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THE BUNDESBANK AND EUROPE

by

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The Bundesbank is the dominant economic institution in Germany, often appearing to be the maker of German economic policy more than the government or any other institution. It dominated the course of West German economic history, sometimes pleasing Chancellors and sometimes driving them to distraction.

The Bundesbank also bids fair to becoming the dominant economic institution in united Europe, whether through its influence on international monetary policy from its headquarters in Frankfurt or through its influence in whatever European central bank may ultimately be established.

The leaders of the bank insist that this has not been and is not now their intention, but that all they wish to do is to carry out their assigned mandate to preserve the value of the German Mark. But others regard them with a mixture of awe and fear that one reserves for those that combine power, authority, and intense conviction.

This paper will describe the Bundesbank and its role in Germany. It will then examine the bank's attitudes and policies toward various proposals and plans for European unity, and especially for European monetary unification. After that, it will review the bank's reaction to the Maastricht agreement and to the simultaneous drive for German and European monetary union. It will conclude by offering some thoughts about the future.

The Bundesbank in Germany

The Bundesbank is the single most important German financial institutions. More than any other such institution, it has acquired almost universal recognition and even notoriety. It has the dominant voice in West German monetary policy. Through that voice, it has established and maintained a firm policy in favor of solid currency value within West Germany, united Germany, and increasingly within the European Community and even the world at large. When the Bundesbank speaks, the Chancellor will listen, as will others in the German government, Europe, and throughout the world.¹

If a central bank's reputation is its most valuable asset, the Bundesbank is among the world's most highly endowed institutions. Its contribution to the economic and political stability of West Germany and Western Europe in the postwar years is almost legendary, and is given due respect even by those who disagree with some or many of its policies. Even persons who know little about Germany and even less about German economics have heard of the Bundesbank and of its passion for (or, as some would say, obsession with) stability.

The Bundesbank often appears to be---and even is---the most important maker of German economic policy, although its exact powers are carefully set forth and circumscribed in the 1957 law establishing the bank. Even when the Chancellor overrules the Bundesbank on questions that are within the competence and the responsibility of the government, he normally does so in a way that does not undercut the confidence which global markets and foreign investors must have in German financial policy.

The Bundesbank's carefully cultivated and ferociously protected image of rectitude emerges from its specifically articulated mandate, set forth in the Gesetz über die Deutsche Bundesbank, as "the preservation of the value of German currency." The creators of the Bundesbank regarded that mandate as so important that it was clearly intended to override the bank's other principal task, "to support the general economic policy of the federal government." Even the latter was carefully limited by the specific provision that the bank "shall be independent of instructions from the federal government."² The mandate to preserve the value of the German currency has become so deeply enshrined in the thinking of the bank's leaders, and has become such a widespread element of global financial planning and action, that the Bundesbank can often influence others without having to act.

The bank is more independent than most central banks, especially in Europe, as intended. It has more authority in the realm of monetary policy than either the French or Italian central bank or even the British. The model on which it was most closely based, at least in its structure although not in its formal mandate, was the U.S. Federal Reserve Bank. But it exercises more functions than the Federal Reserve, in part because it carries out some exchange responsibilities that are assigned to the U.S. Treasury in the American system, and its voting powers are more carefully reserved to members of the regional than of the federal mechanism.

Unlike many central banks, in which board or council members are chosen by the national government and may serve at its pleasure, the Bundesbank has the majority of its Zentralbankrat (Central Bank Council) nominated by Land governments. They do not serve at any government's pleasure, including that of the Land that nominated them.³ The members of the Zentralbankrat who are in the bank's Frankfurt directorate, the Direktorium, are appointed by the German President upon the nomination of the Chancellor, but they do not constitute a majority. Even those members, however, are not subject to government direction.

The German government does have an important role, if it wishes to exercise it. Government representatives can and do at times attend the meetings of the Zentralbankrat, although the government cannot block the bank's actions but is authorized only to delay them for no longer than two weeks. The government can, however, influence the bank's actions through indirect or public pressure. There are also informal contacts between the government and the bank, and it is not unusual for senior officials at the Chancellery and the Finance Ministry to know in advance what the Central Bank Council may be expected to decide at its next meeting. Meetings between German Chancellors and Bundesbank presidents are unusual but they do take place, although the results are not always what the Chancellors might have hoped.

The Bundesbank has normal central bank powers and functions. It issues currency, decides upon discount and other interest rates, makes open market policy, conducts open market transactions, and establishes minimum reserve requirements. It makes as well as carries out policies regarding government deposits, swap transactions, currency exchange, currency market intervention, and sale or purchase of certain securities. Its principal instruments are (1) the discount rate for loans to other banks, (2) the (usually higher) Lombard rate for short-term funding, (3) open market operations, and (4) minimum reserve requirement policies. It determines interest rates by the influence that its actions have upon markets.⁴

The former president of the Bundesbank, Karl Otto Pöhl, was the longest-serving central bank chief in Europe. He was originally

appointed by Schmidt, was reappointed by Kohl, and could have served until 1995. When he was first appointed, he was regarded as a radical because he had been a journalist and a Social Democrat, but he achieved a reputation as a solid money man although he was something of a pragmatist. He was never regarded as one of the true conservatives on the Zentralbankrat. He was better at public relations than most of his predecessors and than his immediate successor, and may have gained his reputation in part by his ability to maintain a cool distance from some of the bank's actions without openly challenging them. Although he said that he was resigning in July 1991 for personal reasons, many Bundesbank students believe that he resigned because he found that too many government decisions---especially on German unification---undercut the bank's capacity to carry out its policies and because he was increasingly frustrated by the array of problems that the bank was facing.

Pöhl's successor until September 1993, Helmut Schlesinger, is regarded as a tried-and-true hard money man. He has been a career Bundesbank official who was promoted to the Direktorium and to the vice presidency of the bank, an expert monetarist whose views on the importance of a stable D-Mark on occasion carried the Central Bank Council against Pöhl. He was often believed to have the conservative state bank chiefs solidly on his side, although there have been rumors that he has been over-ruled by those members on several occasions during his tenure. His appointment was regarded as a sign that the government wanted to support the bank's basic mandate in order to maintain international confidence in the D-Mark during the demanding challenges that unification would bring, even if it did not approve of all his attitudes. His basic view throughout his career has been that the function of a central bank is to hold a steady course geared to preserving monetary stability rather than to engage in anti-cyclical monetary policy. He warned several times during 1991 that rising wage rates and stimulative government fiscal policy were creating a significant risk of inflation that required counter-action by the bank.

Schlesinger had periodically exasperated foreigners, and especially Americans, who have had to deal with him. He was reported to have been the leader in the Bundesbank's decision to raise the repurchase rate several times during 1987, and those rate increases as well as Treasury Secretary James Baker's denunciation of Schlesinger were widely believed to have helped precipitate the October 1987 Crash. Nonetheless, before the end of that year Schlesinger was reappointed to a five-year term as vice president.

Schlesinger's successor in September 1993 is to be Hans Tietmeyer, who made his mark in the Economics and Finance Ministries as a career official and then as state secretary. Kohl, whom he had served as Sherpa, appointed him to the Direktorium in 1990 in the international finance post, one of the Bundesbank's most important positions. It had been held by Leonhard Gleske, who

had acquired a reputation for quiet sagacity through several international crises. Tietmeyer was principal author of a number of important documents, including Count Lambsdorff's 1982 paper that precipitated Helmut Schmidt's retirement from the Chancellorship. Tietmeyer was a widely respected figure in Germany and abroad even before joining the Direktorium.

Kohl might have wished to make Tietmeyer Bundesbank President in 1991 but that would have aroused speculation about the bank's independence from political pressure and might have complicated Tietmeyer's task. Thus, like Pöhl, Tietmeyer was first to serve an apprenticeship on the Direktorium before becoming the head of the bank. The relationship between Schlesinger and Tietmeyer has been as cordial as possible under the circumstances of their cooperation between 1990 and 1993, but nobody has ever suggested that they shared common views on all the many problems that the bank faced during those years. It is a sign of their determined commitment to their professionalism and to their responsibilities to the D-Mark that they have never let any hint of tension enter the public arena, despite constant observation and periodic rumors of sharp disagreements between them.

