmen Wiedervereinigung*.

40 See G. A. Horn, U. Fritsche, and W. Scheremet, "Die doppelte Währungsunion: Deutschland und Europa im wirtschaftlichen Integrationsprozess. Ein Rückblick und Vergleich," *DIW Berlin Quarterly Journal of Economic Research*, no. 2 (2000): 166ff.

could only have been, at most, voluntary wage restraint agreements. But given the widespread illusion among the general population in East Germany that their incomes would quickly attain parity with West Germany, this was an impossibility.

After monetary union, extensive financial resources were deployed to cushion the social impact of growing underemployment and support factories and businesses earmarked for privatization. Purchasing power drained to western Germany, boosting the economy there and fueling inflation. The *Bundesbank*, with its remit of ensuring monetary stability, saw itself facing a "stabilization crisis"[41] and reacted by robustly raising the base interest rates. As a result, the economy in western Germany weakened significantly, placing an additional strain on the *Aufbau Ost* reconstruction program since, for example, with underutilized capacities in western Germany, it was more difficult to find investors. Moreover, the higher interest rates created tensions in the European monetary system.

If it was vital to seize the opportunity for swift political unification and if the aim was to put a brake on the wave of migration from East Germany, monetary union needed to be implemented at the start of the economic restructuring process. In political terms, then, monetary union was absolutely essential, although it proved to be a disaster economically. Fundamentally, the problem was the expectation linked to the adoption of a strong currency that this alone—as it were, automatically—would create economic efficiency and higher incomes. Such an expectation blanked out the fact that incomes have to be earned through the requisite productivity. Moreover, rather like the sorcerer's apprentice, policymakers had further fueled the illusion of East Germany quickly achieving income parity with West Germany.

Since monetary union was embedded in an economic and social union, economic reconstruction in eastern Germany was less driven by the adjustment processes there than, first and foremost, massive transfers from western Germany.[42] This policy has produced considerable achievements—in particular, the re-industrialization of eastern Germany.[43] Nevertheless, eastern Germany is still dependent on transfers, and per capita economic output is now only just slightly over 70 percent of the value in western Germany.

41 M. Neumann, "Transformationsproblem in der ostdeutschen Wirtschaft: Unvermeidliche Anpassungskrise oder wirtschaftspolitische Fehler?," in *Die zweifache Integration: Deutschland und Europa. Workshop zur Strukturberichterstattung*, ed. H. Siebert (Tübingen: 1993), 92.

42 Their own estimates put the cumulative amount at approximately 1.3 to 1.6 billion euros since 1990.

43 See Brenke "Eastern Germany."

Karl Brenke is researcher in the department of Forecasting and Economic Policy of the DIW Berlin | kbrenke@diw.de

JEL: E60, E65, F22

Keywords: german-german currency union

A Stronger Union Through Crisis? 25 Years of Monetary Integration in Europe

By Ferdinand Fichtner and Philipp König

On July 1, 1990, when capital controls in the European Economic Community were removed, the path was paved for the introduction of the euro. This path was marked by a compromise between two schools of thought—those who assumed that the creation of the European Central Bank would be followed by greater economic convergence and political integration, and those who saw the single currency as the coronation of European cooperation and economic convergence. In the initial years following the introduction of the single currency, the compromise as set down in the Maastricht Treaty—the speedy introduction of the single currency, on the one hand, and better cooperation in fiscal policy matters on the other—neither strengthened the institutional foundations of the monetary union nor advanced the political integration process. This resulted in economic divergence and tension in the euro area, which in recent years culminated in a severe crisis. It was only in response to this crisis that some of the necessary changes to the institutional structures of the monetary union were made. There is much evidence to suggest that, when the monetary union was originally being created, such tension and even crisis situations were consciously tolerated because of the stimulus for deeper integration this would provide. Such political maneuvering is very risky, however, since it can lead to the loss of public support for the integration process, thereby threatening the very existence of the common currency. To advance the European project, it is imperative that governments do not rely on the momentum inherent in crisis situations, but instead press ahead with the next stages of integration and take an active approach to bolstering the institutional foundations of the currency union.

The removal of capital controls between the member states of the European Economic Community on July 1, 1990 marked the beginning of what is probably the most ambitious monetary policy experiment in recent history—the introduction of a single currency in Europe.

The basis for the abolition of capital controls (see Table) was the implementation of the Single European Act, which had come into force three years previously; besides the removal of capital controls, the Single European Act also set down the creation of a European Single Market and the objective of an economic and currency union was reaffirmed by the signatory member states.[1]

At the European Council summit in June 1988 in Hanover, this goal was fleshed out and a dedicated committee assigned the preliminary work under the auspices of the then President of the European Commission, Jacques Delors. The report presented by Jacques Delors the following year proposed a single European currency be introduced in three successive stages, beginning on July 1, 1990 at the latest, concurrent with the removal of capital controls. A resolution passed by the European Council at its summit in Strasbourg in December 1989 ultimately confirmed the commencement of the three-stage process on the date proposed in the Delors Report.

