# THE BUNDESBANK

ELLEN KENNEDY

GERMAN ISSUES ■ 19

American Institute for Contemporary German Studies
The Johns Hopkins University

# THE BUNDESBANK

ELLEN KENNEDY

GERMAN ISSUES ■ 19

**The American Institute for Contemporary German Studies (AICGS)** is a center for advanced research, study, and discussion on the politics, culture, and society of the Federal Republic of Germany. Established in 1983 and affiliated with The Johns Hopkins University but governed by its own Board of Trustees, AICGS is a privately incorporated institute dedicated to independent, critical, and comprehensive analysis and assessment of current German issues. Its goals are to help develop a new generation of American scholars with a thorough understanding of contemporary Germany, deepen American knowledge and understanding of current German developments, contribute to American policy analysis of problems relating to Germany, and promote interdisciplinary and comparative research on Germany.




ISBN 0-941441-17-2
ISSN 1041-9810

Additional copies of this AICGS German Issue are available from the American Institute for Contemporary German Studies, Suite 420, 1400 16th Street, N.W., Washington, D.C. 20036-2217. Telephone 202/332-9312, Fax 202/265-9531, E-mail: info@aicgs.org, Web: http://www.aicgs.org

# *FOREWORD*

Professor Ellen Kennedy's short study is the fourth in the Institute's series on key institutions of German democracy. The Institute's original intent was to treat in this series those institutions that are less well known and to omit those such as the Federal Chancellery or the lower house of parliament, the *Bundestag*, that are relatively familiar to Americans interested in contemporary Germany. Quite obviously, this study constitutes a huge exception to that original intent. No German institution is as well known around the globe as Germany's central bank, the *Bundesbank*. So familiar is it indeed that it is referred to everywhere by its German name, sometimes even by the spiteful nickname assigned to it by an irreverent British press, *Buba*.

The Institute has made this exception for many reasons. First, the *Bundesbank* is by any measure the most powerful institution in Germany. Second, the bank, with its independence, its credibility, and its purpose, which is to safeguard the stability of the *Deutschmark* (DM), serve as models for what may within a few years become a European Central Bank and its new European currency, the euro. Third, in this day and age when free markets have come to dominate in almost all countries, those elite institutions, the central banks, among which the *Bundesbank* is the strongest, have become a powerful force. The monetary policies that they pursue impinge on us all to an even greater extent than governments' fiscal policies.

What makes the *Bundesbank* so strong? The ingrained abhorrence of inflation among Germans means that the Bank enjoys broad popular support for its unyielding effort to maintain price stability. Thanks to this effort, Germany has curbed inflation over the decades much more effectively than any other major country. Small and medium-sized business, the *Mittlestandsindustrie*, and pensioners are both particularly influential groups in German society and for both, inflation is anathema. Add to this the *Bundesbank's* high technical competence, Germans' current distrust of politicians who run inflation-promoting deficits, and the Bank's federal structure, which means it has branches throughout the country and is thus close to the people.

The ultimate source of the *Bundesbank's* authority is its credibility among Germans. They rank it among the institutions that they trust the most (the police and the Federal Constitutional Court are the others). Their faith explains how a former European president could quip recently that, "Not all Germans believe in God, but they all believe in the *Bundesbank*." The Bank's credibility among Germans rests less on its competence or its economic forecasting abilities than on its long record of readiness to act swiftly and decisively whenever inflation rears its head.

Among the world's central banks, the *Bundesbank* is probably the most independent. Unlike the chairman of the Federal Reserve Board, who must put in periodic appearances before congressional committees, the Bundesbank president, currently Dr. Hans Tietmeyer, need not answer to parliament for his Bank's policies. Its deliberations are less transparent even than the Fed's. There are few visible government checks on its activities. On occasion too, it can be far more open than the Federal Reserve in criticizing the government's fiscal policy, recently, for instance, the effectiveness of tax reform efforts.

Professor Kennedy examines an inherent contradiction in the law creating the Bank, which both establishes its independence in monetary policy and at the same time obliges it to support the federal government's economic policy. Some chancellors have reminded some *Bundesbank* presidents that the legislation granting independence can always be amended. So a president needs to display political sensitivity—a characteristic particularly marked in the cases of Tietmeyer and his predecessor, the colorful Karl Otto Pöhl, but less so in that of Helmut Schlesinger, who served his term as president in the early 1990s, between theirs.

Professor Kennedy also describes the controversies over the years between the *Bundesbank* and the government, from which the former has usually but not always emerged the winner. Recently, Chancellor Helmut Kohl and his Finance Minister were forced by public outcry that reinforced the *Bundesbank's* position to retreat from their plan to revalue the *Bundesbank's* monetary gold reserves as to enable a quick transfer of several billion DM into the federal budget. (That move would have facilitated the government's effort to limit the budget deficit so as to conform to limits set by the Maastricht treaty's provisions for achieving European monetary union.) On a far more important issue seven years ago, how to finance German unification, Kohl overrode the *Bundesbank*, making it clear that there are limits to the influence of even the most powerful among central banks.

The European Union's plan to create a monetary union in 1999 is based on two parallel factors exemplified by the *Bundesbank*: central bank independence and a stable currency. Indeed, if the European Central Bank is established (in Frankfurt am Main, the seat of the *Bundesbank* today) it will apparently be even more independent than the *Bundesbank* itself. While the German bank was created by amenable parliamentary law, the European Central Bank is being set up by inter-governmental treaty, not by any legislature. It will not be accountable, as the *Bundesbank* in the very final analysis has been, to government, since no European government is likely to emerge any time soon. That Europe's politicians are willing to turn over crucial monetary policy to unelected central bankers in this fashion raises some troubling questions for democratic society.

For those interested in today's Germany or tomorrow's Europe, Professor Kennedy's study will provide a concise and timely picture of how a model central bank has been operating. The Institute wishes to express its warm thanks to the *Deutsche Bundesbank* and to the Federal Press Office for their support of publication costs. Neither they nor the Institute but only the author is responsible for the statements and analysis in this study.

Jackson Janes
Executive Director

Robert Gerald Livingston
Editorial Consultant

# *C O N T E N T S*

# *ABOUT THE AUTHOR*

**Ellen Kennedy** is Associate Professor of Political Science at the University of Pennsylvania. She has written widely on German politics and culture and is the author of *The Bundesbank: Germany's Central Bank in the Monetary System* (1991).

Once relatively obscure, the *Deutsche Bundesbank* (German Federal Bank) is now one of the most familiar German political institutions, so familiar indeed that it is known around the world by the shortened version of its name in German, the *Bundesbank*. Its visibility heightened by the power of the Deutschmark in Europe and on the world markets, the *Bundesbank* and its policy have come to represent much of what Germany's neighbors regard as good **and** bad about the Federal Republic. A bastion of monetary stability, certainly, but one whose antiinflation course can impose economic costs which some politicians and observers at home and also abroad regard as unacceptable. What are the origins of this remarkable institution? What ideas inform its organization? How has recent German history shaped it? These are the questions to be addressed in this short study.

## ORIGINS OF THE *BUNDESBANK*

Like many political institutions in Germany, the *Bundesbank* is the product of German history and of Allied policy after World War II, when the United States and the Soviet Union struggled to shape Europe according to their strategic interests. Both sides in the Cold War believed a Germany informed by their political values was essential to the preservation of peace and both regarded Germany as the strategic and economic linchpin of Europe.

Germany's constitution, the Basic Law (*Grundgesetz*) of 1949, created federal (*Bund*) and state (*Land*) authorities similar to those laid down in the American constitution and revived an indigenous tradition of federalism in Germany.[1]

Organization of the *Bundesbank* follows the general pattern of federal government set down in the Basic Law. It foresaw creation of a central bank (Art. 88) but left the details to later legislation. Until that legislation monetary policy was set by the *Bank deutscher Länder* (Bank of German States or *BdL*) which also coordinated the *Länder* (states') central banks that had already been established in the western occupation zones of Germany. The first postwar central bank was a British initiative but the U.S. Federal Reserve was its model. The *BdL* was independent of government and was federally organized with regional offices based in the *Länder*. *BdL* policies were formally subject to veto by the Allied Banking Commission in the western zones. Through the political acumen of *BdL* President Wilhelm Vocke in coordinating *BdL* policy with the Allies their veto was never exercised.

When Chancellor Konrad Adenauer's government began to draft legislation for the German central bank in 1950, differences over the proper relation between political and central banking authorities quickly emerged. Finance Minister Fritz Schäffer proposed that the Allied veto power be transferred to the German federal government and the *Bundesbank* be subject to oversight by a committee of the *Bundestag*. Chancellor Adenauer also argued that government should control central bank policy, and his relations with the *BdL* and its successor, the *Bundesbank*, were often contentious. Economics Minister Ludwig Erhard, father of Germany's "economic miracle," sided with Vocke and the *BdL*, arguing for central bank independence in monetary policy. Six years of debate, largely over that issue, followed before the *Bundesbank* Act was passed in 1957.