The Central Bank Council of the Bundesbank before German unification had 18 members, including the 7 members of the bank's Direktorium in Frankfurt as well as the 11 presidents of the West German Land banks. The representatives of the state banks outnumbered the Direktorium and could outvote it, although public and foreign attention usually concentrated on the Frankfurt establishment and on the Direktorium. The state bank presidents were reputed to grumble periodically that the Direktorium had become excessively influenced by international considerations and had sometimes neglected Germany's true interests.

One of the delicate questions arising out of German unity was a possible reapportionment of the seats in the Zentralbankrat to be decided within a year after unification, or by October 1991. If each of the five new Länder of the former GDR were to have had a state bank, and if each of those banks were to be represented on the Zentralbankrat, the Zentralbankrat would have had 23 members and the Frankfurt Direktorium could theoretically be outvoted by 16 to 7. Even if all 10 seats available to the Direktorium were to have been filled, the balance of power would still have been 16 to 10 against them. This would have called into question the bank's internal power balance and perhaps ranked international considerations too far down the list of the bank's priorities. There was also some question whether a Zentralbankrat of 23 or even 26 would be too large and unwieldy to be efficient and effective.

A number of arrangements were proposed to overcome the potential imbalance between the center and the states in the Zentralbankrat. One proposal, quickly denounced as a Frankfurt power grab, would have reduced the total number of state banks to

seven, giving the president the deciding vote in case of a tie. A number of the smaller banks understandably opposed amalgamation proposals,⁵ and the German upper house, the Bundesrat, voted to give each Land a central bank.

As the debate unfolded during 1991, it became increasingly clear that a decision on the number of state banks could affect the policy orientation of the bank. Because the Eastern German states need to have the most rapid development possible, they might be inclined to favor lower interest rates to encourage investment and growth even at a potential risk of somewhat greater inflation. The Western German states would presumably be less ready to take such risks. Some of the proposals for amalgamation of state banks seemed deliberately intended to weaken the influence of the new states, as several of their banks were to be merged with Western state banks so as to lose an independent voice.

After considerable discussion, the government by mid-1991 appeared to lean toward a compromise proposal that would leave fewer than 16 but more than 8 state bank representatives on the Central Bank Council. But the allocation of those seats remained a difficult issue, especially because even the compromise suggestions appeared to leave the new states of Eastern Germany under-represented. The policy implications were uncertain and might only be measurable over time.

After a debate that continued for almost two years, longer than originally planned or expected, the Bundesbank conservatives carried the day. The final shape of the Central Bank Council was designed as they wished. The state bank presidents will continue to have a majority of 9 to 8 over the Direktorium in the Central Bank Council. Moreover, with the exception of a new regional bank in Saxony-Thuringia, each Eastern German state bank has been merged with a Western German (or, in one case, West Berlin) state bank in order to make certain that the stable money principles that have traditionally guided the West German state banks will continue to prevail. The Bundesbank could assert with some satisfaction, at the end of the process, that "the priority of safeguarding the currency over any general economic tasks remains unchanged."⁶

In those cases where formerly German and new Eastern German regional banks were to join, the former West German officials always became the new heads of the regional banks, further making certain that the Central Bank Council remained firmly in the hands of those who had held power before unification. In several cases, however, it was made clear that the East German states would have their turn at the positions of future heads of those regional banks divided between Western and Eastern states. This promises more access for Eastern German thinking into the Central Bank Council over time.

The Bank and Early European Monetary Integration

West Germany has been at the core of European monetary integration in the European Monetary System (EMS) even more than of commercial integration in the European Community. It helped to start the EMS and has long provided the anchor of its principal operating element, the European Exchange Rate Mechanism (ERM). It now exercises considerable, and sometimes even dominant, influence on the future evolution of European monetary affairs. But it was not the Bundesbank that led the way into European monetary integration; nor was the bank ever enthusiastic about it.

The EMS was much more difficult for Germany to propose or even to accept than the EC. Although West German business and government felt very much at home in the Common Market from the beginning, they had reasons to be much more anxious about monetary cooperation. For the two concepts are very different although they may be complementary, and they look especially different to the Germans.

A common trading area within Europe helps Germany to do what it does best: to produce and to export. Although the Germans have also had to open their own borders to others, they have always been justifiably confident that they could meet such a challenge. Money, however, is something else again, especially in Germany. West Germany's monetary policy was seen by many Germans as the guarantor of the Federal Republic's stability and prestige. Any West German political or economic debate assumed the solidity of the D-Mark as a national purpose. European monetary cooperation could only be acceptable in West Germany if it did not jeopardize either the D-Mark or the policy that had given the currency its success and had given West Germany its prosperity and domestic tranquility.

Many Germans feared that European international monetary cooperation would inevitably have a pernicious effect on Germany's own money by posing a risk to the independence of German financial and monetary policies. They believed, and not without reason, that many other states in Europe did not share Germany's belief in monetary stability as the principal objective of financial policy.

The West German government and the Bundesbank in particular tried, therefore, to make sure that no European monetary arrangement would interfere with Germany's freedom to choose its purposes and its policies. They consistently tried to construct arrangements that would give them a dominant influence over European policy or, if that was impossible, would enable them to pursue their traditional goals for themselves.

The West German government and the Bundesbank did not always agree about what constituted satisfactory arrangements, with the bank usually being more cautious than the government. Nonetheless, West Germany helped to establish the system and was among its main beneficiaries.

The main debate in Germany, as in several other large European countries, was between those who came to be known as the "monetarists" and those who came to be known as the "economists."⁷ The "monetarists" believed that introducing fixed exchange rates would force countries to pursue similar policies and that this would make frequent interventions less necessary and perhaps even unnecessary after some time. The "economists" argued that common economic policies had to precede fixed exchange rates because the exchange rate system would break down otherwise. They thought a common currency should cap a structure of common policy, not help to build it.

Most West German economists as well as government and Bundesbank officials belonged solidly in the "economist" camp.⁸ They did not want to join in any European monetary collaboration until European states had agreed to coordinate economic policies. The experience with such early efforts at monetary cooperation as the "snake," and the costly and frequent interventions that it had required before it finally broke down, only hardened their attitudes. Even those Germans who favored D-Mark revaluation, as Economics Minister Karl Schiller did during the 1960s, wanted it to take place on German terms.

The Bundesbank insisted that its mandate to protect the D-Mark extended to the currency's external as well as internal value. The Bundesbank's Direktorium questioned the readiness of the other major European countries to follow its policies, and it would not accept the inflationary risks of having constantly to intervene. Bank officials and private German bankers derided the Europäische Währungsgemeinschaft as the Europäische Inflationsgemeinschaft.

It was against this deeply skeptical background that Chancellor Helmut Schmidt decided to take Germany's policy on European monetary integration into his own hands after Roy Jenkins, then President of the EC Commission, in October 1977 proposed a new framework for European monetary cooperation. During the next 12 months, Schmidt and French President Valéry Giscard d'Estaing worked closely with Jenkins and with each other to devise an acceptable system. Because of the Bundesbank's and the Economics Ministry's opposition, Schmidt conducted the important initial phase of the negotiations in great secrecy, keeping them from the German bureaucracy and from the Bundesbank.

Schmidt and Giscard decided to establish EMS largely because they feared that the global economic order might well collapse if nothing was done to reinforce European collaboration. They were

profoundly disturbed by Washington's policies, especially by the American decision in the late 1970s to let the dollar fall. Schmidt was encouraged to find that France, which had left the snake, was now prepared to take another look at European monetary cooperation and even to recognize some merit in German policies. He hoped for what he termed a "European zone of stability" in an unstable world.

When Schmidt and Giscard presented their proposal at the European summit in Copenhagen in April 1978, they found broad support or at least interest from virtually all participants except British Prime Minister Jim Callahan. Even Italy was prepared to rejoin a European currency system, although it wanted special arrangements to give the lira a wider band. The Europeans hoped that the EMS would succeed where the snake had failed. At the core of the system was the European Exchange Rate Mechanism, the system for coordinating and perhaps ultimately synchronizing exchange rates, so that all European currencies would remain linked to each other.

The EMS also established a European currency named the Ecu. The name represented the acronym for European Currency Unit and was also, perhaps not coincidentally, the name given to French gold and silver coins in the late Middle Ages. It was designated to represent a basket of currencies from the countries of the European Monetary System, to be used initially for certain clearing and credit transactions and ultimately to become a common currency for Europe.⁹ The widespread use of the Ecu as a transactions currency was expected to save \$25 billion annually in exchange transaction expenses, and its advocates also expressed the hope that economic growth would be boosted by as much as 5 per cent because investors would no longer be discouraged by the risks of exchange-rate fluctuations.