First Steps on the Road to Monetary Union

As early as in 1970, a commission chaired by Luxembourg premier Pierre Werner presented the first proposal for the creation of an economic and monetary union.[2] Known as the Werner Plan, this proposal included a road map for the creation of a monetary union over a period of ten years. It comprised a three-stage design for closer cooperation on economic policy matters, the

1 These were Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxemburg, the Netherlands, Portugal, and the United Kingdom.

2 P. Werner, "Report to the Council of the Commission on the Realisation by Stages of Economic and Monetary Union in the Community," *Bulletin of the European Communities*, Supplement 11 (1970): 1–65.

Table

Capital Controls in ERM Depending on Types of Transactions
Year: 1988

	Securities		Loans		Other Transactions	
	Primary Market	Secondary Market	Trade Credit	Other	Deposits	Other
Belgium	K/A	K	K	K	K	K
Danmark	K	K	A	A	A	A
France	R/A	K	R	R	K/R	K
Germany	K	K	K	K	K	K
Ireland	A	K/R	K/A	K/A	K/U	K/U
Italy	A/U	K/R	K/A	K/A	K/U	K/U
Luxemburg	K/A	K	K	K	K	K
Netherlands	K	K	K	K	K	K
United Kingdom	K	K	K	K	K	K
Greece	A/U	A/U	A	A	R/U	R/U
Portugal	R/A	R/A	A	A	A	A
Spain	A	K/R	A	R/A	K/A	A

First letter refers to capital inflows, second letter to capital outflows; if only one letter is shown it refers to both in- and outflows.
K = no controls
A = authorization required
R = resreicted (for example with respect to maturity, use, volume)
U = prohibited (or required authorization that was usually not granted).

Source: Eichengreen, B. und Wyplosz, C. (1997): a.a.O., 159. Originalquelle: Morgan Guaranty Trust Co. (1988): Financial Markets in Europe Toward 1992. World Financial Markets 5, 5.

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liberalization of capital movements, and measures to combat structural differences between the participating countries. Despite the strong initial support that it enjoyed in Germany and France, the Werner Plan was soon shelved. Given the currency turmoil following the collapse of the Bretton Woods system and the resultant floating of exchange rates in Germany and the Netherlands, it is very likely that, in the early 1970s, the political will and scope required to irrevocably commit to a monetary union would have been lacking.[3]

The mid-1980s saw a turn of events. The decision to create a common agricultural policy lent the European integration process new momentum. In 1986, increasing integration at institutional level, ever-stronger trade links between member states, and the pending expansion of the European Community through the accession of Spain and Portugal finally culminated in the ratification of the Single European Act (SEA).[4]

The removal of capital controls set down in the SEA immediately elicited the question of a reform of European monetary and exchange rate policy. In 1979, on the initiative of Helmut Schmidt and Valéry Giscard D'Estaing, the European Monetary System (EMS) had been created, obligating participating countries to keep exchange rate fluctuations within fixed bandwidths. Since individual national monetary policies continued to be autonomous, the free movement of capital was not compatible with this arrangement.[5]

In addition, the EMS had regressed into a "deutschmark block" of sorts, where the other members felt forced to follow the stability-oriented policy of the German *Bundesbank* or to depreciate their currencies against the German mark.[6] As a result, the feeling of disgruntlement toward Germany and the monetary policy of the German *Bundesbank* had continued to grow steadily following the creation of the EMS.[7] In 1987, this led French Treasury Secretary Édouard Balladur, seconded

3 See O. Issing, *The Birth of the Euro* (Cambridge University Press, 2008), 5; W. Buiter, G. Corsetti, and P. Pesenti, *Financial Markets and European Monetary Cooperation – The Lessons of the 1992–93 Exchange Rate Mechanism Crisis* (Cambridge University Press, 1998), 22.

4 B. Eichengreen, *The European Economy since 1945 – Coordinated Capitalism and Beyond* (Princeton University Press, 2007), 336.

5 R. Mundell, "Capital mobility and stabilization policy under fixed and flexible exchange rates," *Canadian Journal of Economic and Political Science*, vol. 29 (1962): 475–485.

6 Issing, *Birth of the Euro*, 7.

7 H. James, *The Making of the European Monetary Union* (The Belknap Press of Harvard University Press, 2012), 227.

by Italian counterpart Giuliano Amato, to call for the creation of a new, less asymmetric monetary policy arrangement.[8] The essence of the Franco-Italian criticism was that the restrictive monetary policy pursued by the German *Bundesbank* was, judged by economic conditions in many other EMS member states, too restrictive. To defend the fixed exchange rate, weaker countries were thus forced to follow an–from their perspective–inappropriately restrictive monetary policy.