## INFLATION AND THE *BUNDESBANK* ETHOS

Inflation destroyed the value of money in Germany twice during this century. The national traumas associated with the great inflation of the 1920s and with the years immediately following Germany's defeat in 1945 created a powerful political culture in favor of monetary stability that informed the spirit of the *Bundesbank* Act and can still function today as a reservoir of support for the Bank's policies.

During the Second World War, the mark maintained its position by the sheer force of Nazi dictatorship over the economy of occupied Europe. After Germany's surrender in 1945, barter became the means of exchange in daily life: chocolates, cigarettes and other goods "organized" from the occupying Allies were more valuable than money until the Deutschmark was introduced on June 20, 1948. This was a decisive reform often credited with jump-starting the Germany economy. In a currency exchange that served as a model for German monetary union at the time of German unification in 1990, holders were allowed to exchange forty of their old marks for an equal number of new ones.[2]

The paradigm experience of inflation in Germany—and of hyperinflation—occurred in the first years of the Weimar Republic, when the value of the currency completely collapsed. Before the First World War the U.S. dollar cost 4.2 *Reichsmarks*; in 1919 it cost twice that. Until 1923 the mark steadily lost value against the dollar and as a means of exchange within Germany. Inflation peaked during 1922-23 when the rate of devaluation reached millions and Germans frantically exchanged their paper money for anything with barter value.

In November 1923 the *Rentenmark* reforms halted the spiral of devaluation and inflation. This new currency guaranteed by a body independent of government replaced the *Reichsmark* and laid the foundation of Weimar's stable, prosperous years from 1924 until 1928.

The consequences of these experiences for German political culture have been much debated. Because Weimar's failure led to the rise of dictatorship in Germany and dictatorship in turn to world war, the question of economic stability is politically charged for Germans. No single factor, of course, led to the rise of Hitler, but the inflationary experience itself has taken on a mythical quality in German popular memory. The *Bundesbank*'s emphasis on monetary stability and the value of the German currency therefore resonates within the broader fear of Germans that economic failure can directly cause political collapse.

The *Bundesbank* built its reputation on an uncompromising opposition to inflation. Since the establishment of the *Bank deutscher Länder*, German central bankers have regarded protecting the currency as **the** purpose of a modern central bank. Independence from government has been seen as the chief means to that end.[3] In frequent statements, *Bundesbank* policymakers emphasize that their job is to create stable money, even if that limits cooperation with the government's political goals. "There is no such thing as a little inflation" former President Helmut Schlesinger liked to say.[4] When Hans Tietmeyer succeeded Schlesinger in 1993 as *Bundesbank* President, he emphasized that "on one thing we are all in agreement: without a stable currency there can be no lasting economic prosperity and political stability."[5]

The comparative success of the *Bundesbank* in keeping inflation low—an average of 2.7 percent between 1948 and 1988—contributes to its popularity and to the public's acceptance of sometimes painful monetary policies.[6]

But public policy and political rhetoric often diverge, even in the *Bundesbank*. Although its antiinflation rhetoric appears rigid to observers, the Bank works with a definition of inflation that allows for an "unavoidable" rate of inflation determined by expected growth in real output and prices. As the *Bundesbank*'s history shows, the goal of "stable money" acts as a norm for the central bank and a normative criterion for the German economy. The stability norm has remained constant but the *Bundesbank*'s tolerance for deviation from it has allowed more flexibility in practice than rhetoric suggests.

## RESPONSIBILITY

The purpose of the *Bundesbank* is defined by its statute in these terms: "to regulate the amount of money in circulation and of credit supplied to the economy, using the monetary powers conferred on it by this Act, with the aim of safeguarding the currency."[7] Neither the U.S. Federal Reserve nor any other central bank in Europe is prescribed such a definite purpose. While the statute clearly defines the *Bundesbank*'s purpose, the means to achieving it have been much debated.

There are two elements in "protecting the currency:" the **external** value of the mark measured against other currencies, and its **internal** value as represented by the goods or services it will buy in the domestic economy.

### Exchange Rate Stability

Instability on the foreign exchange markets since the 1960s has often forced the *Bundesbank* to weigh two critical factors in monetary policy, the international value of the mark and domestic inflation. In a system of fixed exchange rates, there is the risk of "imported inflation" whenever other countries' inflation rates are higher than Germany's. The major components have been the dollar-Deutschmark relation and the value of the mark against other European currencies. Under the Bretton Woods regime of fixed exchange rates[8], for example, the *Bundesbank* often complained that its obligation to support the U.S. dollar forced the creation of strong marks to bolster a weak dollar, thereby increasing the German money supply. Dollar-denominated imports were also more expensive. When Bretton Woods broke down in 1971, its collapse was greeted by the *Bundesbank* as bringing relief from the pressures of imported inflation.

When the European Monetary System (EMS) was established in 1979,[9] it added a regional dimension to the international one of the dollar. While largely successful in creating a zone of stability in Europe, the EMS reproduced many problems associated with Bretton Woods. Like that system, the EMS became prone to currency speculations beyond the ability of governments and central banks to master. When its fluctuating bands were dramatically enlarged after the French franc crisis of 1993, the *Bundesbank* reaction was, as it had been at the end of Bretton Woods, one of relief.

The experience of both systems, Bretton Woods and the EMS, has been to solidify the *Bundesbank*'s view that intervention on the markets to support currency values will be ineffective if the economic fundamentals are out of balance. When monetary growth is out of control, or where there are structural imbalances in trade or budget deficits, the effects of market intervention will quickly fade.

**Domestic Price Stability and Growth**

The most politically sensitive aspect of *Bundesbank* policy concerns the relationship of its stability goal to other aspects of the German economy. In paragraph 12 of its statute the *Bundesbank* is enjoined "while carrying out its responsibilities, to support the Federal government" but at the same time the Bank is "independent of the Federal government." The tension inherent in this paragraph creates a field of political action for the *Bundesbank* in which the most controversial issues always concern concrete decisions about the means to monetary stability.[10]

Whether a currency can be managed successfully depends on a complex set of factors, including fiscal policy, monetary policy and policy toward the markets. This “general economic policy” involves many actors with complex functions and relationships. However independent a central bank might be, it obviously cannot control them all. Given public expectations about economic growth, full employment and the balance of trade (embodied in Germany’s Stability and Growth Act of 1967) paragraphs 3 and 12 of the *Bundesbank* Act place Germany’s central bank in a unique position. Economic problems of the eastern *Länder* after unification in 1990 combined with already present imbalances in Germany’s economy and public finances to intensify that fundamental dilemma.

**Monetary Instruments**

Public law gives the *Bundesbank* four instruments of monetary policy: two interest rates, the discount rate (*Diskontsatz*) for its normal loans to other banks, and the Lombard rate used for short-term funding and overnight bank deposits; open-market policy; and the minimum reserve policy. As government regulation of the international markets has diminished over the last two decades, the Bank has relied increasingly on open market instruments to manage the mark’s external value.

The *Bundesbank* does not control interest rates or credit ceilings directly, as do some central banks. It tends to use the instruments at its disposal to influence the markets indirectly. “Long-term adjustment” and “fine-tuning” instruments belong to the *Bundesbank*’s set of monetary tools, although these are not always clearly distinguishable (as in the case of market transactions or repurchase agreements). Liquidity instruments aim at satisfying the banks’ longer-term needs or restraining them. The discount and Lombard rates are designed to influence interest rates and the markets over a long time.

Short-term bonds with maturities of one week to one or two months are used by the *Bundesbank* to “fine-tune” the market. Daily shifts of public money to the banking system, sales of short term treasury bills, repurchase agreement transactions and sometimes foreign currency swap and repurchase transactions are all used in this way. The *Bundesbank*'s use of these instruments since the 1970s has increasingly drawn it into market management, and they are likely to become even more important in the future. Open-market transactions are more flexible than more traditional central bank instruments (such as reserve policy or interest rates) but they are also much more visible. That aspect can produce dramatic political and economic effects, such as the 1987 American stock market crash. American officials claimed at the time that the *Bundesbank* set off the crash when it increased the price of repurchase agreements from 3.55 percent (July) to 3.60 percent (August).

## ORGANIZATION

When the public thinks of "the *Bundesbank*" it is most often identified with the staff located at Frankfurt, but the Bank is a more complex and broadly based institution than that. Its three main organs are the Central Bank Council (*Zentralbankrat*), the Directorate (*Direktorium*) and the Boards of the *Land* Central Banks (*Vorstände der Landeszentralbanken*).

(A) The Central Bank Council -- The most important policy questions, such as interest rates, are decided here. Composed of the Directorate located in Frankfurt and the Presidents of the *Land* Central Banks (LCB), the Central Bank Council (CBC) meets every two weeks at the Frankfurt headquarters of the Bank. Explicitly authorized by public law to set German monetary policy, it is the supreme organ of the *Bundesbank*.