The EMS and especially the ERM, with the Bundesbank at their core, did succeed in making Western Europe something of a "zone of stability." After a difficult beginning, marked by frequent currency realignments during the early and middle 1980s, and even by a time of D-Mark instability because of the second oil shock and a negative German current account balance, the exchange rates of the ERM currencies have been much more stable toward each other than toward the dollar and the yen. In that sense, the ERM has constituted the joint float that some of its proponents had envisaged. The divergences between the ERM currencies declined consistently between 1979 and 1989, whereas the divergences between the ERM currencies and the dollar increased.¹⁰

Equally important, the ERM may well also have had the effect of reducing inflation, one of its most important objectives, and it certainly contributed to inflation's decline. Average annual inflation rates in the ERM states fell from 12 per cent to 3 per cent between 1980 and 1988.¹¹ The ERM achieved this essentially by imposing the discipline of the Bundesbank on the other states and

central banks. This amounted to a cold shower for several ERM countries, especially at the beginning. But the Bundesbank did relax its rigorous discipline on occasion to make it easier for others to remain in the system. It permitted the growth in German money supply to exceed its targets during the mid-1980s to help ERM states.

Some major currencies, such as the franc, stabilized earlier than others, such as the lira, in part because of a more determined French commitment to the ERM after the spring of 1983 and in part because of high Italian budget deficits. Whatever the pace of adjustment, however, there were no defections as there had been during the snake. In fact, other currencies---such as the Spanish peseta---joined the ERM. The BDI proclaimed a "European Stability Zone," showing how certain European currencies had remained stable against each other even as the dollar had fluctuated widely during the early and mid-1980s, and also illustrating how the price deflators for consumer goods in ERM countries had converged during the 1980s.¹²

Greater price stability in Western Europe could not be credited exclusively to the EMS and the ERM. Inflation rates declined globally during the 1980s as a gradual process of disinflation set in after the second oil shock. But political leaders and economists could argue convincingly that the ERM had played a role in that process. They could also recognize that there were certain advantages to be gained from joining West Germany in a commitment to price and currency stability, and they could even note---perhaps with some surprise---that the Germans appeared to have gone out of their way to help others work with them to a common purpose.

The Bundesbank's evaluation of the EMS in 1989 recognized these achievements and particularly cited the ERM as an example of successful cooperation at a time of "turbulence evident in the dollar rates."¹³ It asserted that the ERM had stood the test of time and that the other countries in the ERM had imported stability from the Federal Republic.

Nonetheless, the Bundesbank questioned whether the ERM should be used to keep exchange rates constant when competitive forces argued for devaluation. It complained that the Federal Republic was generating almost three quarters of its foreign exchange surplus within the EMS area although only half of its trade was with EMS countries. It warned that such surpluses pointed to competitive differences that could not and should not be offset only by capital flows, as later adjustments would be more painful. It also warned repeatedly that constant D-Mark interventions in currency markets in order to support delinquent ERM currencies could finally undermine the stability of the D-Mark itself.

However one might choose to allot credit for the success of the EMS and of the ERM, it represented a theoretical setback for the Bundesbank even as it represented a practical triumph. For it showed that the "monetarist" school might well have been correct, and that a stable exchange rate mechanism, accompanied by a commitment to hold to the agreed rates, could compel states and their central banks to pursue congruent policies as long as they were determined to stay within a system. It suggested also that the exchange rate mechanism might act as a catalyst in facilitating policy because it gave states an additional reason to coordinate and could be said to provide a reproach of sorts if they failed to coordinate.

While the "monetarists" and the "economists" might extend their debate, the ERM experience had achieved one significant and even revolutionary breakthrough. It had convincingly demonstrated the benefits of coordination, thus opening the door to further proposals for European monetary cooperation.

Germany in the ERM during the 1980s

The German anchor role was central to the success of the EMS and the ERM. It has often been said that the ERM represents a "D-Mark zone" within the European Community, with Austria and perhaps Switzerland added from outside the EC. The D-Mark has been the lead currency, the principal intervention currency, the principal reserve currency, and the psychological as well as the practical anchor. Karl-Otto Pöhl could report by January 1990 that, of the one fifth of all global currency reserves held in D-Marks, many were held in EMS central banks and treasuries as a sign of mutual commitment and confidence.¹⁴

During the dozen years between the creation of the ERM and the Maastricht summit at the end of 1991, the revaluation of the D-Mark against other ERM currencies had been 38 per cent (including 58 per cent against the Italian lira and 45 per cent against the French franc), but most of the revaluation had taken place at the beginning and the practice had declined sharply during the last five years.¹⁵ At the end of the decade, it could be said that the ERM had been a considerable success for all the states involved. But it had mainly been a success for West Germany and for the Bundesbank, demonstrating the benefits for others of associating themselves with Germany's economic philosophy and with the disinflationary policies of its central bank.

The size of the German economy relative to other ERM economies probably made little difference. Neither did the volume of its international trade, although Germany had led the ERM in both categories. The United States had enjoyed similar relative standing

vis-à-vis the remainder of the world at the beginning of the 1970s, but the Bretton Woods system still collapsed when others (especially Germany) were not prepared either to emulate the policies of the United States or to draw the consequences. ERM worked because other states were prepared to accept the Bundesbank's doctrine and the discipline that it required.

Moreover, Germany was at several key points more ready to help the system to succeed than the United States had been, although the Bundesbank periodically muttered during the decade about the special burdens that the ERM placed on it and on the D-Mark.¹⁶ The German government may well have been contemplating that Germany might be obliged to play a long-term leadership role in Europe and that this was a good time to show that it was ready to do so.

Actually, the performance of the D-Mark and of the Bundesbank were not quite as stable throughout the ERM period as their high standing might suggest. From the beginning of 1980 until February of 1981 the D-Mark was weak against the dollar and against most ERM currencies because of the second oil shock and because the Federal Republic was suffering the reaction to its reflation policies of the late 1970s.¹⁷ The D-Mark then remained weak against the dollar but strong within the ERM until 1985. It later strengthened against the dollar but stabilized within the ERM, essentially compelling the ERM countries to take the same ride that it was taking.

Nor was German performance always the subject of unalloyed admiration in Europe. Several ERM states had heated discussions between 1986 and 1988 about whether or not the Bundesbank's determination to preserve the value of its currency might not be exporting deflation as well as, or instead of, stability. The alleged "deflationary bias" of German policy became a subject of speculation throughout Europe and the United States until the German economy itself began to resume its growth rate toward the end of 1988.¹⁸ The term "Euroclerosis," which had surfaced periodically throughout the 1970s and 1980s, again found favor among Western and especially among American economists.

The ERM also offered Germany some very real commercial advantages. It helped to make possible the persistent West German trade surplus within the European Community during the latter 1980s, when European currency stability was in full force. Such a surplus could not have been maintained under traditional circumstances, as it could probably not have been indefinitely compensated by financial and investment flows and would sooner or later have brought about either revaluation by Germany or devaluations by those Community countries most subject to the imbalance. Either would at some point have made German products less competitive. Moreover, as the Bundesbank itself suggested, the D-Mark was somewhat undervalued, as its real (i.e., price-adjusted) external value actually fell against most EMS currencies in the ten years after 1979.¹⁹ But the other states still measured their

currencies against the German currency and wished to be tied to it, despite the commercial disadvantages.

Germany's partners may, therefore, have paid a price in large trade deficits and in some slowdown. By the end of the 1980s, both the French and the Italian economies were turning down even as West Germany's was taking off. France and Italy also found their trade deficits doubling during the last half of the decade,²⁰ and France was not yet fully competitive in Europe and the world despite the strong dose of stability.²¹ But both France and Italy, as well as other ERM states, appeared to have decided that the long-term benefits of stability would reverse the negative trends.

If Jacques Rueff had been correct in asserting that "L'Europe se fera par la monnaie ou ne se fera pas," then the West German government, the Bundesbank, and the D-Mark had helped show the way toward a united Europe with the success of the EMS and the ERM. The 1980s ended and the 1990s began with intense European discussion about the possibilities of a wider ERM and about the prospects for true European monetary union under a common currency.