Free capital movements threatened to exacerbate this asymmetry. Without the option of capital controls, weaker countries could only attempt to put a stop to speculative capital flows by raising interest rates.[9] The less support from the German *Bundesbank* as guardian of the "anchor currency" in the EMS, the more expensive this was in real economic terms.

The creation of a Single Market as part of the Single European Act brought the removal of capital controls in its wake; but it unleashed economic centrifugal forces that required the reorganization of European monetary and currency arrangements.

Single Currency: Locomotive for Integration or Coronation of Long-Term Integration Process?

The debate on monetary matters in Europe was characterized by two opposing schools of thought. Those representing the so-called monetarist position,[10] often expressed in French circles, assumed that the creation of a monetary union would provide stimulus for deeper economic integration and would automatically result in precisely that (locomotive theory). Diametrically opposed was the so-called economistic position—one that was rather prominent in Germany, for example—that economic structure and economic performance have to converge first; this process may be accompanied by institutional changes and can ultimately lead to a monetary union (coronation theory).[11]

In January 1988, in response to the Franco-Italian criticism of the EMS, German Foreign Minster Genscher issued a "Memorandum for the Creation of a European Currency Area and a European Central Bank."[12] On the one hand, the memorandum constituted a break with the previous German standpoints in currency matters. Leaving behind a strictly economistic course, Genscher moved towards the monetarist position by accepting that economic convergence and monetary integration *can* happen concurrently.[13] In doing so, Genscher was taking the initiative to carry out the much-needed reform of the European currency system, but at the same time representing Germany's position on the all-important issues of the day. In fact, Genscher's memorandum underlined the need for economic convergence between member states, and the proposals made on the institutional structure of a European central bank were likewise based on principles which were rather German in nature, for instance, political independence and the primacy of price stability.[14]

The Delors Commission appointed in June 1988 took up this compromise line in their report:[15] on the one hand, the report issued a clear stability-oriented mandate and outlined the political independence of the new central bank, emphasizing the need for an absolute minimum of economic convergence prior to introducing the new currency. On the other hand, the commission called for the speedy establishment of a new European system of central banks and a European central bank in the second phase of the transition to the monetary union.[16]

During this transitionary phase, however, the compromise between monetarist and economistic thinking caused all sorts of difficulties. In December 1991, the Maastricht Treaty, which set forth criteria for the intended pre-monetary-union economic convergence and defined a fixed timetable for the introduction of the monetary union, was ratified: after the removal of capital controls in the first stage of the process, the second stage—which included the establishment of the European Monetary Institute (EMI) as a precursor to the ECB—was set to begin on January 1, 1994; the third stage— the final and irrevocable fixation of exchange rates and the introduction of the single currency—was to have been completed by January 1, 1999 at the latest.

8 E. Balladur, Memorandum by Edouard Balladur to the ECOFIN Council (1988); translated for the European Commission Monetary Committee.

9 Foreign currency reserves, the alternative means to intervene, were by no means sufficient to counter the speculative capital that could be moved on the financial markets.

10 This must not be confused with the economistic position of "monetarism" which was largely characterized by the works of Milton Friedman.

11 Buiter et al., *Financial Markets*, 32; Issing, *Birth of the Euro*, 6.

12 Eichengreen, *European Economy*, 351; European Parliament, "Der lange Weg zum Euro," *CARDOC (European Parliament Archives & Documentation Centre),* no. 8 (February 2012): 56.

13 S. Schieder, "Liberalismus vs. Realismus: Der Versuch einer Einordnung des "Genscherismus" in die Theorie der internationalen Beziehungen," in *Hans-Dietrich Genschers Außenpolitik*, eds. K. Brauckhoff and I. Schaetzer (Springer VS, 2015), 41–66.

14 James, *European Monetary Union*, 229.

15 Eichengreen, *European Economy*, 352.

16 Buiter et al., *Financial Markets*, 29. See James, *European Monetary Union*, for a detailed discussion on the eight Delors Commission sessions.

In the event of delays in the convergence process, this tight schedule barely left enough leeway to make viable adjustments. Given that it was the responsibility of the heads of state and government to monitor compliance with the criteria, the mandatory economic convergence conceded to the economistic position took on a political dimension, too; much suggests that deviations from the path of convergence by key member states would have been tolerated.[17,18]

At the same time, free capital movement was a *fait accompli* which, in conjunction with the fixed convergence criteria as per the Maastricht Treaty, made the European currency structure susceptible to speculative attacks during the transitionary second stage of the monetary unification process.[19] The –in particular in case of unfavorable economic conditions and existing structural differences between the countries– fragility of this arrangement became apparent during 1992 and 1993.