Council decisions are taken on the basis of simple majority rule. Each of the LCBs has one vote, regardless of its territorial size or economic wealth. The discussions are private, and records are sealed for thirty years. According to all reports, CBC meetings cover a broad agenda, ranging from domestic and international economics to specific decisions on monetary policy. Papers may be presented on economic matters by the Directorate or the *Land* Central Bank Presidents, and members of the government may also attend these meetings. In its own context the CBC is a democratic institution whose decisions are discussed and voted upon by its members. The power to sway a vote one way or the other is no different here than in similarly constituted institutions—it is a matter of persuasion and argument.

CBC decisions are announced, usually by press releases, immediately after its meetings. Sometimes there is a press conference. These press conferences can be moments of high drama—for example, when interest rates change significantly or the Bank's monetary targets are announced. They are always noted by the financial press and often affect the international markets. During periods of disagreement between the government and the *Bundesbank*, such as those discussed below, policy made in the CBC can virtually block a political course planned in Bonn.

(B) The *Bundesbank* President -- The president is nominated by the cabinet of the federal government, with the chancellor playing the decisive role of course. After consultation with the *Bundesbank* Central Bank Council, he is appointed by the president of the Federal Republic for a period of normally eight years but not less than two years, and he is eligible for reappointment. As a member of the Central Bank Council and the Directorate (see below), the president must possess considerable managerial and political skills.

Recent presidents have sometimes seemed to overshadow the Bank itself, largely because of their prominence in international monetary affairs. Karl Otto Pöhl (1980-1991) was particularly adept with the German and foreign press and frequently found himself the focus of public attention. Helmut Schlesinger (1991-1993) already had the reputation of being a hard-liner on the CBC before he succeeded Pöhl. His short term encompassed two stormy periods in the European Monetary System (1992-93) and confirmed his reputation for being the central banker most committed to fighting inflation.

But the president's power in the Bank and ultimately among his international colleagues is, like all presidential power, the power to persuade. Commitments on some international issues—such as European Monetary Union contained in the Maastricht Treaty (see below

p. 26)—undertaken by German politicians can often be fulfilled only with the agreement of the CBC and its cooperation. The president's standing among G-3 or G-7 leaders or his "recognition value" among the public may enhance his power on the CBC, but it cannot substitute for a consensus or a majority there.

(C) The Directorate -- The Federal Republic has been remarkably stable compared to the Weimar Republic or some other western European systems. Since 1949, there have been only six chancellors. The *Bundesbank*, with six presidents, follows that general pattern (see Appendix A). In the case of the Bank, the law helps to insulate the Directorate from political influence. Their appointment for terms of eight years decouples the Directorate and the presidency from the pattern of Federal elections which are held every four years normally, and makes it difficult for a government to hand over the *Bundesbank* to political supporters.

Like the president, members of the Directorate are nominated by the cabinet and appointed by the Federal President. The *Bundesbank* Law specifies only that directors should have "special professional qualifications" and they are appointed for terms of eight years with the average length of service being twelve.

Administrative divisions in the Bank are not fixed by statute and may be reorganized by the directors. At present the main divisions in the *Bundesbank* are: Trades Settlement and Personnel (area I) headed by Dieter Haferkamp; Statistics and Economics (II) by Professor Otmar Issing; International Relations (III) by Helmut Schieber; Control and Accounting, Data-Processing, and Payments (IV) by Wendelin Hartmann; Minimum Reserves and Cash (V) by Edgar Meister; and Legal Affairs and Administration (VI) by Peter Schmidhuber. Vice-President Johann Wilhelm Gaddum directs the Credit Area. Press, Public Relations, and Auditing fall under the office of President Tietmeyer.[11]

The Directorate is the largest administrative unit of the *Bundesbank*. As the Deutschmark's importance on international markets has grown, so too has its power. At the beginning of 1997, the Bank's Central offices in Frankfurt had a staff of about 2,500, of which slightly over 1,000 were civil servants. The *Land* central banks together had over 13,400 employees, about 5,700 of them civil servants. The Frankfurt staff performs a variety of tasks ranging from preparation of position papers and consultative documents for internal Bank use or for the government down to destroying old bank notes and issuing new ones. The Frankfurt staff also carries out currency market interventions and monitors exchange markets from an operations room at the *Bundesbank*. Staff in the International and Foreign Division regularly consults other central banks, and the *Bundesbank* sometimes intervenes in concert with them or alone to affect market trends. The tremendous speed required for such interventions which can demand daily or even hourly judgement are essentially executive in nature and could not be carried out by a deliberate body such as the CBC. The growth of the central bureaucracy's power in such a politically sensitive area as international exchange is one factor in the wariness toward Frankfurt sometimes expressed by the *Länder* Bank presidents.

(D) *Land* Central Banks (LCBs) -- The *Länder* Central Banks were originally established on a strict principle of "one *Land*, one vote." Each of the eleven *Länder* (individual states) in the pre-1990 Federal Republic had an LCB and hence each had a vote on the *Bundesbank*'s policymaking council. With German unification it might have been possible simply to create a new LCB in each of the new *Länder*. Instead the structure of *Länder* Central Banks in the *Bundesbank* was reformed entirely. Smaller LCBs were merged into larger units and only one entirely new LCB (Saxony and Thuringia) was established. The result was a reduction in the number of LCBs from eleven to nine on November 1, 1992.[12] (See Appendix B.)

While the effects of this change on the politics of the Central Bank Council are not yet clear, the chief functions of the newly organized LCBs remain the same as they were in the pre-1990 Federal Republic. They are the main administrative branches of the *Bundesbank*, dealing with state governments and local banks across Germany. Their most mundane job is to distribute banknotes and coins to local banks, but the LCBs also carry out important aspects of *Bundesbank* policy.

Each LCB varies slightly but their personnel divisions and substantive organization of the main offices (usually in the *Land* capitals) can be schematically described as follows. **Credit** divisions administer credit operations of the LCB and supervise the branch offices' administration of the *Bundesbank*'s interest rate policies. **Banking** divisions supervise bank operations according to the Credit Law (*Kreditwesengesetz*), and the *Bundesbank*'s minimum reserve policy. Irregularities and reports on the general structure of the banking industry in a particular *Land* are made by these divisions to the *Bundesbank* Directorate. The **Economic** division observes and analyzes general monetary and economic trends in the *Land*, reporting these to the LCB President in his or her capacity as a member of the *Bundesbank* Central Council. The **Statistics** divisions collect and analyze data. A **Foreign Currency** division tracks investments by residents of the *Land* in other currencies, and those of nonresidents in D-Mark investments. There are also **Bond** divisions which supervise securities transactions, and the credit needs of the states. Personnel, accounting, facilities management, and legal divisions such as those common in every bureaucratic organization can be found in the LCBs too.

Aside from such functions, the LCBs serve as a federal anchor for *Bundesbank* policymaking in two ways. First and most important, the main offices and the branch offices act as "listening posts" in the provinces. This aspect of their structure follows the Directorate model. They differ from the *Bundesbank* Directorate in having a Managing Board responsible for running the LCB on a daily basis and an Advisory Board made up of representatives of local business and banking, agricultural and labor interests.

According to the law, members of the Advisory Boards are not appointed to represent their interest groups but to give expert advice. Yet they clearly do function as representatives of economic groupings. Unlike the LCB Managing Boards, the role of *Länder* Bank Advisory Boards is purely consultative. An LCB President and his or her Managing Board looks to them as a source of representative opinion on monetary and credit policy. Their effectiveness depends on the energy and imagination of the LCB President in integrating opinion from the

Advisory Boards into the decision-making process as a whole from the *Länder* up to the fortnightly meetings of the Central Bank Council. Certain LCB presidents are regarded as very skillful public opinion leaders able to turn technical expertise and political savvy into influence on the CBC.

The second justification for the *Bundesbank*'s federal structure flows from the function of the LCBs as listening posts for representative public opinion. The presence of an independent and unelected body with so much power over the lives and well-being of the country's citizens as the *Bundesbank* seems to affront the principles of a democratic constitution. In Britain, the Chancellor of the Exchequer and the Prime Minister, both elected officials, have enjoyed decisive authority over the policies of the Bank of England.[13] In the United States the Federal Reserve system is subject to Congressional review. Its chairman regularly sits before House and Senate committees on Capitol Hill and must submit a semiannual report to Congress. The *Bundesbank* is comparatively unconstrained by such constitutional arrangements and can pursue its policies formally independent of the elected officials and the German government and the *Bundestag*. Not only in law but in fact, it is Germany's monetary sovereign.

## POLITICS AND POLICY

The *Bundesbank* Act gives something to both sides: the *Bundesbank* must "support the general economic policy of the Federal Government" but the law also states that the central bank "shall be independent of instructions from the Federal Government."[14] The *Bundesbank*'s relationship to German governments has evolved as much through conflict as through cooperation. Most often disagreement between the Bank and the government has turned on credit policy (interest rates and the minimum reserve requirement) or on exchange rates.