From EMS to EMU

The members of the European Community decided even before the end of the 1980s to explore further monetary cooperation as the Community advanced toward the single internal market. In June 1988, at the European Council meeting in Hanover, they established a commission chaired by the President of the European Commission, Jacques Delors, to study and propose "concrete stages leading toward economic and monetary union." Delors had volunteered to undertake the task. His report, submitted on April 17, 1989, envisaged a transition in three stages toward a European Monetary Union (EMU) with a single common currency:²²

-- The first stage, to be entered on July 1, 1990, was to expand the ERM to include all Community members, most notably Great Britain, to permit free capital flows, and to take other measures that would further coordinate economic and monetary policies.

-- The second stage, for which no date was then proposed, was to create a European system of central banks, leading to a single central bank, and an exchange rate mechanism under which European currencies would be permitted to float within very narrow bands smaller than those of the then current ERM. The Community was also to be empowered to set basic economic targets for its members on even such sensitive subjects as the size and financing of budget deficits.

-- The third and last stage was to provide for the creation of a single currency managed by a European Central Bank

and for even greater Community powers to direct the policies of member governments in order to achieve common financial policies.

The Delors report balanced and combined the conflicting theses advanced by the "monetarists" and the "economists." It placed a high premium on the expanded ERM in the first stage. It provided for the free movement of capital as part of that first stage because capital movement combined with the ERM would compel nations to coordinate their economic policies whether or not they had agreed to do so. But it also envisaged structures for policy coordination even in that first stage and it actually envisaged a European role in guiding national economic policies as part of the second stage. By then, the combination of the ERM and some centralized target setting would exercise the kind of control that both the "economists" and the "monetarists" had sought, and the European governments would be in an increasingly tight lock-step. The final stage, a common currency, could not be far behind, and might have no more than symbolic meaning if the other pieces had already fallen into place.

Even as the discussion about the shape and objectives of European Monetary Union proceeded, steps toward that union were advancing. In June 1989, at Madrid, the European Council endorsed the recommendations for EMU, including the date of July 1, 1990, as the date for beginning the first stage. Eight EC members eliminated all capital controls by that date, and four others (Greece, Ireland, Portugal, and Spain) were given different grace periods until the end of 1992 to do the same. In June 1990, at Dublin, the European Council agreed that a conference of EC member states would meet in December 1990 to discuss the EC treaty amendments that would be necessary to complete economic and monetary union.

The purpose of the 1990 conference was to arrange to have necessary amendments ratified by national parliaments before the end of 1992, at the time that the Single Market was to enter into operation. It was also intended to make certain that the EMS, ERM, and EMU processes, which had been managed on the basis of intergovernmental agreements and consultations separate from the formal legal structures of the EC's Treaty of Rome, would become integrated into those structures. The EMU and the EC with its single market would, in effect, become a single entity.

The European banks joined the governments in moving toward a common European currency, but did so in a manner calculated to reinforce their own roles and their own independence from those governments. A crucial step was taken in December 1989, when the European Community central bankers met in Basel, Switzerland, and agreed to the demands that Pöhl and other Germans advanced, especially with respect to the independence of central bankers against government influence. They took a number of steps that would, in Pöhl's words, make the committee of central bankers "a kind of forerunner for the future European central banking system"

and an embryo from which the future central bank of Europe might grow.²³

Pöhl cited four points on which the bankers had agreed:

- Their main objective was to fight inflation.
- They would organize themselves to "strengthen the position of the committee as a partner of the Council of Ministers in Brussels," a sign that the bankers intended to play a central role in the move toward EMU.
- The committee was the forerunner of the European central banking system.
- The research staff of the Bank for International Settlements (BIS) in Basel would coordinate monetary targets "with the objective of price stability as a policy objective of all member central banks."

The bankers met several times during 1990 and 1991 to continue to assert their views and to organize themselves for further action.²⁴ They showed ever greater determination to shape the process of European monetary integration and especially to make certain that governments did not have final control over decisions that bankers believed they were better qualified to make. Pöhl almost certainly urged them in that direction. These meetings, as well as a study commissioned by the Association for the Monetary Union of Europe,²⁵ showed not only the momentum that was arising behind EMU but also the degree to which the concept that money should be a real store of value as well as a medium of exchange was becoming widely recognized.

The EMU process continued apace. The EC Foreign Ministers met in Ireland in May 1990. And on July 1, 1990, stage one of the EMU formally began. In September 1990, in a major shift of policy, Great Britain finally joined the ERM with a 6 per cent band. This was a significant addition to the ERM, although it was taken as reluctantly as many earlier British steps toward Europe had been taken. Great Britain also offered a separate proposal for a "hard Ecu," under which the Ecu would become another currency trading in Europe for certain purposes and would be exchanged for existing currencies but pegged to the strongest of those currencies. It was to be available for public use and to settle debts, but it would theoretically not add to the money in circulation because it would be issued in exchange for other currencies.

The Bundesbank's Views on EMU from 1989 to 1990

After the Delors Plan was announced, the German government and the Bundesbank reacted cautiously although Pöhl had helped to draft the report. Having been pleased with the achievements of the ERM, the Germans were prepared to examine an arrangement that would go

further toward monetary union. But they were not ready to agree to anything that would upset what they regarded as the foundations of their own prosperity.

German reactions to the Delors Report came from many sources, but mainly from the Bundesbank. Bank officials formed a chorus to list the conditions under which Germany would adhere to EMU. Pöhl himself used virtually every possible opportunity to clarify the bank's views about EMU and the European central bank. Pöhl maintained that the Bundesbank was in no hurry to see any kind of European monetary integration or common currency unless it was the right kind.²⁶

The Bundesbank was highly skeptical toward the Ecu. Leonhard Gleske, then member of the Direktorium responsible for international matters, warned already in 1989 that the Ecu as then conceived could not match the vital role that the D-Mark had played in making the ERM work effectively. He said that the Ecu represented a useful accounting unit but he warned that it could not serve as a reserve currency, intervention currency, or store of value, as the D-Mark had. He also warned that national currencies should not and could not be replaced by an international currency that did not have the same characteristics as a successful national currency.²⁷

The Bundesbank nonetheless recognized the value of having a European Monetary Union and an artificial currency, the Ecu, for certain purposes. Klaus Köhler, a member of the bank's Direktorium, recalled that both the dollar and the pound sterling had suffered on balance from their roles as the principal currencies of the Bretton Woods system and its predecessors. The current account deficits that were needed to provide global liquidity could not be sustained without a loss of confidence and finally a collapse of the fixed exchange rate system. Köhler said that this was why the Bundesbank had supported the Ecu for certain purposes despite some reservations. Nonetheless, he warned, the Ecu was far from ready to perform as a key currency, and the D-Mark was finding itself increasingly obliged to serve at the center of the EMS and the prospective EMU. He warned that the Bundesbank did not want to perform this role, insisting that it would be more desirable to "share the burden," but that the D-Mark could not be replaced until an adequate substitute was available.²⁸

The Bundesbank did, however, outline the conditions under which it might be prepared to support European Monetary Union and a European currency. They contained no surprises:²⁹

-- The European currency must be as strong and stable as the D-Mark.

-- It must be issued by an independent issuing bank, impervious to instructions or pressures from governments or from European institutions.

-- The bank must not be subject to drawn-out consultations before it can make decisions, especially in circumstances like the 1982 debt crisis or the 1987 Crash, when a central bank must be able to act fast and flexibly.

-- The bank must be able to follow long-term strategies and policies, as money flows require time to work through a financial system.

-- Any system that relies on "coordination" between governments and central banks would be "half-baked" and must be avoided, for banks must be independent.

-- There can be no limitations on the European central bank's authority to protect the stability and value of a currency.

-- If all European states and institutions were to exercise "self-discipline," fewer formal rules might be needed.

It would be misleading to believe that German conditions about EMU and about a possible European currency represented only the attitude of the Bundesbank. The Advisory Council of the German Economics Ministry issued a report that fully matched the Bundesbank in content and in tone. The 30-member body, which had several times met to discuss the possibilities for a European currency system, said that it could see a number of advantages to a common European currency but it warned that such a currency could prove disastrous if it became an instrument or an object for manipulation.³⁰

As 1990 advanced, the Bundesbank became ever more deeply concerned about the risk that EMU might not emerge as it wished.³¹ Even as the bank went through the motions of negotiating with other banks about EMU and of watching the government conduct its own policy, it was becoming increasingly disturbed at the prospect at having to stabilize closer European monetary integration at a time when its resources were fully committed toward East Germany and Eastern Europe.