The 1991 recession had brought about a rise in unemployment, which was already at a high level in Europe. This increased the real economic costs of the restrictive monetary and fiscal policy measures which were required to meet the convergence criteria. At the same time, the German *Bundesbank* had inflationary pressures resulting from reunification to contend with; since 1991, the *Bundesbank* had been gradually increasing its interest rates with no regard for the impact this had on the common exchange rate mechanism. Faced with ever increasing interest rates in Germany, the other countries involved also had to raise interest rates to avoid excessive capital outflows, making their economic problems even worse.

In a referendum held in 1992, the Danish population voted against the Maastricht Treaty and subsequently the French government announced they would also be holding a referendum. This shattered the expectations placed in the irreversibility of the monetary integration. If the French had also rejected the Maastricht Treaty, this would have put a definitive end to the single currency.[20]

Given this possibility, the acute real economic cost of the "convergence policy" was suddenly of considerable consequence, thus increasing the vulnerability to speculative attacks. Faced with concerted speculative attacks, countries such as Italy or the United Kingdom, whose currencies were overvalued, were consequently more likely to devalue their currency, and leave the European exchange rate mechanism. Indeed, from the summer of 1992 on, the financial markets were increasingly putting their bets, among others,[21] on a devaluation of the Italian lira and the British pound. As a result, both countries initially had to leave the exchange rate mechanism and the United Kingdom even turned away from membership of the single currency.[22] This currency turmoil was not fully over until July 1993, when the bandwidths for exchange rate fluctuations were substantially widened.

Hence, the transition period conceded to the economistic school of thought was extremely fragile and even threatened to end in the failure of the entire monetary union project.

Europe—an Optimum Currency Area?

In view of the imminent introduction of the single currency, optimum currency area theory (OCA theory) experienced a renaissance in academic and policy-oriented publications.[23] A number of studies were conducted to examine whether the economies of the member states of the (future) European monetary union had experienced asymmetric effects (shocks) and, if so, wheth-

17 A particularly impressive example of the inherent political dimension of the convergence criteria is the following statement by former German Chancellor Helmut Schmidt. In the 46th edition of the German weekly *Die Zeit* of November 8, 1996, Helmut Schmidt writes an open letter to the then President of the German Central Bank Hans Tietmeyer, who repeatedly insisted that the convergence criteria be strictly complied with: "What you fail to mention is Article 104c, which was added to the EC Treaty as a result of the Maastricht Treaty, and the broad scope for decision-making that this affords the European Council—outwith any criteria whatsoever. Rather, you persist in giving the inaccurate impression that the criteria laid out in the Maastricht Treaty protocols are absolutely binding. However, since the ratification of the Maastricht Treaty, the EC Treaty now states: 'If a member state meets just one or none of these criteria, all other relevant factors shall be taken into account, including the medium-term economic and budgetary situation in the said member state.' [...] I can openly admit: I, too, wish for a high degree of convergence among the national economies of the member states. Convergence is not, however, crucial for the euro to work."

18 See L. Bini-Smaghi, T. Padoa-Schioppa, and F. Papadia, "The Transition to EMU in the Maastricht Treaty," *Princeton Essays in International Finance* (1994): 194.

19 This applies in particular to the requirement to keep the exchange rate stable for a period of two years in order to proceed to the third stage. If a country were forced into depreciation once, however, it would be debatable whether it would be willing to take on board the costs of a restrictive monetary and fiscal policy for a further two years in order to be able to qualify for membership to the single currency. If not, this would justify the *ex post facto* attacks. For more on this, see B. Eichengreen and C. Wyplosz, "The Unstable EMS," in *European Monetary Unification – Theory, Practice and Analysis*, ed. B. Eichengreen (MIT University Press, 1997), 153–224; Buiter et al., *Financial Markets*.; B. Eichengreen, "Epilogue: Inconsistent Quartets," in *European Monetary Unification – Theory, Practice and Analysis*, ed. B. Eichengreen (MIT University Press, 1997), 323–328.

20 On September 20, 1992, the French population voted for the adoption of the Treaty, albeit by an extremely tight majority of 51.1 percent, which was not enough to stabilize trust in the markets as an immediate consequence.

21 There were also strong speculations against the Swedish krona, the Finnish markka, the Spanish peseta, the Portuguese escudo, and the French franc.

22 For a more detailed description of the British pound crisis and the EMS crisis in 1992/93, see Eichengreen and Wyplosz, "Unstable EMS"; Buiter et al., *Financial Markets*; B. Eichengreen, *Globalizing Capital – A History of the International Monetary System* (Princeton University Press, 2004).

23 A brief overview on the theory of optimum currency areas can be found in A. Belke, K. Bernoth, and F. Fichtner, "The Future of the International Monetary System," *DIW Economic Bulletin*, no. 37 (2011): Box 2, p. 15.

er the adjustment mechanisms in place—in particular high factor mobility between the countries—had been effective enough to offset the absence of an independent monetary and exchange rate policy.