### Credit Policy

Before passage of the *Bundesbank* Act, Wilhelm Vocke secured the *BdL*'s position with the Allies and successfully asserted the Bank's independence from the government of Konrad Adenauer. Adenauer opposed central bank independence from the start, and often engaged in losing battles over monetary policy. The most dramatic of these was his attempt to intervene directly in the *BdL*'s credit policies in November 1955. He received the abrupt response from President Vocke that "far-reaching credit policy belongs to the competence of the Central Bank Council." The Ministers for Economics and Finance were always welcome, Vocke continued, to attend the Council's meetings, which provided an opportunity for bank-government consultation.

Ludwig Erhard succeeded Adenauer as chancellor in 1963 during a period of relative calm in monetary affairs. A deficit appeared in the current account for 1962, the first since 1950, but otherwise the economy posted small surpluses. Between 1961 (the first revaluation of the mark) and 1965, interest rates remained low, at three percent. When the current account went into a deficit in 1965, however, the *Bundesbank* began to tighten its credit policy in a scenario remarkably like that of the early 1980s. Bank President Karl Blessing (1957-1969) lectured the Erhard government on the dangers of high government spending at a time of increasing inflation. During the summer of 1966, the Bank's discount rate went up to five percent, nearly doubling its previous level. Unemployment also increased. Erhard was unable to achieve a consensus in his cabinet on social programs, taxation and government spending. Facing an election that fall, he resigned and a Grand Coalition of Social Democrats and Christian Democrats took office at the end of November 1966.

Nearly fifteen years later, a similar set of factors seemed to face the coalition government of Social Democrats and Free Democrats headed by Helmut Schmidt with a choice between monetary stability and economic growth. By 1980-81 the international context of *Bundesbank* policy was very different—the Deutschmark had become an important reserve currency worldwide and the anchor of the newly-created European Monetary System (1979). While still the single most important currency in international trade, the dollar had started to suffer from an overall weakening in the American economy during the 1970s. All the industrialized countries had been affected by large increases in the price of oil after the 1973 Arab-Israeli War. A combination of high energy costs and very high interest rates in the United States (as high as twenty-one percent at times during 1980-81) increasingly strained the European economies. Driven up by U.S. credit policy,[15] the dollar rose dramatically against the mark and other currencies, putting new pressure on the EMS. From the late 1970s governments in the G-7 group of nations tried and failed to find ways out of the "stagflation" in their economies.[16]

In 1980 Schmidt's government presided over the largest budget deficit in thirty years—twenty-eight billion marks, or 1.82 percent of the Gross Domestic Product, and a trade deficit of twenty-five billion marks. Inflation was relatively high at 5.5 percent, as was the Lombard rate at 9 percent.

In response, the *Bundesbank* began in February 1981 to raise German rates still further, hiking them from nine to twelve percent at one Central Bank Council meeting (February 19) and instituting "emergency" measures in minimum reserve policy. Between February and April 1981, *Bundesbank* officials openly intervened in politically sensitive questions of public policy. Vice-President Helmut Schlesinger rebuked the trade unions for excessive wage demands. President Karl Otto Pöhl pointed out to the SPD-led government that nuclear energy would be less costly, a view that was highly unpopular among Chancellor Schmidt's Social Democrats. The Bank's message was clear: no more deficit financing.

The government's reaction was equally clear. Trying to avoid cuts in social services and intent on stimulating the German economy, Schmidt tried to find a way out of the interest rate corset by securing foreign capital for public spending. When the *Bundesbank* refused to issue bonds to finance social programs favored by the SPD, Schmidt tried to use the Credit Agency for Reconstruction (*Kreditanstalt für Wiederaufbau*)[17] as a middleman to borrow money and administer it for increased public investment and to subsidize energy production.

There was nothing illegal about Schmidt's plan but it did challenge the *Bundesbank*'s authority over credit and interest policy. It failed ultimately because that challenge was perceived as a violation of the established norms of Germany's political culture—and because the Bank found a potent ally in Schmidt's coalition partners, the liberal FDP.

Schmidt relied on fears about unemployment and cuts in public programs to carry his case against the Bank. The Bank in turn mobilized anxiety about the deficits and the sharp decline in Germany's reserves (from 109.5 billion marks in 1978 to 61.5 billion at the end of 1980), a point the Free Democrats had been making in cabinet negotiations with Schmidt's SPD.

Forced to choose between cuts in social programs or new taxes, Schmidt and his party chose the latter. The Free Democrats refused to support their plan for a surtax to finance programs aimed at reducing unemployment. In the fall of 1982 they left the coalition with Schmidt's party and formed a new one with Helmut Kohl's conservative Christian Democrats.

**Exchange Rates**

Between the time the mark became fully convertible, in 1958, and the end of the Bretton Woods system, in 1971, a set of now familiar problems emerged. Market demand for one currency puts pressure on others in a system of fixed exchange rates by forcing central banks to intervene in the market in order to maintain existing values in the system. When the banks intervene to support a declining currency, their stock of the currency being supported increases. Purchase of that currency on the markets further adds to the money supply, increasing inflation. The dilemma posed by such exchange rate fluctuations means that a central bank must often pursue two sometimes incompatible goals, maintaining price stability at home and protecting the value of its currency on foreign exchange markets.

A wave of external speculation on revaluation of the mark began in 1957, confronting the *Bundesbank* for the first time with the dilemma of an "exposed flank" that still remains a major concern today. The almost continuous export surpluses run by the German economy from 1951 onward set off the speculation. Both the franc and the pound appeared overvalued from 1954 on, and large amounts of money began to flow into the mark, aggravating the balance-of-payments disequilibrium. *Bundesbank* President Otmar Emminger (1977-1979) was the first to recognize that fixed exchange rates implied this dilemma of "imported inflation." As director of the *BdL*'s international section starting in 1953, Emminger had argued that external stability exacted a cost in domestic terms. As early as 1956 he favored revaluation of the mark by six percent against the dollar, the anchor currency of Bretton Woods, but Vocke and other members of the Central Bank Council resisted. Economics Minister Erhard also favored revaluation of the mark, but then-President Vocke brusquely rejected any change. His successor Karl Blessing also rejected revaluation, and the *Bundesbank* tried to stem demand for the mark over the next three years by reducing interest rates and lowering minimum reserve requirements. To no avail. In fact in early 1961 the Adenauer government warned the *Bundesbank* that its credit policies were actually causing inflation by overheating the German economy.

In Germany as in the United States exchange rate policy is a political question to be decided by governments. The problem in the early 1960s was an overvalued dollar and an undervalued mark. Since President John F. Kennedy refused to devalue the dollar, the only option open to the German government was to revalue the mark. Economics Minister Ludwig Erhard tried to convince Blessing and the Central Bank Council to support his revaluation of the mark, but they remained opposed, remarking that "one shouldn't operate on a healthy currency (DM) to cure a sick one (the dollar)." Having cast its prestige openly against Erhard, the Bank nevertheless lost out to him in March 1961, and the mark rose five percent against the dollar. Afterwards, Erhard let it be known that had the *Bundesbank* not expressed its support for the new parity, the government had been prepared to use its suspensive veto over the reduction of minimum reserves just approved by the *Bundesbank*'s Central Bank Council. Blessing's adamant resistance had left an impression of inflexibility and impracticality on the part of the *Bundesbank* which his successors tried hard to avoid repeating.

Political history over the last three decades supports two conclusions about the *Bundesbank*'s position in the German political system. The first is that the Bank will transgress the line dividing its authority in monetary affairs from the government's over general economic policymaking when its chances of success are good against a relatively weak opponent. In the conflict between government and the *Bundesbank* during 1981-82, the Bank found a powerful ally in the Free Democrats, without whom its challenge to government policy would probably not have been so direct. The second conclusion is that the *Bundesbank* enjoys a position of authority in public opinion. Able to draw on Germans' preference for government above political parties, the Bank can more easily justify action as motivated by a concern for the common good than can party politicians. Moreover there are no signs that the *Bundesbank* Act or its stability norm are about to be changed. Congressional debate over the role of the Federal Reserve in the United States or opposition to increased independence for the Bank of England as "a dangerous panacea" find no echoes in Germany.

**German Unification**

In many ways the *Bundesbank*'s evolution since 1958 is a model of institutional success. But during 1990 Chancellor Kohl maneuvered the process of German unification along lines he set out, defeating the *Bundesbank* on a series of important points. This case is the most dramatic policy setback for the *Bundesbank* and illustrates its dependence on the larger political environment.

The division of Germany occupied a unique position in national life before 1989-90. Reunification of a country divided after 1945 had been the political holy grail of every government since Adenauer and was enshrined in the 1949 Constitution of the Federal Republic. No western politician publicly renounced it, however far away unification might seem. Set against that background, the monetary or economic concerns of the *Bundesbank* could be made to appear technicalities by a determined government—and they were when Kohl announced a "German Economic and Monetary Union" in early 1990.

The timing of Kohl's initiative was humiliating for the President and Vice-President of the *Bundesbank*. Karl Otto Pöhl and Helmut Schlesinger had gone to Berlin on February 6, 1990 to discuss economic policy and steps toward eventual monetary union with Horst Kaminsky (President of the *Staatsbank*, the GDR's counterpart to the *Bundesbank*) and German Democratic Republic (GDR) Economics Minister Christa Luft. After extensive talks, Pöhl appeared late in the day before reporters, accompanied by Kaminsky. The vast disparities between the two states' economies, Pöhl and Kaminsky agreed, meant that their monetary union was a long way off. "We both believe it would be premature to consider such a far-reaching step at this stage," Pöhl declared.