On September 19, 1990, the Bundesbank took the unusual step of issuing a lengthy official statement clearly intended to set forth its views on EMU in the most formal possible manner. The statement also asserted that the problems posed by German monetary union had to be completely under control before further European integration could be contemplated.³²

Returning to the old arguments of the "economists," the Bundesbank said that "economic union" must be the basis for monetary union, adding that "sufficient and durable convergence among member states" had to precede EMU. Before EMU could proceed, the Single Market had to be implemented, fiscal border controls had to be eliminated, and inflation had to be "very largely stamped out." The Bundesbank emphasized the importance of a bank board with "durably guaranteed independence," listing the conditions needed for that independence. It proposed a central bank structure much like that of the Bundesbank itself, adding that the bank system

would have to give priority to monetary stability. No bank or nation should be able to follow independent policies.

The most striking part of the Bundesbank document, however, was the warning that it issued to the German government. It stated that the conditions listed in its statement represented "unconditional, not negotiable, requirements." It stated that the German delegation would have to represent these views at an upcoming government conference with no compromises. To underline its warning, it asserted that the risks which EMU posed for monetary stability applied especially to Germany. Finance Minister Waigel issued a brief statement supporting the bank's position.

An even more negative statement on EMU came from Helmut Schlesinger, then still a member of the Direktorium and not yet president of the bank. Speaking in London in September 1990, he listed not only the usual Bundesbank reservations about European Monetary Union, but he added another. Speaking "personally," he said that he questioned whether Europe could manage a common currency until it had created what he termed the "relevant political structures." To the "monetarists" and the "economists," he added what appeared to be a third group, perhaps to be termed the "politicians," who also wanted even certain political preconditions fulfilled before Germany would agree to monetary union.³³

The Bundesbank continued the steady drumbeat of its concerns and reservations about EMU throughout the remainder of the year. Speeches by one member of the Zentralbankrat after another concentrated on the dangers of EMU. Almost half of every copy of the Bundesbank publication, Auszüge, carried statements pointing out the dangers of EMU and underlining the necessary preconditions. The Finance Ministry, while less voluble, also remained cautious.

The Bundesbank was not, however, carrying the day within Germany itself. The Foreign Office, especially Foreign Minister Genscher, continued a quiet prodding toward EMU, in part because of Genscher's own belief that the time for closer European integration had come and in part because of consistent pressure from France and perhaps other European states. Chancellor Kohl shared Genscher's commitment to European integration but also listened carefully to Pöhl. The result was a policy that increasingly confused the listeners to the German dialogue, especially as it was interwoven with moves toward German unity that undoubtedly took priority in the minds of German politicians and officials.

Other voices joined the debate. Both the BDI and the Sachverständigenrat supported the Bundesbank. On the other hand, a major West German weekly, Die Zeit, attacked what it termed the "Mischief of DM-Nationalism" and warned that behind the Bundesbank's tirades against EMU proposals one could begin to hear a Kommandoton (command tone) that gave no credit to Germany. It

reminded its listeners of Thomas Mann's famous saying that he would rather have "a European Germany" than "a German Europe."³⁴

Despite the coincidence of European Monetary Union and German monetary union, and the potential for conflict, progress toward EMU continued during the remainder of 1990. The EC Commission released a report, optimistically entitled One Market, One Money, which positively assessed the probable impact of EMU on the European and world economies. It specifically recommended an early transition to the second stage, an early establishment of the new European central bank, which it termed the "Eurofed," and the designation of the Ecu as the single EC currency. The report raised some eyebrows in Bonn and Frankfurt, as it appeared to put European governments and central banks---and especially the German---under pressure, but no immediate German action followed.

The next step in the EMU process took place at a special EC summit in Rome in October 1990. At that summit, Chancellor Helmut Kohl and the other European leaders (except Margaret Thatcher) agreed that the second phase of EMU was to enter into force on January 1, 1994. This date was not as early as the mid-1993 date originally proposed by Delors and supported by Genscher, but it also represented a setback for the Bundesbank which wanted no date to be set.

In the same vein, the Rome summit agreed that, within three years after the beginning of the second phase, the EC Commission and the monetary institutions would report on the functioning of that phase and on the progress made toward what it termed "real convergence," so as to prepare a decision regarding passage to the third phase---which was to occur "within a reasonable time."

The agreement set the date of 1994 for the establishment of the Eurofed. The Eurofed would thus begin to play some role in the management of the ERM and EMS during stage two of the EMU process. It would presumably help to coordinate the policies of the European national central banks---including the Bundesbank(!)---and would prepare itself for the day when it was to take over full responsibility for European monetary policy and for managing the Ecu as the single European currency.

The Eurofed was to be modeled after the Bundesbank and the U.S. Federal Reserve, with more of the characteristics of the Bundesbank, but its precise organization, powers, and responsibilities were yet to be negotiated and determined. Even before stage two and Eurofed, however, the intensity of monetary coordination was to accelerate through the establishment of a Committee of Central Bank Governors that was to become the principal body to discuss EC/EMS monetary policies as well as external monetary relations, as with the U.S. dollar and the U.S. Federal Reserve Bank. It was also understood that economic

coordination had to progress from what Delors termed "an academic exercise" to something more concrete and more effective.³⁵

Shortly after the Rome summit, Mrs. Thatcher fell and was succeeded by John Major as Prime Minister. While that change would probably not put an end to Britain's reservations about European monetary integration, it meant that London's reservations would be uttered less categorically and would perhaps be held less tenaciously. Great Britain would presumably be more flexible, and that meant a greater probability that EMU might come to pass. That might have been good news for Kohl and Genscher, but not for the Bundesbank.

Even more dramatically, at the European Council summit in Rome on December 14-15, 1990, the heads of government agreed to transform themselves into two Inter-Governmental Conferences (IGC's) to negotiate terms for European economic and monetary union on the one hand and for European political union on the other. These two IGC's, reminiscent of the IGC that had convened in 1985 and had produced the Single European Act, promised to lead the Community to new levels of integration. Although Delors used the summit to complain about recalcitrant states, and specifically included Germany among those states, the atmosphere in Rome was positive and promising. EMU was on track, speeding ahead, and the combination of moves toward political and monetary union showed that the leaders of Western Europe were dead serious about establishing a truly united European economy.

Within weeks of the beginning of 1991, however, the Bundesbank made clear that it had heard enough, and that it would have the final say on EMU even if its views had not fully prevailed on some other issues. The first step taken by the bank was to raise the discount rate by half a point on January 31, 1991. It made the move without apparent consultation with its major ERM partners, disturbing both the French and Italians who nonetheless decided not to devalue but to follow suit. The second step was to propose its own draft for the Eurofed, a draft that fully complied with the bank's views of the Eurofed and that also postponed its creation until the end of stage two of EMU.

The Bundesbank did not stop there but added additional conditions, stating that EMU members had to have their fiscal deficits under control (a slap at Rome and at Bonn) and had to signal their interest in the process by making their central banks independent before EMU began (a slap at Paris and London). The bank also argued that it might be desirable to reach EMU in geographic as well as substantive stages, with the first countries included to be only those whose governments and central banks were truly ready (a slap at almost all major and some minor European states).³⁶

To reinforce the bank's views, Pöhl on March 19 made an allegedly offhand remark in which he termed German monetary

unification a "disaster," prompting an immediate fall in the D-Mark. Pöhl's purpose was not primarily to denounce German monetary integration, which was a done deal on which his views were well known, but to warn that European monetary integration would fail if it were to proceed before the right conditions had been fully created.

Members of the German government followed divergent paths. Chancellor Kohl, in a joint statement with Britain's Prime Minister John Major on February 11, supported the British plan to go slow on EMU, and specifically not to create the Eurofed until the end of stage two. The following month, however, Foreign Minister Genscher issued a joint statement with French Foreign Minister Roland Dumas in which he committed the German government to creating the Eurofed at the beginning of stage two.³⁷ The French support for EMU was merging with the wish of the German government for greater European integration.

German financial officials and bankers were plainly getting worried. The burdens of German unification were proving to be far greater than many Germans had expected. United Germany was being called upon to finance or to help finance virtually every international venture, from the U.S. military campaign in the Gulf to the reconstruction of Eastern Europe, the Soviet Union, and perhaps the new Russian republics, and nobody could be certain what might come next.