Following a detailed cost/benefit analysis and in due consideration of the criteria derived from OCA theory, an extensive study by the European Commission conducted in October 1990 found that the creation of a European monetary union could be expected to result in microeconomic efficiency gains (e.g., as a result of the removal of transaction costs) and greater macroeconomic stability (with regard to inflation, production, and employment).[24] One of the arguments presented was that, given the very diversified economic structures of the European economies, individual countries were relatively immune to sector-specific shocks, which is why those had very little effect on macroeconomic developments. In addition, the high degree of capital market integration in the European Economic Area (EEA) was considered an important factor in favor of the creation of a monetary union.[25] Moreover, the integration on the goods and factor markets that a monetary union would bring about tends to go hand in hand with increasing business cycle synchronization, which in turn means lower costs for the relinquishment of country-specific monetary policy.[26]

By way of contrast, a number of other studies, e.g., those based on comparisons with the US, concluded that countries in the European Community were more prone to asymmetric shocks than other areas of economic integration.[27] According to such studies, mobility, in particular with regard to labor, lagged far behind that of other regions.[28] Other studies criticized the level of financial policy integration in the European Community, saying it lagged far behind the US, which is why it is of limited use in correcting any economic divergence in the monetary union, should that occur.[29]

Overall, when it came to the suitability of the European Economic Area for monetary integration and the road map outlined in the Maastricht Treaty, experts were rather skeptical. Such concerns, however, had very little impact on the actions taken by the key political decision-makers; with the exception of the exit of the United Kingdom in 1992, the road map laid out in the Maastricht Treaty was implemented according to plan. In this way, the introduction of the single currency demonstrated the dominance of the monetarist position:[30] instead of creating the economic policy and institutional conditions for a European fiscal and monetary union before actually establishing the monetary union, the single currency was introduced in the good faith that it would become the key driving force behind ever deeper integration.

Jacques Rueff, French economist and later adviser to Charles de Gaulles, is reported to have said as early as 1949: “L'Europe se fera par la monnaie ou ne se fera pas”—Europe will be created by means of a single currency or not at all. Half a century later, Otmar Issing, Chief Economist of the European Central Bank, stated: “With the onset of Monetary Union the Maastricht Treaty has created a unique, historical asymmetry. On the one hand, a European, supranational monetary order, yet predominantly national sovereignty in most other areas. This combination creates a tension that will leave its mark on the future integration process. There can be no turning back, as the failure of Monetary Union would not only be extremely costly from an economic point of view, but the political fallout would be unimaginable and would be tantamount to a catastrophe. The brightest and most respected former skeptics have conceded this much and now share the conviction that, once it has been set in motion, European Economic and Monetary Union must not fail.”[31]

The Road Into the Crisis

Initially, monetary integration in the euro area was a success in economic terms.[32] In the medium term, the European Central Bank was largely able to maintain its target rate of inflation of close to but below two percent. The monetary union also resulted in deeper goods and capital market integration, as well as a marked conver-

24 Commission of the European Communities, “One market, one money: An evaluation of the potential benefits and costs of forming an economic and monetary union,” *European Economy*, no. 44 (October 1990).

25 P. Bofinger, “Europa: Ein optimaler Währungsraum?,” in “Europäische Integrationsprobleme aus wirtschaftswissenschaftlicher Sicht,” eds. B. Gahlen, H. Hesse, and H. J. Ramser, *Wirtschaftswissenschaftliches Seminar Ottobeuren*, vol. 23 (Tübingen: J.C.B. Mohr (Paul Siebeck), 1994), 125–151.

26 J. Frankel and A. Rose, “The Endogenity of the Optimum Currency Area Criteria,” *Economic Journal*, vol. 108, issue 449 (1997):1009–1025.

27 B. Eichengreen, “Is Europe an Optimum Currency Area?,” *NBER Working Paper,* no. 3579 (1991).

28 T. Bayoumi and E. Prasad, “Currency Unions, Economic Fluctuations, and Adjustment: Some New Empirical Evidence,” *IMF Staff Papers*, vol. 44(1) (1996): 36–58.

29 X. Sala-i-Martin and J. Sachs, “Fiscal Federalism and Optimum Currency Areas: Evidence for Europe From the United States,” *NBER Working Paper*, no. 3855 (1991).

30 A very different position is advocated by Charles Wyplosz, “EMU – Why and How It Might Happen,” *Journal of Economic Perspectives*, vol. 11, no. 4 (1997): 3–21. He argues that the convergence criteria fixed in the Maastricht Treaty very much underline the dominance of the economistic school of thought. What is not considered, however, is that, from a strictly economistic perspective, this constitutes, at best, a compromise with the monetarist camp.