Only the day before, Pöhl had spoken at length with Kohl by telephone and had traveled to Bonn for consultations with Finance Minister Theo Waigel before flying on to Berlin. According to one account, neither Kohl nor Waigel had made a decision on monetary union at that time.[18] But by 10:00 p.m. on Tuesday evening, Kohl had decided to offer economic and monetary union to the east in preparation for political unity. Kohl did not even attempt to inform the *Bundesbank* President while he was in Berlin but made the announcement directly to the press.

Kohl's gesture was rooted in his sense that reunification could be achieved only if decisions were taken quickly. The international constellation favorable to it was fragile: Gorbachev's position in the Soviet Union was weakening; the British and the French seemed opposed to unification; and it was unclear how long the Americans would support Kohl on it. He saw the first free elections in eastern Germany—scheduled for March 18, 1990—as a referendum on German unification which his party (the Christian Democrats) had to win. The *Bundesbank* was simply outflanked on the timing of monetary union.

It fought on, however, over issues such as the rate of conversion which would be offered to eastern Germans for their old currency (GDR marks). The Kohl government favored a one-to-one conversion rate for an unspecified amount of eastern marks.[19]

The *Bundesbank* wanted the more realistic parity of two-to-one. After an intensive public campaign the *Bundesbank* secured a small reduction. Most west Germans opposed 1:1, but east Germans demonstrated for it in numbers; and there was no support in Bonn for the *Bundesbank*'s less generous rate. Ultimately the first 4,000 eastern marks were converted at one-to-one. Wages and salaries were converted at the generous ratio of one-for-one parity.[20]

The chancellor ignored the *Bundesbank* in creating a "Unity Fund" to finance rebuilding the eastern economy, for which the Bank would be called upon to issue government debt. His move prompted public criticism of the government by *Bundesbank* officials, and Karl Otto Pöhl later remarked that he probably should have resigned over the question.

The generous conversion rate offered to east Germans was criticized as inflationary and consequently the source of the *Bundesbank*'s tight money policy since unification. However, it was less to blame than other aspects of fiscal policy since 1990. Rebuilding the eastern economy posed an enormous burden. Transfers to the east totaled two-thirds of the eastern region's Gross National Product in 1991—an investment from the west that was funded through new government borrowing. Since 1990 deficit spending has increased and Germany's large budget surpluses have evaporated. Compared to the effects of unification on the German budget, the deficit that brought down Helmut Schmidt's government in 1982 looks small: a 28 billion mark deficit (1.82 percent of GNP) in 1980 compared to 140 billion marks in 1991 (5-6 percent of GNP). To combat resultant inflationary pressures, the *Bundesbank* has kept interest rates relatively high since unification, with the Discount at 6-8.75 percent and market rates at 8-9.6 percent in 1990 - 1992.

Germany's very strong external position—its large surpluses on both trade and current accounts—on the eve of unification proved to be a "war chest" to meet the country's new, post-unification financial requirements. Here too, the burdens of unification are obvious: the trade surplus, a hallmark of the German economy in the post-Bretton Woods era, went from 135 billion marks (1989) to 21 billion (1991); the current account went from a 108 billion mark surplus to a 34 billion mark deficit.

The *Bundesbank*'s insistence on a strong mark was clearly signaled once again in the spring of 1990, when it intervened to support the German currency against the dollar at $1.73. Moreover, "German unification was precisely the sort of country-specific real shock for which a revaluation within the EMS would have been in order."[21] The government refused, thus setting the stage for a succession of crises in the European Monetary System, which led in summer 1993 to its virtual suspension.

## GLOBAL AND EUROPEAN CONTEXTS AND CONSTRAINTS

"Since the mid-1950s," former *Bundesbank* President Otmar Emminger wrote, "German stabilization policy has repeatedly been undermined by influences originating abroad. In no other major country has imported inflation played such a major role as in the Federal Republic of Germany."[22]

### From the German "Locomotive" to the Wall Street Crash of 1987

Yearly economic summits and frequent consultation on monetary and political questions among the most important industrial nations that became the "G-5" and "G-7"[23] grew directly from Helmut Schmidt's desire for better policy coordination. By the mid-1970s the G-5 and G-7 meetings had taken on an importance for the international political economy comparable to U.S.-Soviet summits for strategic issues. This new kind of summit opened the *Bundesbank*'s "exposed flank" in two ways.

During two periods, 1977-1982 and 1985-1987, the Americans applied intense pressure on the Germans to generate more demand in their domestic economy and thus stimulate the global economy. In the first period, those demands played into the Schmidt government's domestic interests. Although the *Bundesbank* opposed deficit financing, it acceded to the Schmidt government's demands and after the Bonn summit of 1977 agreed to produce an estimate of how large a deficit would, in the Bank's judgment, be supportable. The government considered something like one percent of GNP or twelve billion marks appropriate, and the *Bundesbank* was persuaded by factors in the international economic environment to go along with the Chancellor's policy of fiscal stimulus. In the Bank's internal debate, the Keynesians won against the monetarists. Schmidt's effort to link domestic political demands for more social spending to cooperation with the Americans resulted in an overextension of German resources that eventually helped bring down his government.

During the second period (1985-87) many of the same factors were at work, but they were complicated by a dramatic expansion of the U.S.

budgetary and trade deficits and the *Bundesbank*'s concern in the mid-1980s with the inflationary potential stored up during the previous period of fiscal stimulus. Moreover, further external pressures were being generated by the European Monetary System (see below), for which the Deutschmark had become the *de facto* intervention and anchor currency. The *Bundesbank*'s warnings on inflation during this period may look fanciful to outsiders. Energy prices had fallen drastically and the equally dramatic devaluation of the dollar against the mark helped lower prices in the Federal Republic. Import costs were on average nineteen percent lower in 1986 than in 1985 largely as a result of the decline in oil prices.

**A "Grossly Overvalued Currency:" Managing the Dollar**

The G-5 ministers announced in late January 1985 that the dollar was "grossly overvalued and that this warranted concerted action." The *Bundesbank* led central bank intervention in March and April to bring it down. Further discussion at the Plaza Hotel in New York City in September extended the G-5 commitment to effect an "orderly appreciation" of other currencies, indirectly devaluing the dollar. Secretary of the Treasury James Baker led these efforts, reversing the Reagan Administration's previous policy of laissez-faire on exchange rate issues. The Americans agreed to try to reduce their domestic budgetary deficit while letting the dollar fall.

Exchange rate policy belongs traditionally to governments, not central banks. But to be effective accords such as that struck at the Plaza on the dollar required the *Bundesbank* to fund large exchange rate interventions, selling dollars to help bring it down.

Both those factors—demand for economic stimulus and the renewed burden of managing the dollar—structured events leading to the crisis year of 1987. Throughout the year international, particularly American, pressure on the Germans continued. A key group in the *Bundesbank* led by Helmut Schlesinger argued that the growth in money supply would eventually come out in the form of inflation, and they took a hard line against accommodating the Americans' desire for lower German interest rates. The New York Stock Market crashed in October 1987. After American officials criticized the Bank as having contributed to its causes, although those causes were many, including a steep rise in equity prices since early in the year, deficits in the U.S. trade balance and federal budget, and an increase in American interest rates.

The institutions that then helped to stabilize the collapse of equity prices on Wall Street in a dramatic example of international coordination were the very same that had applied so much pressure on the *Bundesbank* prior to autumn 1987—primarily the Federal Reserve but also the other central banks of the G-7 and the EMS.

**A "Zone of Monetary Stability" — the EMS**

Since the late 1960s "monetary union," or a common currency for Europe, has been seen by European leaders as the first step toward European political union. But the European Monetary System (EMS), which was set up in 1979, produced many of the same problems for the *Bundesbank* on the regional level of Europe as international cooperation had on the global.

The *Bundesbank* initially opposed the EMS for the same reasons it had chafed under the Bretton Woods system, on which the EMS, with its tight "bands" to limit fluctuations among currencies was to some degree modeled. It feared that the obligatory intervention and financing mechanisms of the European Monetary Cooperation Fund (EMCF) foreseen by the EMS would turn the whole scheme into an artificial exchange rate system divorced from economic fundamentals. Negotiations between the *Bundesbank* and Chancellor Schmidt centered on whether nations whose currencies came under pressure would have automatic drawing rights. After a threat to amend the *Bundesbank* Act, Schmidt finally reached a compromise with the Bank which allowed it more autonomy in deciding whether to intervene or not.

In the very first year of its existence, 1979, EMS theory and practice parted company. Although interventions were to take place in the currency of the central bank intervening, the mark immediately became the normal intervention currency. By the end of the year, the mark had become the "anchor currency" of the EMS and it stood at or near the top of its EMS band. In eleven revaluations between 1979 and 1987 the mark always appreciated whereas the French franc usually devalued.

