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

Publishers
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Dr. Ferdinand Fichtner
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Press office
Renate Bogdanovic
Tel. +49-30-89789-249
presse@diw.de

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