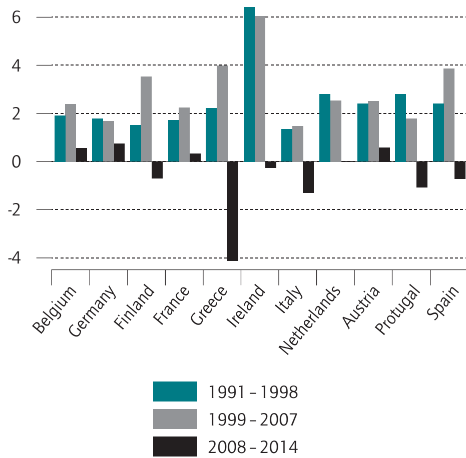
31 O. Issing, “ Europe: common money - political union?,” FAZ lecture held on September 20, 1999 in Frankfurt, https://www.ecb.europa.eu/press/key/date/1999/html/sp990920.en.html.

32 H. Tietmeyer, *Herausforderung Euro* (Munich, Vienna: Carl Hanser Verlag, 2005): Chapter 23.

Figure 1

Growth Before and After Introduction of the Euro

Average Yearly Growth Rate of Gross Domestic Product (in Percent)



Source: International Monetary Fund.

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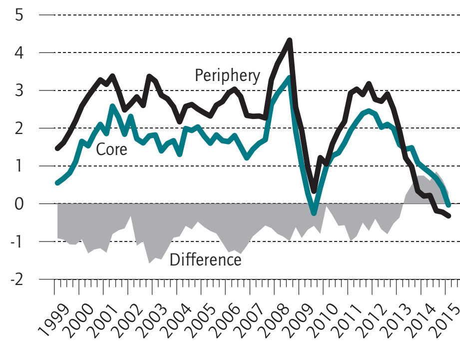
Figure 2

Inflation in Euro Area Countries

Y-o-y Change in Price Level (in Percent)



Core: Belgium, Germany, Finland, France, Netherlands, Austria.
Periphery: Greece, Ireland, Italy, Slovenia, Slovakia, Spain, Portugal.
Weighted by nominal gross domestic product.

Source: OECD, National Statistical Authorities.

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gence of interest rates on public and private debt.[33] As a result of these developments, in the years immediately after the introduction of the common currency until the onset of the global financial crisis in 2007, many member states experienced a stronger economic development than in the previous decade (see Figure 1).[34]

The inflation rates of the individual member states also converged to the inflation target of the ECB, although differences prevailed (see Figure 2).[35] These led (given almost identical nominal interest rates) to diverging real interest rates, which in those countries with stronger price development—driven to some extent by considerable divergences in the development of wages[36] and shortcomings in fiscal discipline[37]—generated excessive debt-financed demand and fostered the development of substantial current account imbalances (see Figure 3).[38] Without an autonomous monetary policy, the individual countries did not have the all-important adjustment mechanism to counter such unfavorable developments promptly. Other control mechanisms and instruments—alternatives to monetary policy which could have been employed to keep, in particular, private and public debt at a sustainable level—were not created while the monetary union was being fashioned, nor were they developed in the first ten years of the monetary union's existence.

Brought on by the global financial crisis of 2008 and 2009, tension grew within the European Monetary Union. Contrary to the common belief that a balance of payments crisis cannot happen within a monetary union, a reversal of capital flows took place. Debt-financed growth in the individual countries whose current account deficits were already considerable came to a halt, resulting in a vicious circle that, to this very day, has not been broken: undesirable developments in the banking system, public finances, and the real economy mutually inten-

33 See R. Baldwin et al., "Study on the Impact of the Euro on Trade and Foreign Direct Investment," *European Economy-Economic Papers* (2008): 321.

34 See F. P. Mongelli and C. Wyplosz, "The euro at ten – unfulfilled threats and unexpected challenges," manuscript, *Fifth ECB Central Banking Conference* (2009), https://www.ecb.europa.eu/events/pdf/conferences/cbc5/Mongelli_Wyplosz.pdf?d045ab7c3ac1f189381c5af61a274ae8.

35 I. Angeloni and M. Ehrmann, "Euro Area Inflation Differentials," *The B.E. Journal of Macroeconomics* 7(1) (2007): 1–36.

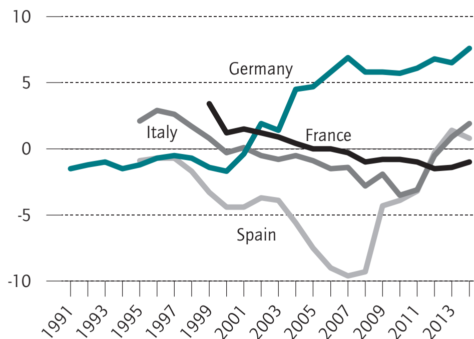
36 For a more detailed description, see U. Fritsche et al., "Auswirkungen von länderspezifischen Differenzen in der Lohn-, Preisniveau und Produktivitätsentwicklung auf Wachstum und Beschäftigung in den Ländern des Euroraums," research project commissioned by the German Federal Ministry for Economic Affairs and Labour (Bundesministerium für Wirtschaft und Arbeit), *DIW Berlin: Politikberatung kompakt*, no. 8.