Table EMS Realignments: Changes in Bilateral Central Bank Rates (%) 1979-1987

| | | | German mark | Belgian franc | Danish krone | French franc | Irish punt | Italian lira | Dutch guilder |
|---|---|---|---|---|---|---|---|---|---|
| 1979 | 24 | Sept. | +2 | | -2.86 | | | | |
| | 30 | Nov. | | | -4.76 | | | | |
| 1981 | 23 | Mar. | | | | | | -6 | |
| | 5 | May | +5.5 | | | -3 | | -3 | +5.5 |
| 1982 | 22 | Feb. | | -8.5 | -3 | | | | |
| | 14 | June | +4.25 | | | -5.75 | | -2.75 | +4.25 |
| 1983 | 21 | Mar. | +5.5 | +1.5 | +2.5 | -2.5 | -3.5 | -2.5 | +3.5 |
| 1985 | 22 | July | +2 | +2 | +2 | +2 | +2 | -6 | +2 |
| 1986 | 7 | Apr. | +3 | +1 | +1 | -3 | | | +3 |
| | 4 | Aug. | | | | | -8 | | |
| 1987 | 12 | Jan. | +3 | +2 | | | | | +2 |

*Sources: Deutsche Bundesbank*; J. Fels, *Intereconomics*, no. 5, 1987.

During the currency crises of 1992-93 (discussed below), the mark rose steadily on the markets while speculation forced the French, Italian and British currencies toward the bottom of their bands within the EMS.

From the *Bundesbank*'s perspective, the EMS forced a balancing act between international cooperation and the *Bundesbank* norm of "protecting the currency." Formal alignment of the currencies is a political matter decided by governments and finance ministers in Europe. The *Bundesbank* advises the German government on these questions but does not decide the timing or substance of exchange rate changes. Its power lies between realignments in the strategy and tactics of intervention. Only when two currencies are at the extremities of their relative values are the two respective central banks required to intervene to protect the agreed EMS cross-rates. The signal for such intervention is normally given when a weak currency drops to the bottom of its band value. Intervention follows the request of the central bank whose currency needs to be supported to enable it to remain inside its assigned "band" within the EMS system and with the agreement of the bank whose currency is being used. Because the mark is the leading intervention currency of the EMS, such procedures enhanced the *Bundesbank*'s power in Europe, which it has used to enforce its norms on other countries.

While such interventions may have enhanced economic stability in Europe as a whole they sometimes have presented other European governments with very uncomfortable choices in the areas of wages, interest rates and taxation. The fiscal stringencies necessary for these governments to follow the *Bundesbank*'s stability course carried political consequences as well. Repeated French efforts over the years to gain influence over German monetary policy can largely be explained as attempts to buffer the effects of *Bundesbank* policy on the French economy. After German unification in 1990 these pressures became a force that eventually broke apart the bands of the exchange rate mechanism and resulted in the exit of the British pound and Italian lira from the Exchange Rate Mechanism in 1993.[24]

The question of asymmetry was key to political tensions within the EMS by the 1992-93 crisis. The positions of France and Germany as depreciator and appreciator respectively define each country's EMS politics; and their circumstances since the start of the system illustrate the gap between its theory and practice. The domestic costs of its EMS interventions throughout the 1980s were carried by the French economy. During the 1980s Deutschmark strength enforced the anti-inflationary policies favored by the *Bundesbank*. While that eventually led to reduced French inflation rates, France joined the "hard-currency" countries at the cost of relative national autonomy. Its demands for increased "symmetry" aim at regaining some of an earlier freedom of decision. For the *Bundesbank*, however, symmetry spelled inflation.

Far from bending its policies to such goals, the *Bundesbank* was able to force asymmetry—and thus the stable money policies favored by the Germans—on other members of the ERM despite the express intentions of the European Monetary System. The EMS crises of 1992 and 1993 were a result of that asymmetry. The first, in 1992, centered on the British pound and Italian lira, the second on the French franc. Although separated by nearly a year, EMS turbulence in 1992 and 1993 should be seen as a single crisis reflecting weaknesses in Europe's exchange rate system.

## Sterling, Lira and Franc Crises

At the Dutch town of Maastricht in December 1993, European leaders agreed to create a monetary union, with a common currency and central bank replacing national ones in stages. The common currency was to be introduced no later than January 1, 1999.

When European finance ministers and central bankers met at Bath, England in early September 1992, both the British pound and the Italian lira were growing weak. Both were trading on the markets at or near their base set by the European Monetary System. Since 1987, however, there had been no change in the rates among the EMS currencies. The German finance minister and *Bundesbank* President Schlesinger now wanted a formal realignment among them to relieve pressures caused by the weakening pound and lira. The British government, anxious to avoid the humiliation of a pound devaluation, urged the Germans to reduce their interest rates instead.

No agreement could be reached at Bath. A *Bundesbank* plan to devalue all EMS currencies except the mark foundered. The weakened pound came under huge pressure from speculators and began a slide that not even the most extraordinary intervention by the central banks could stop. The British pound, followed by the Italian lira withdrew from the EMS shortly after the Bath meeting.

Soon afterwards the *Bundesbank*'s chief economist acknowledged that high German interest rates had hurt other nations' economies but argued that these disadvantages to them were being eclipsed by the boom in their exports to Germany, stimulated by the requirements of rebuilding the economy in the eastern German *Länder*.[25]

The French franc crisis a year later was remarkably like the first. Speculation against the franc began in the summer of 1993. Central banks' intervention to support it failed. French officials at first vehemently denied that a franc devaluation or a realignment within the EMS was in the cards. Only after eighty billion marks had been expended without stabilizing the falling franc, did European central bankers and finance ministers agree to widen the ERM "bands" from 2.5 percent to 15 percent.

Schlesinger admitted that the greater width of the new bands made the ERM system fundamentally different. But with obvious relief he also asserted that by making it more difficult for speculators to target individual EMS currencies, the changes would allow central banks—above all the *Bundesbank* of course—to lighten their interventionist burdens in international money markets.

The long period of interest rate increases in Germany that began in 1990 ended in 1993. No longer bound so tightly to fluctuations in the currency markets, the *Bundesbank* began to lower its rates. Other European nations won more independence from the Germans' stability norm, making way for greater flexibility in their domestic economic policy in the short term but focusing the political questions of European unity even more sharply.

## THE *BUNDESBANK* AND UNITED EUROPE

German unification in 1990 took place under the umbrella of Helmut Kohl's pledge that it would further the ends of European unification. His vision of European unity informs the Maastricht Treaty on European Union (EU) that came into effect on November 1, 1993. But the politics that accompanied that vision—British and French fear of Germany, the new security problems of the former communist countries of the east, enlargement of the EU itself—made the question of a common European currency perhaps the most important issue in the Maastricht Treaty.

The debate over European Monetary Union (EMU) with a single currency and European central bank to manage it resembled the development of the EMS. In both cases, the *Bundesbank* took similar positions. In public skeptical-to-cool over both ideas, the Bank was privately hostile toward them, only participating when there was no realistic alternative and always protective of its stability norm and its independence. When then-President Pöhl suggested rigorous criteria for European monetary union in early 1990, some within the *Bundesbank* hoped these criteria would simply be rejected by the heads of government. By the end of the following year, however, they had become the criteria for the European Monetary Union agreed upon at Maastricht.

The essence of the *Bundesbank*'s position rested on its longtime argument, which it had asserted in vain at the time of monetary union between eastern and western Germany in 1990—that a common currency should represent substantially similar economies. This does not mean that every national economy should be structurally alike, but that certain economic and monetary indicators must be in line before a currency union can succeed.

The Maastricht Treaty made this "convergence theory" the basis for progress toward a single European currency. This approach requires that participant countries have low inflation, low government deficits, similar long-term interest rates, and that union be preceded by a period of exchange rate stability within the EMS. Only if those general criteria were met, according to the theory, could European currency union be achieved together with monetary stability. The terms agreed at Maastricht in 1993 were in effect the *Bundesbank*'s: economic convergence indicators and a central bank for Europe that would be independent and committed to monetary stability.

The Bank also argued that monetary union without political union is unlikely to succeed. An agreement that leaves national governments free to set fiscal policy in a national perspective is likely to undermine management of those factors in the economy on which an anti-inflation course depends: "In the final analysis, a monetary union is an irrevocable . . . community which, in the light of past experiences, requires a more far-reaching association, in the form of a political union, if it is to prove durable."[26]

The Maastricht Treaty reasserts a familiar set of issues for the *Bundesbank*. The management of internal and external stability and the corollary question of imported inflation remain at the top of the Bank's agenda. The outcome of the 1992-93 EMS crises relieved it of some of the pressures on this front, but the prospect of a European Monetary Union outside the "convergence criteria" would magnify them beyond anything the *Bundesbank* had experienced under Bretton Woods or the EMS. Would a common currency in Europe prevent the kind of exchange rate speculation that marked both those systems? Perhaps. Or would the speculation simply move to another arena, such as the dollar's value against the Japanese yen or a new European currency? Perhaps also.