An outsider could be pardoned for wondering if the Bundesbank had become so deeply concerned about the risks of EMU in an unstable and even risky environment that it was prepared even to weaken the EMS and the ERM to delay or perhaps scuttle progress toward EMU. Whatever its purpose, the bank was conducting its business in the shrillest tone that it had used since the oil shocks and the monetary crises of the 1970s.

The bank was also getting results. At a meeting of Finance Ministers and central bankers in May 1991, the idea of a "two-speed Europe" was presented and discussed, opening up the possibility that Germany and the Bundesbank would have to cooperate in the early phases of EMU only with those states that would present no undue stability problems, like the Benelux states and (perhaps) France. There were also reports that the date for the Eurofed had been set back for two years, to 1996, at German request. By the end of the meeting, the Bundesbank had again shown that it, and it alone, would have the final word on Eurofed and EMU and that it would set the timetable. Anybody who disagreed was welcome to stay out.

In case any doubts remained about the attitude of Hans Tietmeyer, whom Kohl had put on the Direktorium and who was to succeed Schlesinger in 1993, Tietmeyer in April 1991 made it obvious that he also was in no hurry about EMU.³⁸ He strongly

advocated the "two-speed Europe," saying that a number of states in the EC (he cited Great Britain, Italy, and Greece) did not yet fit into the Stabilitätsblock and that a common monetary system could not overcome excessive policy divergences. He made it clear that the Bundesbank would simply not join any EMU that included states and central banks it regarded as unqualified. He also denounced Delors for setting target dates as a way (in Delors's alleged words) "of testing Germany's commitment." He warned that nobody could force the Bundesbank to act against its best judgment and its basic mandate and obligations, and he stated that convergence had to precede monetary union.

As if to make sure that nobody would miss his point, Tietmeyer pronounced the solemn rule that "a stable currency is more important than a united currency."

Maastricht

The Bundesbank's skeptical attitude did not stop the movement toward European fixed exchange rates. Nor did it put to rest the ideal of a European currency and of a European bank. If anything, it may have strengthened the conviction of other European Community governments that they needed a true European bank in order to gain greater influence over the management of European monetary policy and to reduce or at least to balance the power of the Bundesbank. Nonetheless, the Bundesbank had made it clear to all EC governments that it would block any move toward European monetary union if that move did not lead to a strong and stable currency. The Bundesbank's views, strongly supported by Finance Minister Theo Waigel, began to carry ever greater weight in European discussions.

It is clear that the Bundesbank and perhaps some of its fellow central bankers played a major role in shaping the currency provisions of the Maastricht Treaty agreed at the European summit in December of 1991. That treaty had many elements that the Bundesbank could welcome. It signalled that the move to a European currency would be conducted under conditions that assured stability, and that countries and currencies that did not accept those conditions would be kept outside the system until they were ready to play by its rules.

The treaty provided for a transitional stage to economic and monetary union to begin in January 1994, with the creation of a European Monetary Institute. The Institute was given the mandate of coordinating EC members' monetary policy, of overseeing the preparation for the transfer to the European currency, and of creating the right conditions for the final stage---a European System of Central Banks (ESCB), a single European Central Bank (ECB), and a common currency. The Institute itself was either to evolve into the European Central Bank before the final stage of

European Monetary Union (EMU), or to be dissolved when the ECB was formed.

The new ESCB and ECB were the kinds of institutions that the Bundesbank might welcome. Their mandates were to be like the Bundesbank's and the structure of the ECB itself is to resemble that of the Bundesbank. When the ECB is established, it is to set interest rates in conformity with a commitment to price stability although, without prejudice to this, it should also support the EC's economic policies and objectives such as high employment and steady sustainable growth. Its council, like the Bundesbank's, is to consist of an executive board (like the Direktorium) and the presidents of the national banks---the members of the ESCB. It is to be independent of political control, and the central banks of all European states are to be independent of such control even before the end of the first stage of EMU.

The Maastricht principals agreed that the final stage of EMU is to begin in 1997 if the European Council decides that a majority of EC members have met five criteria:³⁹

- Inflation within 1.5 per cent of the average of the three best (i.e., lowest) rates;
- Long-term interest rates within 2 per cent of the three best rates;
- A budget deficit of less than 3 per cent of GDP;
- A national debt of less than 60 per cent of GDP;
- A stable currency, as shown by conformity with the narrow band of the ERM and with no devaluations for two years before the Council's decision.

If the majority of EC members do not meet these standards, (which have come to be informally known as the EMU convergence criteria), EMU is to start in 1999 with as many members as do meet the criteria. Great Britain is authorized to leave the system. At French insistence, however, Germany must enter EMU if France is to enter.

The European government mechanism to coordinate monetary policy is to be Ecofin, a committee of national finance ministers. The ECB President is to report to the Ecofin and to the European Parliament. The Ecofin is to set the exchange rate policy for the new European currency, the Ecu or whatever it may finally be called, in consultation with the ECB. The Ecofin will also be authorized to monitor the financial and fiscal policies of EC states, especially their budget deficits, and to exercise certain sanctions if those states do not conform to the Maastricht criteria. It is a sign of the seriousness that the European states and central banks attach to the German lead that the man who has been selected to head the Brussels Committee that may lead to the organization of the Ecofin is Güenther Grosche, a long-time civil

servant member of the German Finance Ministry who has always had good relations with the Bundesbank.

The Maastricht formula represented a compromise between the monetarist and the economist camps on European integration. It pleased the monetarists by establishing a strict calendar for the transitional stages to EMU and by using monetary policy and the wish for a common currency to compel convergence upon the European economies. It pleased the economists (and thus the Bundesbank) by making EMU membership subject to the kind of criteria which would force governments and central banks to pursue similar policies even before the final stage of EMU. Most important, from the standpoint of the economists, it created a standard for membership in the EMU. Beyond all that, however, it also left some time for national currencies to coexist with the European currency even after 1999.

Although the Maastricht arrangements were designed to please the Bundesbank and to assuage German concerns, the German people reacted very negatively. Popular media showed pictures of "Germany's beloved D-Mark" vanishing into the distance or sinking into a morass, and public opinion surveys revealed genuine fear that the politicians had surrendered the cornerstone of German prosperity for the sake of Europe. The risk of giving up the stable D-Mark for some new currency managed by non-Germans became a strong popular issue.

The German government had to offer repeated assurances that it would never give up the D-Mark for another currency that was not as strong or as stable. It took some time for the German public even to entertain the notion that savings might one day be held in another currency than the D-Mark, and the public consistently made clear that it would do so only if that currency would be as strong as the D-Mark.

More important than the German popular or official reaction, however, was that of the Bundesbank. It came in the form of a statement by the Central Bank Council as well as several other assessments in the bank's monthly report.⁴⁰

The Council's statement reiterated a number of well-known Bundesbank positions. It expressed regret that monetary union was moving forward more rapidly than a "comprehensive political union," which it regarded as a prerequisite. It repeated that such a political union remained necessary if monetary union was to be effective.

The Council stressed that the German government had taken the bank's advice on a number of important points, as if to assure the worried German public. But it warned that the commitment to EMU would "make heavy demands on the stability policy of the member states and on the decisions to be taken at Community level." It also warned that the success of any decisions taken on the path

toward the envisaged economic and monetary union had to be based "solely on their stability performance," and that "the fulfillment of the entry criteria of the convergence conditions must not be impaired by any dates set."

In its accompanying material, the Bundesbank reiterated the same themes and particularly its assurances to the German public and presumably also to investors in German D-Marks. It stressed that the policy unit of the European monetary system would be the European System of Central Banks, with the European Central Bank to be subsidiary to the ESCB and thus to the Bundesbank's influence. It also stressed that the D-Mark and the European currency would coexist for some time at fixed exchange rates until all the conditions had been set for a European currency that would actually displace all national currencies. And it reiterated the importance of having the ESCB and the ECB remain completely independent from national governments.

But the Bundesbank had more on its mind in early 1992 than the Maastricht conditions for EMU. It was attempting to establish German unity as well as to prepare European unity, and was finding neither task particularly easy. It could have been expected to react guardedly to Maastricht, no matter what the conditions of the treaty might have been. But the fact that the Maastricht Treaty was signed as the bank was trying to counteract the high German government fiscal deficits and the upsurge in the German money supply made the Bundesbank both more hesitant about proceeding toward EMU and more assertive in its insistence on the proper conditions for EMU.