37 European Central Bank (2003), Monthly Bulletin December 2003: 53–55.

38 C. Wyplosz, *The Eurozone Crisis – It's about Demand, not Competitiveness*, mimeo. (The Graduate Institute: Geneva, 2013); Mongelli and Wyplosz, "Euro at ten." Ahead of many in examining the problem of real interest divergence in fixed exchange rate systems was Sir Alan Walters, advisor to the then British Prime Minister Margaret Thatcher; see A. Walters, *Sterling in Danger – The Economic Consequences of Pegged Exchange Rates* (Fontana/Collins, 1990).

Figure 3

Current Account Imbalances in the Euro Area
Current Account Surplus
(in Percent of Gross Domestic Product).



Source: Eurostat.

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sified, resulting in a spiral of economic distortions and prevailing uncertainty among market players.[39]

During the crisis, at the latest, it became evident that the convergence criteria outlined in the Maastricht Treaty were not sufficiently comprehensive: both balance of payments imbalances and the development of private sector debt were excluded. At the same time, during the creation of the monetary union, the main focus was on the institutional framework of the European Central Bank, while other areas—a common banking supervision[40], a lender of last resort for countries[41], or an institutionalized sovereign debt restructuring mechanism[42]—were disregarded entirely.[43]

Crises as a Pacemaker of European Integration?

Essentially, the monetarist expectation that the introduction of the single currency would result in enhanced integration and coordination on economic policy matters remained largely unfulfilled, at least in the initial years of monetary union; it was only in response to the crisis in the euro area after 2010 that selective changes to the institutional framework in the euro area have been pushed through: This is exemplified by the 2012 European Fiscal Compact, the EU six-pack, or the supranational banking union agreement which illustrate at which speed the crisis acted as a catalyst and enforced modifications to the institutional framework of the monetary union, which should in fact have been carried out before the crisis.

In practice, therefore, the creation of the monetary union proved to advance integration. And yet, even since the inception of the common currency, political decision-makers were probably aware of the fact that a process like this could potentially cause considerable tension. Testimony to this is a statement by the then President of the European Council Romano Prodi in 1999: "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."[44]

In a similar vein, German Foreign Minister Joschka Fischer wrote in 1999 that "the creation of a common currency results in a situation of tension induced by the absence of common political and democratic structures, tension whose momentum will shatter the current status quo in the very near future."[45] And even in 2011, German Minister of Finance Wolfgang Schäuble was quoted as saying "we can only achieve a political union if we have a crisis."[46]

Thus, in line with what one may call a "nasty accident theory"[47] of European integration, crises are almost desired in the monetary union, as these generate the political justification needed to further the integration process. Taking a fatalist stance towards Jean Monnet's dictum that people only accept change in necessity and see necessity only in crisis,[48] it is argued that crises are an integrative force. For this reason, the general accept-

39 For more details on the vicious circle of the bank, national debt, and macroeconomic crisis, see J. C. Shambaugh, *The Euro's Three Crises* (2012), http://www.brookings.edu/~/media/Projects/BPEA/Spring%20 2012/2012a_Shambaugh.pdf.

40 F. Bremus and C. Lambert, "Banking Union and Bank Regulation: Banking Sector Stability in Europe," *DIW Economic Bulletin*, no. 9 (2014).

41 G. Illing and P. König, "The European Central Bank as Lender of Last Resort," *DIW Economic Bulletin*, no. 9 (2014).

42 C. Große Steffen and J. Schumacher, „Debt Restructuring in the Euro Area: How Can Sovereign Debt Be Restructured More Effectively?," *DIW Economic Bulletin*, no. 10 (2014).

43 For an overview of the necessary institutional reforms in the euro area, see also F. Fichtner et al., "Making the Euro Area Fit for the Future," *DIW Economic Bulletin*, no. 9 (2014).

44 Interview with Romano Prodi, *Financial Times*, 1999.

45 J. Fischer, "Die Bürger wollen wissen, wohin die Reise geht," *Frankfurter Rundschau*, February 3, 1999), cited in F. Niess, *Die europäische Idee – Aus dem Geist des Widerstands* (Frankfurt am Main: Suhrkamp Verlag, 2002): „(…) aus der Vergemeinschaftung der Währung gegenüber den noch fehlenden politischen und demokratischen Gemeinschaftsstrukturen [wird] ein Spannungsfeld entstehen, dessen Dynamik den gegenwärtigen Status quo bereits in naher Zukunft erschüttern wird".

46 W. Schäuble, "Seeing in Crisis the Last Best Chance to Unite Europe," *New York Times*, November 18, 2011; in the original: "We can only achieve a political union if we have a crisis."