The second issue was posed by German unification, and it looms over the European Union. The experience of German unification, especially the east German and west German currency union which preceded political unification, may also offer important evidence about the likely course of a European monetary union without political union. German monetary union saddled Germany with a bundle of economic, fiscal and inflationary problems: east German consumption exceeded production; eastern wages were out of line with worker productivity; and no one foresaw the collapse of so much of industry in the east with its consequent unemployment.

To deal with these problems, the German government provided huge transfers and special subsidies, which created large public deficits with attendant inflationary pressures that the *Bundesbank* offset through higher interest rates. That interest rate policy in turn burdened other European economies, contributing together with higher inflation in some other EU countries to a and consequent real devaluation of their currencies. The *Bundesbank*, faithful to its mandate to combat inflation at home and intent on maintaining its credibility throughout the world in the face of the unprecedented fiscal pressures that resulted from German unification, was prepared to cut interest rates (as it indeed did after January 1993) only, as the Bank's monthly report of the time put it, ". . . as far as this seemed justifiable in terms of anti-inflation policy."

Advocates of Maastricht reject any comparisons between the two Germanys' monetary union of 1990 and the forthcoming European Monetary Union (EMU) on the grounds that there will be relative economic symmetry among EMU participants but not full political union. Others contend that politically determined transfer payments and subsidies for poorer regions in a European union could well replicate the consequences of the Germanys' currency union. Moreover, if there are two tiers of participants in the EMU, with full membership for those countries meeting the Maastricht criteria while others remain outside, it could create a two-class Europe with all the potential political strife that implies. Whichever view is right, the question of asymmetry that plagued the European Monetary System is unlikely to go away.

The future of the *Bundesbank*, and of a European central bank modeled on it, belongs to the historic imponderables of Maastricht.

The *Bundesbank* has succeeded because of the political culture within which it has operated. A European central bank will succeed or fail for the same reason. In the old Federal Republic before 1990 the *Bundesbank* could count on a public that accepted the Bank's stability norm even when adhering to that norm meant short-term advantages such as higher wages and lower interest rates had to be sacrificed. Under the changed circumstances of unification since 1990, there are signs that even in Germany strain in "the stability consensus" is deeper, that acceptance of the high socio-economic costs of unemployment in return for low inflation is weakening.

The future of consensus in a united Europe, or in a European Monetary Union, is even less clear. A European "stability consensus" does exist among some of the prospective members of the EMU. At least, France, Germany, Austria, the Netherlands, Luxembourg, and Belgium—perhaps Italy—look eligible to meet the criteria for monetary union by 1999. But that does not mean all these countries understand "stability" in the same way, or that given political and economic pressures within their systems they would support a *Bundesbank*-like approach to issues of inflation, fiscal policy, exchange rates, and interest rates. The "stable money" norm originated in Germany's history of devastating inflations, a memory not shared by her European neighbors. However successful a European Central Bank might be in managing the euro (the ungainly name selected for the EMU's common currency), however similar in formal structure this institution may be to that of Germany's central bank, that institution will not be the *Bundesbank*.

Finally, the future of the *Bundesbank* and European Monetary Union will depend in good part on the success of the Europeans in meeting two great challenges. Not quite a "federation of states," the European Union is also not a "supernational organization." It is not yet clear whether the EU means—in the language of the German Constitutional Court—the disappearance of the sovereign powers of the member states.[27] But the stormy course of its ratification focused the debate on Europe's greatest political challenges. One is the democracy deficit[28] in both its forms, shared identity and institutional procedures. The other is the conflict between the bureaucratic activism of the Commission vs. the principle of devolving as much autonomy as possible to local authorities ("subsidiarity"), which is enshrined in European documents and law.[29]

The success of the *Bundesbank* in managing the Deutschmark contributed importantly to the acceptance of democratic government in western Germany after World War II. If European Monetary Union extends economic security among its members and if the new European currency comes to be as much a symbol for that achievement as the Deutschmark became in the case of Germany, then the *Bundesbank*'s leadership will prove to have been the keystone of Europe's success as well.

## APPENDIX A:
## PRESIDENTS OF THE *BANK DEUTSCHER LÄNDER* AND THE *BUNDESBANK*

| | |
|---|---|
| Wilhelm Vocke<br>President, *Bank Deutscher Länder* | 1948-1957 |
| Karl Blessing<br>President, *Deutsche Bundesbank* | 1957-1969 |
| Karl Klasen | 1970-1977 |
| Otmar Emminger | 1977-1979 |
| Karl Otto Pöhl | 1980-1991 |
| Helmut Schlesinger | 1991-1993 |
| Hans Tietmeyer | 1993-present |

## APPENDIX B: MEMBERS OF THE CENTRAL BANK COUNCIL OF THE *BUNDESBANK**

President: Prof. Dr. Dr. h.c. Hans Tietmeyer

Vice President: Johann Wilhelm Gaddum

### Members of the Directorate:

Dieter Haferkamp
Wendelin Hartmann
Prof. Dr. Dr. h.c. Otmar Issing
Edgar Meister
Helmut Schieber
Peter M. Schmidhuber

### Presidents of the *Land* Central Banks:

Dr. Günter Palm -- Baden-Württemberg
Dr.jur. Franz-Christoph Zeitler -- Bavaria
Klaus-Dieter Kühbacher -- Berlin and Brandenburg
Prof. Dr. Dr. h.c. Helmut Hesse -- Bremen, Lower Saxony and Saxony-Anhalt
Prof. Dr. Hans-Jürgen Krupp -- Hamburg, Mecklenburg-Western Pomerania and Schleswig-Holstein
Ernst Welteke -- Hesse
Prof. Dr. Dr. h.c. Reimut Jochimsen -- North Rhine-Westphalia
Hans-Jürgen Koebnick -- Rhineland-Palatinate and Saarland
Prof. Dr. Olaf Sievert -- Saxony and Thuringia

* As of May 1, 1997

## ENDNOTES

[1]. See Uwe Thaysen, "The *Bundesrat*, the *Länder*, and German Federalism," *German Issues* 13 (1994).

[2]. In August 1948 there was a further exchange of twenty old marks for twenty new. The rate of 1:10 (one new mark for ten old ones) applied to amounts above that held by private persons in bank accounts. In October 1948 there was a further exchange which meant that people actually received about 65 pfennigs on the mark for their holdings.

[3]. The rates of inflation in western countries seem to confirm the connection. Between 1950 and 1992 prices rose in Britain by 1,600 percent; in the U.S. by 480 percent; in Switzerland by 300 percent; but in Germany by only 250 percent. Geoffrey Wood, "Money: and an independent central bank" Banking World October 1993 in Auszüge aus Presseartikeln No. 71, October 13, 1993.

[4]. Schlesinger's reputation in this regard earned him the nickname of the "Bavarian Prussian," so unbending was he on inflation. At a farewell reception for Schlesinger in Washington Federal Reserve Chairman Alan Greenspan called him the "central banker's central banker."

[5]. "*Ansprache von Dr Hans Tietmeyer, Präsident der Deutschen Bundesbank*", Auszüge aus Presseartikeln, No. 68, October 4, 1993.

[6]. Germans ranked the *Bundesbank* well ahead of the government in a poll taken by the Allensbach Institute (1968); fifty percent of those asked viewed the Bank positively with only nine percent negative; the Federal government polled thirty-three percent positive, twenty-five percent negative.

[7]. *Bundesbank* Law, para. 3.

[8]. "Bretton Woods" refers to the international monetary regime in effect from 1944-1971. The name stems from the resort hotel in the White Mountains of New Hampshire, where in July 1944 the international agreement was drafted that established a set of "bands" within which currencies could fluctuate, but only to a very limited degree. Under the Bretton Woods system, the dollar was the reserve, intervention and vehicle currency, whose stability was assured by its convertibility to gold and the American government's promise to remain neutral with regard to the dollar's value against other currencies. After a series of crises, President Richard Nixon ended the dollar's convertibility to gold in 1971, marking the end of Bretton Woods.

[9]. The European Monetary System (EMS) came into existence in March 1979 and includes all members of the European Community. Not all members belong to the

Exchange Rate Mechanism (ERM), however, which operates as a regional system of fixed exchange rates anchored by the German mark. As of this writing (1997) the ERM includes the following currencies: Austrian schilling; Belgian franc; Danish krone; German mark; Spanish peseta; French franc; Irish pound; Luxemburg franc; Dutch guilder; and Portugese escudo. The value of these currencies fluctuates around agreed central rates, the so-called "bands" of plus or minus fifteen percent.

10. While many politicians have attempted to shape the outcome of the *Bundesbank*'s deliberations, "in the final analysis, (the *Bundesbank* Law) leaves a decision about what protecting the currency demands to the central bank." See Spindler/Becker/Starke, *Die Deutsche Bundesbank*, p. 18.