The very prospect of a European bank could not help but worry the Bundesbank, no matter what the criteria for EMU entry might have been. Ever since the early 1970's, the Bundesbank had effectively controlled European monetary policy. The D-Mark had been the anchor currency of the Snake and of the EMS/ERM, even if it had occasionally weakened with respect to other currencies. Because of the link between domestic and foreign monetary policy, the bank's domestic monetary policy became German foreign policy and also became European monetary policy. But the Bundesbank will lose its dominance if and when the ECB is established. It will become only one of many banks with a voice on the new council. The President of the ECB might well be a German, and the ECB might be located in Germany. But many different banks will have a voice in European monetary policy, in effect removing the Bundesbank's virtual monopoly of authority. And some of those banks, even if they were to have met the Maastricht convergence criteria, might on occasion want to pursue policies different from those of the Bundesbank.

More problematic from the Bundesbank's standpoint is the dawning recognition that those other banks, through their influence on European monetary policy, will also have a voice in German

monetary policy. For the EMU cannot function if separate European states and central banks are free to ignore any ECB policy they dislike. The Bundesbank might not only lose control over European money but perhaps control over German money as well. This could be a violation of its own basic mandate, and it would certainly be a violation of its stability doctrine if the new bank failed to pursue the right kind of policy.

The members of the Zentralbankrat face a theological issue that is reinforced by bureaucratic concerns. The latter are obvious, and painful. The creation of a European central bank would not only reduce the authority of the Bundesbank and its Zentralbankrat members as a collective, but it would virtually eliminate the powerful influence over German and European money now held by the presidents of Germany's state and regional central banks. It is little wonder that the heads of the state banks have undertaken to complicate the process of European monetary unification.

But it would be a mistake to place undue weight on this factor. For the men of the Zentralbankrat are not only bureaucrats; they are also men of deep and abiding conviction. They are not protecting their positions but are concerned about the future of Europe and---it stands to reason---of Germany. They believe firmly and unashamedly that true growth and prosperity depend on stable money above all else. The notion that a European bank council might be peopled by persons of less rigorous conviction, and that those council members might be subject to influence by the governments of separate European states, fills them with deep and genuine concern. One reason why the Bundesbank has insisted so strongly, if often in isolation, that political union should precede monetary union, is because the members of the Zentralbankrat wish to prevent having self-serving pressures for stimulus arising out of separate national political circles before election time.

The Bundesbank also became worried about the potential impact of the move toward EMU on the D-Mark's massive international reserve role. For any significant sign of weakening in the D-Mark, or any large transfer of reserve share to the Ecu, could prompt holders of the German currency to begin dumping it in amounts that the markets could not absorb. In that case the D-Mark would be weakened at a most sensitive time in the ERM-EMU process and at a time when Germany is obliged to import massively from abroad to help with unification. That kind of effective D-Mark devaluation would strike a severe blow at Bundesbank efforts to control inflation. Although objective financial observers have always questioned whether the Bundesbank's fear of potential massive D-Mark dumping was real or was merely a ploy to justify the bank's restrictive policies, some members of the Central Bank Council were reported to raise this issue periodically during the Council's meetings.

The bank responded to its multiple challenges by setting forth on a course that was designed to put the indelible imprint of the Bundesbank's philosophy and policy upon the new bank and the new currency. Or, if that was not possible, either to break up EMU or to make it so fiercely selective that only a few could finally join. Thus the bank engaged itself into a rigid, even doctrinaire, assertion of the primacy of currency stability. It proceeded to raise short-term interest rates throughout 1991 and much of 1992, before and after Maastricht. It did so with a determination that made many observers wonder whether it was reacting only to German fiscal deficits or was attempting also to let everybody in Europe understand in advance that they would be entering a very different regime from the one to which they might have become accustomed before the Bundesbank assumed control.

The Bundesbank's policies were not only directed toward Europe, however. Within a week after the Munich G-7 summit in July of 1992, and in defiance of the summit's pledge to accelerate economic growth in the G-7 countries, the bank raised its discount rate. It was signalling that it would not be persuaded by any combination of circumstances or forces to review its policies.

As German interest rates rose, other European currencies and central banks found it difficult to match German policies at home. The recession that had hit Germany spread throughout Europe, in part for cyclical reasons but also because of the forced emulation of Bundesbank policies by any states interested in joining EMU. As the recession spread, several EMU states could not support their currencies except at the cost of an ever deeper slowdown. They showed signs of weakening.

As might have been predicted, a violent ERM crisis erupted. It came in September, 1992, after several states had begun to decide that they could no longer keep up with German rates. As those central banks began to lower short-term rates, investors began to desert their currencies and speculators began to dump them. In response to desperate pleas from several European countries and from much of the German political and economic community, the Bundesbank lowered its flagship Lombard rate but only by a desultory quarter point. Within days, the Italian Lira had to be devalued and taken out of the ERM. The British Pound also came under attack in a special speculative frenzy launched by a preliminary publication of an interview in which Bundesbank President Helmut Schlesinger suggested that other currencies than the Lira were also overvalued. This triggered what the British have come to call "Black Wednesday," September 16, when the Pound crashed as the Bundesbank refused to support it. London believed the Bundesbank had wanted to force the devaluation of the Pound, and the already difficult relations between the Bundesbank and the British authorities worsened. Britain withdrew the Pound from the ERM.

The Spanish Peseta fell in September and in November, 1992, and fell again in May of 1993, but it remained within the ERM. The Portuguese Escudo and the Irish Pound also had to be devalued.⁴¹ Some currencies saved themselves by raising short-term rates to stratospheric levels during the crisis. Only the French Franc and the smaller currencies traditionally tied to the D-Mark (such as the Belgian Franc, the Dutch Guilder, or the Danish Krone) did not devalue but remained in the ERM. All other EC currencies effectively devalued against the D-Mark. The defense of the Pound cost the Bundesbank and the Banque de France tens of billions of D-Marks, on which they realized a small profit after the French currency had stabilized. More important, however, it cost the Bundesbank its reputation for objectivity, at least in London.

The Bundesbank had shown its power and its readiness to exercise that power to shape and even to dictate the policies of other central banks. It had done so not only by the long stretch of high interest rates but by the stern messages that the bank had sent forth at every opportunity. After the crisis, the bank's then Vice President Hans Tietmeyer observed that the crisis had corrected exchange rates that had been out of balance with economic realities. He also reiterated the Bundesbank's long-standing belief that a common currency should await common political structures.⁴² But the governments and central banks of several other countries could not and did not hide their displeasure at the bank's policies.

Again, as a year earlier, the bank had made clear to all observers that it would set the tone for European money. It had demonstrated its readiness to join a European system and even to yield the unique authority it had long possessed. But it had also demonstrated with equal force that it would only surrender the D-Mark and its own authority on its own terms and to a system that would be as strict as its own. It told all European governments and central banks in unmistakable terms that it wanted those non-Germans who might one day perhaps gain some voice in the management of European (and German) money to be convinced that only one policy was correct, and they were to learn that lesson from the bank itself. The Bundesbank had made clear that it was prepared to carry out the terms of Maastricht strictly and (some might say) unforgivingly.

The Bundesbank's policy might have been self-defeating. The resentment that other countries felt about the bank's domination might be counterproductive, leading them away from admiration and emulation in the opposite direction. But the issue for the Bundesbank was simple and categorical: If Europe was no longer to be dominated by the Bundesbank itself, it should at least be dominated by the Bundesbank's ideals. The Central Bank Council hoped that others would come to appreciate the value of stable money by the experience of having unstable money.

Even the most generous reading of the convergence criteria in the Maastricht treaty indicates that some countries will not qualify for EMU by 1997 and probably not even by 1999. The requirement for a national debt below 60 per cent of GDP will ban Italy, Ireland, and Greece, for decades if not forever. Others might not qualify for other reasons. At the time of the Maastricht treaty, only three countries (France, Denmark, and Luxembourg) met the convergence requirements of the treaty. Within a year, only two countries met them.

This division between the good and the bad did not disturb the leaders of the Bundesbank. Tietmeyer said after the September 1992 crisis that the bank was quite prepared to accept what he called "gestaffeltes Vorgehen," a process under which some would join before others.⁴³ The bank is also quite prepared to forego EMU or at least to postpone it if EMU would bring unqualified members into a common European currency system. And it is prepared to split the EMU, if necessary, to create at least a partial zone of European stability with those currencies that qualify.