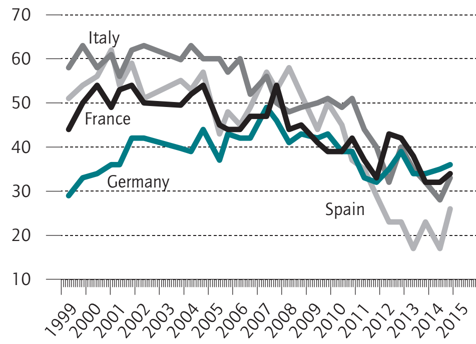
47 G. Rachman, "Super-Sarko's Plans for the World," *Financial Times*, October 20, 2008.

48 J. Monnet, *Mémoirs* (Paris: Fayard, 1976), 129: "Les hommes n'acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise."

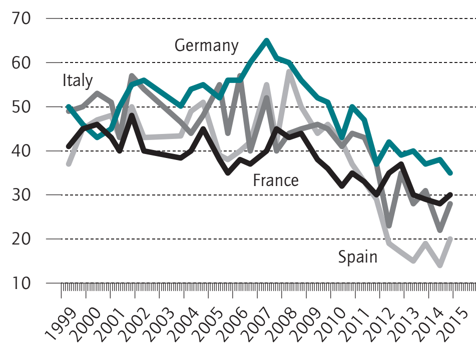
Figure 4

Trust in ...
In Percent[1]

... the European Commission



... the European Central Bank



1 Proportion of respondents that answered "Tend to trust" to the question "Please tell me if you tend to trust or not to trust in the ...".

Source: Eurobarometer.

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ance of change and reforms by the public is not an absolute must for political integration; accordingly, waving a "there is no other alternative" banner, reforms can be pushed through despite political opposition.

Political calculation such as this is not without its risks, however. The adjustment burden resulting from the current crisis has generated exceedingly high and direct, palpable costs, placing considerable pressure on the people of the countries affected worst. Willingness to bear such burden is rather limited and this has shaken the political landscape considerably, as can be seen almost all over Europe. Against this background, the commitment to deeper integration has diminished, and support for the idea behind a monetary, fiscal, and political union, as well as the Union's institutions has waned significantly (see Figure 4). According to the monetarist position, the integration process driven by the creation of a monetary union requires the single currency to be introduced irrevocably; however, crisis-induced tension which, in the best-case scenario, would foster integration could trigger a process which could just as easily lead to disintegration.

Conclusion

In his treatise *Exit, Voice, and Loyalty,* Albert Hirschmann discusses the options that a population has when faced with institutions it is dissatisfied with.[49] A stance that relies on the momentum inherent in crises to set the pace of integration risks the population expressing their dissatisfaction by choosing the *exit* option and the European integration process losing all support. The costs involved in returning to national currencies are both incalculable and in all likelihood extremely high. However, having said that, crises can be very expensive for the population, meaning that a nasty-accident integration policy cannot rule out the possibility of the European integration project being a success.

Hence, the monetarist strategy, relying on the common currency as a pacemaker for the integration process and thereby accepting deep and severe crises, is extremely fragile. This is illustrated by the recent dramatic developments in Greece. The economic divergences that were built up since the country's introduction of the common currency, have, over the past few years, caused massive economic and social distortions. As a consequence, at the beginning of 2015, a government was elected that refused to support the established economic policy consensus in the monetary union. In this way, the economic turmoil paved the way for political tensions between Greece and the other member states, which, almost exactly 25 years after the removal of capital controls in Europe, enforced the introduction of capital controls in Greece and threatens to cause the exit of Greece from the common currency.[50]

In light of this, it would be advisable to return to the idea of parallelism of monetary integration and economic cooperation as enshrined in the Maastricht Treaty which in some respects took account of economistic considerations. In future, European policy should focus more on this notion and foster political integration both actively and in democratic discourse with the population, thus allowing it to raise its *voice*, rather than allowing themselves to be driven by crisis. This is very likely to underpin the *loyalty* from which Europe and the single cur-

49 See A. Hirschmann, *Exit, Voice, and Loyalty* (Harvard University Press, 1970).

50 At the time of printing of this DIW Economic Bulletin, the consequences of the failure of the negotiations between Greece and its European partners about the extension of the financial support programmes were not conceivable.

rency takes its strength and, according to Hirschmann's theory, should reduce the relevance of the *exit* option. This is all the more valid in view of the fact that the end of the single currency would also mean the end, at least temporarily, of the entire political integration process, sending Europe back to times way before 1990, when on July 1 the removal of capital controls paved the way for the common currency.

Ferdinand Fichtner is Head of the Department of Forecasting and Economic Policy at DIW Berlin | ffichtner@diw.de

Philipp König is a Research Associate in the Department of Forecasting and Economic Policy at DIW Berlin | pkoenig@diw.de

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