11. As of February 1, 1997. Source: "Banking Information," *Deutsche Bundesbank*, February 1997.

12. The LCBs are now Baden-Württemberg; Bavaria; Hesse; North Rhine-Westphalia; Berlin and Brandenburg; Bremen, Lower Saxony and Saxony-Anhalt; Hamburg, Mecklenburg-Western Pomerania and Schleswig-Holstein; Rhineland-Palatinate and Saarland; and Saxony and Thuringia.

13. Reversing previous government policy in May 1997, the new Labour government of Prime Minister Blair granted the Bank of England the right to set interest rates independently.

14. "Die Deutsche *Bundesbank* ist verpflichtet, unter Wahrung ihrer Aufgabe die allgemeine Wirtschaftspolitik der Bundesregierung zu unterstützen. Sie ist bei der Ausübung der Befugnisse, die ihr nach diesem Gesetz zustehen, von Weisungen der Bundesregierung unabhängig." *Bundesbank*gesetz (BBkG) (*Bundesbank* Law), para. 12.

15. See below, p. 20.

16. "Stagflation" was a term which came into use following the 1978 oil price increase to describe the high inflation and depressed industrial demand caused by high interest rates and high energy costs.

17. The *Kreditanstalt für Wiederaufbau* came into existence in 1952 as an agency of the *Bank deutscher Länder* charged with facilitating credit for postwar reconstruction. The agency passed to the Federal government when the *Bundesbank* Law of 1957 came into effect.

18. David Marsh, *The Bundesbank: the Bank that Rules Europe*, (London: Heinemann, 1992), p. 211. Marsh quotes from an interview with Horst Teltschik, foreign affairs advisor to Kohl.

[19]. The Bonn opposition party, the Social Democrats, was initially favored in the eastern German elections of March 1990. Since the conversion rate directly affected the wealth of east Germans, Kohl calculated that it would have a decisive impact on the electoral fate of his CDU party. The Bonn coalition parties (CDU and FDP) did win the March elections.

[20]. Children could convert 2,000 eastern marks at one-for-one and adults over fifty-nine could convert 6,000 at that rate. Other savings were converted two-for-one.

[21]. C. Randall Henning, *International Monetary Policymaking in the United States, Germany and Japan* (Washington: Institute for International Economics, 1994) p. 81.

[22]. Otmar Emminger, "The D-Mark in the Conflict between Internal and External Equilibrium", Essays in International Finance, No. 122, (Princeton: Princeton University Department of Economics, International Finance Section,1977), p. 1.

[23]. The G-5 consists of the United States, Germany, Britain, France and Japan; the G-7 adds Italy and Canada.

[24]. The Italian lira rejoined the system in November 1996.

[25]. German imports increased by 11.5 percent and 13 percent in 1990 and 1991. This surge in German demand created an average .5 percent increase in the GNP of Germany's trading partners. Otmar Issing, "The impact of German unification on the members of the European Community," lecture at the Finance & Investment Seminar, Edinburgh University, October 23, 1992.

[26]. Monthly Report of the *Bundesbank*, October 1990, pp. 40-44.

[27]. The Court referred to the "*entstaatlichung der Mitgliedstaaten*" in its decision on the Maastricht Treaty. (BVerfG/October 12, 1993)

[28]. "Democracy deficit" refers to the relative lack of authority exercised within the European Union by elected officials and parliaments compared to that of the EU's bureaucratic structures. The term has been used by those opposed to European integration on the grounds that national parliaments and elected governments insure democratic decision-making more effectively than do "eurocratic" institutions.

[29]. Karl M. Meessen, "Maastricht nach Karlsruhe" *Neue Juristische Wochenschrift* (47) no. 9, 1994, pp 549-554.

## SUGGESTED FURTHER READINGS

Caesar, Rolf & Hans Eckart Scharrer (eds.) *Maastricht: Königsweg oder Irrweg zur Wirtschafts- und Währungsunion*? (Europa Verlag: 1994).

Cooper, Richard N., Robert D. Putnam, C. Randall Henning, *Can Nations Agree? Issues in International Economic Cooperation* (Washington: Brookings Institution, 1989)

Destler, I.M. and C. Randall Henning, *Dollar Politics: Exchange Rate Policymaking in the United States* (Washington, D.C.: Institute for International Economics, 1989)

Emminger, *D-Mark, Dollar, Währungskrisen* (Stuttgart: Deutsche-Verlags Anstalt, 1986)

Giavazzi, Francesco and Alberto Giovannini, *Limiting Exchange Rate Flexibility: The European Monetary System* (Cambridge, MA.: MIT Press, 1989)

Goodman, John B., *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca: Cornell University Press, 1992)

Goodman, John B., "The Politics of Central Bank Independence," *Comparative Politics* (23) April 1981.

Hankel, Wilhelm, "Germany: Economic Nationalism in the International Economy" in _Wilfrid Kohl and Giorgio Basevi (eds.), West Germany:A European and Global Power (Lexington, MA.: Lexington Books, 1980).

Kaufmann, Hugo M. *Germany's International Monetary Policy and the European Monetary System* (New York: Columbia University Press, 1985)

Kenen, Peter, *EMU After Maastricht* (Washington, D.C.: Group of Thirty, 1992).

Kennedy, Ellen, *The Bundesbank: Germany's Central Bank in the International Monetary System* (Council on Foreign Affairs: 1991).

Leaman, Jeremy, "Diktatur der Bundesbank?", *Blätter für deutsche und internationale Politik*, (July, 1993) pp. 802-814

Lippert, Barbara & Rosalind Stevens-Ströhmann, *German Unification and EC Integration* (Royal Institute of International Affairs: 1993).

Lulow, Peter, *The Creation of the European Monetary System* (London: Butterworth, 1982)

Marsh, David, *The Bundesbank: the Bank that Rules Europe* (London: Heinemann, 1992).

*Monetary Policy Instruments: National Experiences and European Perspectives* (Bankhistorisches Archiv, Beiheft 27: 1994).

Scharpf, Fritz W. *Crisis and Choice in European Social Democracy* (Ithaca: Cornell University Press, 1991)

*The monetary policy of the* Bundesbank (Frankfurt am Main: *Deutsche Bundesbank*, October 1995).

American Institute for Contemporary German Studies

**German Issues**

German Issues 1* "West Germany/East Germany and the German Question," edited by R.G. Livingston, AICGS, 1986, 65 pp.

German Issues 2* "The Federal Republic: An Integral Part of the Western World," by Richard Lowenthal, AICGS, 1986, 24 pp.

German Issues 3* "Research and Study of the German Democratic Republic," edited by R. G. Livingston, AICGS, 1986, 77 pp.

German Issues 4* "West German Political Parties: CDU, CSU, FDP, SPD and the Greens," edited by R. G. Livingston, AICGS, 1986, 102 pp.

German Issues 5* "West Germany's Economy: Origins, Problems, and Perspectives," by Norbert Walter, AICGS, 1987, 31 pp.

Special Number* "German and American Management: Similarities, Differences, and Problems," by Herbert Henzler and Mark Young, AICGS, 1989, 15 pp.

German Issues 6* "The German Problem: A Personal View," by George Kennan, AICGS, 1989, 15 pp.

German Issues 7* "After the Revolution: the New Political Landscape in East Germany," by Daniel Hamilton, AICGS, 1990, 49 pp.

German Issues 8* "The Path to German Unity—The Constitutional, Legal and International Framework," by Rudolf Dolzer, AICGS, 1990, 45 pp.

German Issues 9* "Unified Germany at the Polls: Political Parties and the 1990 Federal Election," by David Conradt, AICGS, 1990, 38 pp.

German Issues 10* "Speeches for Our Time," by Richard von Weizsäcker, AICGS, 1992, 77 pp. Introduction by David Clay Large. Supplement, 8 pp.

German Issues 11 "France and the New Germany," by Steven Philip Kramer, AICGS, 1993, 24 pp.

German Issues 12* "America and the New Germany," by W.R. Smyser, AICGS, 1993, 40 pp.

German Issues 13* "The *Bundesrat*, the *Länder* and German Federalism," by Uwe Thaysen, AICGS, January 1994, 43 pp.

German Issues 14 "The Federal Constitutional Court," by Donald Kommers, AICGS, April 1994, 44 pp.

German Issues 15* "Election Year 1994: Continuity and Change in the German Political Parties," by Jonathan Carr, AICGS, September 1994, 40 pp.

German Issues 16 "The Federal Presidency," by Franz Spath, AICGS, April 1996, 44 pp.

German Issues 17 "European Monetary Union or Neotribalism in Europe?," by Norbert Walter, AICGS, June 1997, 25 pp.

German Issues 18 "Lessons from the Past, Visions for the Future," by Roman Herzog, AICGS, July 1997, 98 pp.

German Issues 19 "The *Bundesbank*," by Ellen Kennedy, October 1997, 40 pp.

German Issues 20 "The *Verfassungsschutz*," by Michaela Richter, forthcoming.

German Issues 21 "The *Bundesnachtrichtendienst*," by Hans Georg Wieck, forthcoming.

German Issues 22 "Party Parliamentary Groups (*Fraktionen*)," by Suzanne Schüttemeyer, forthcoming.

* No longer available.