The most likely candidates to join Germany on the fast track of that kind of two-track solution have been Austria, the Benelux countries, Denmark, and France, a sufficiently large number to form a core around which others could attempt to rally over time.

Schlesinger himself underlined the Bundesbank's insistence on full compliance with the Maastricht conditions when he told a Handelsblatt interviewer in January, 1993, after the ERM crises, that the Maastricht conditions should not be weakened but strengthened. He added that "the next several years must not be years of compromise but of persuasion," and that, just as Germany had wanted national unification only in freedom, it must want European unification only in stability.⁴⁴

It would be a mistake, however, to interpret the bank's policies as a sign that the Bundesbank opposes a European currency. A number of senior Bundesbank figures have at various times expressed their conviction that a common European currency is desirable. Such a currency would ease one of the burdens felt by the Bundesbank, for the bank must now defend stability with only its own reserves and those of its immediate friends instead of with the reserves of an entire continent. Former Central Bank Council member Leonhard Gleske once spoke with envy about the American Dollar and about how the large American domestic market helped the Dollar adjust more easily than any single European currency to global fluctuations and crises. He also observed that one of the objectives of a European currency would be to assume the leading international role that even the D-Mark could not assume, and that such a European currency could gradually replace the Dollar as a transactions and reserve currency.⁴⁵ This must be a powerful incentive for the Bundesbank, which has long distrusted American monetary and fiscal policies.

The Bundesbank, like the German government, wants a full European Monetary Union and a united European currency, whatever it may be called. But the bank wants those things on its own terms and under conditions that will guarantee stability. Given the strong German popular wish for a solid currency, the German government will not be in a position to overrule the bank on this point even in the unlikely event that it might wish to do so.

A full EMU will therefore come about only when the Bundesbank is satisfied that all European governments are fully committed to stability and when they have shown this by adhering to the convergence criteria and by passing whatever other tests the bank may yet pose. As Schlesinger and Tietmeyer have insisted on every possible occasion, the Bundesbank believes that a stable currency is more important than a common currency.

The Right Way, or none

United Germany will, one day, be an economic superpower. Germany will be the dominant economy of Europe. It will be the most important economic base between the United States in the West and Japan and China in the East. It will be, or at least it can be, the economy that leads Europe and much of the world into the 21st Century. It will help to shape the world as a whole even more than it does now.

Germany and its financial capital Frankfurt are becoming the financial centers of Europe in reality if not yet in name. In Europe, Frankfurt trades more in long-term obligations than any other financial centers, and there is every sign that this will continue. If it does, Frankfurt will continue to think in other terms than London, Paris, and other European financial centers. With German unification, the Frankfurt stock exchange will consolidate German regional exchanges and become a major European trading center.

Then, as now, the Bundesbank and its thinking will be at the center of the German system. They may be functioning as they now function, managing money for Europe and much of the world from their offices from Frankfurt. Or they may be functioning as the central element of a European central bank, with all the many complications, obligations, and opportunities that the new role will bring.

Even if the Bundesbank is succeeded by a European Central Bank as Europe's main financial institution, the ECB will have to follow German financial philosophy if it is to be accepted in Germany and thus if it is to succeed. The Bundesbank's current concerns are almost in vain, for German philosophy will continue to have the

most powerful role in European monetary matters no matter who runs the bank if the Germans are prepared to insist on it.

But the Bundesbank will make assurance doubly sure. It has set upon a course that will destroy European Monetary Union if that union becomes something different from what the bank can accept. The Bundesbank has made clear that there will be no exceptions to the Maastricht convergence criteria, and it has said it in language that suggests the subject is not negotiable. It has also made clear that instability and the collapse of value constitute too high a price to pay for European Monetary Union, whatever the principled and practical merits of EMU might be. The bank is even prepared to concede these merits, and may appreciate them. But they are secondary conditions.

Given the current economic situation in Europe and Germany, it is impossible to foresee a road to EMU on the calendar envisaged at Maastricht. The vast majority of the European Community's currencies---including even the D-Mark---do not meet the convergence criteria in 1993 and are increasingly diverging from them. It is highly unlikely that more than six or seven countries can meet them even by 1997, and it seems at least equally unlikely that many more than that could meet them by 1999. If so, the Bundesbank position is clear and unequivocal: There will be no common European currency. There might, however, be a two-track option, in which some countries join and others fall into line later when they qualify.

Out of all this comes an observation for others as well as for Europe. If there were expectations that the new European currency might be softer than the D-Mark, or that the new European bank might be more flexible than the Bundesbank, the Frankfurt Zentralbankrat wants to remove them from the field now. Under the Bundesbank, Germany has been a center of solid and stable currency. Under that same bank, parts of Europe have formed themselves into such a center of stability as well. And the new European Bank Council is already being given the catechism that it must learn if it is to take over the reins of European money.

Under that European Bank Council, wherever it may be and whoever may chair it, the doctrine of solid money will be advanced and perpetuated. That is the word from Frankfurt, and it is a word that others would be best to absorb with the same seriousness with which it is uttered.

ENDNOTES

1. The best sources of information on the Bundesbank, from which this discussion is mainly drawn, are the publications of the bank itself. They are among the most thorough of any central bank, containing not only an impressive array of statistics but many articles describing the performance of the German economy as well as specific financial issues. In the course of the articles, the Bundesbank also tells much about itself. Also see David Marsh, The Bundesbank (London: Heinemann, 1992); Ellen Kennedy, The Bundesbank (London: Chatham House, 1991), and Roland Sturm, "The Role of the Bundesbank in German Politics," West European Politics, April, 1989, pp. 1-11.
2. Kennedy, op. cit., p. 13.
3. John B. Goodman, "Monetary Politics in France, Italy, and Germany: 1973-85," Paolo Guerrieri and Pier Carlo Padoan, eds., The Political Economy of European Integration (New York: Harvester Wheatsheaf, 1989), pp. 192-193.
4. Kennedy, op. cit., p. 27.
5. For details of this discussion, see Frankfurter Allgemeine Zeitung, January 17, 1991; Süddeutsche Zeitung, January 21, 1991; and Die Zeit, February 8, 1991.
6. For a description of the new arrangements and a map of the new bank regions and the responsible bank centers, see the Bundesbank Monthly Report, August 1992, pp. 48-53 (the citation in the text is from the last page).
7. Kaufmann, "The Deutsche Mark between the Dollar and the European Monetary System," Kredit und Kapital, April 1985, p. 32.
8. Germany's fundamental views toward the European Monetary System are in Kaufmann, Germany's International Monetary Policy and the European Monetary System (New York: Brooklyn College Press, 1985), pp. 12-111.
9. The D-Mark component of the Ecu and its exchange rate with the Ecu can vary. They are currently at about 30 per cent and DM 2 per Ecu, respectively. For their history, see Haase et al., op. cit., p. 210.
10. Steinel, loc. cit., p. 445.
11. Ibid.
12. Graphs showing the decline in currency fluctuations, in inflation, in the deflators, and in long- as well as short-term interest rates of the ERM countries, as well as the growth in their

external current accounts, are in Manuel Guitian, Massimo Russo, and Giuseppe Tullio, Policy Coordination in the European Monetary System (Washington: International Monetary Fund, 1988), Occasional Paper No. 61, pp. 29-33; OECD material is in OECD, OECD Economic Outlook 46 (Paris: OECD, 1989), p. 38; BDI chart is in BDI, Wirtschafts-und-Währungsunion (Köln: BDI, 1989), pp. 16 and 28.

13. "Exchange Rate Movements within the European Monetary System," Monthly Report of the Deutsche Bundesbank, November 1989, pp. 28-36.

14. Auszüge, January 16, 1990, p. 2; for further records of the D-Mark role, including the volume of interventions in the ERM, see Guitian, Russo, and Tullio, op. cit., pp. 50-56.

15. Monthly Report of the Deutsche Bundesbank, November 1989, p.31; The precise shifts between the value of the D-Mark and other principal currencies, including several ERM currencies, since 1972, are published periodically in Auszüge under the title Entwicklung des Aussenwertes der D-Mark. Those figures reflect an increase in the D-Mark's value against all other currencies except the Swiss franc and the Japanese yen, and an increase of 23.6 per cent vis-à-vis the Ecu between the end of 1978 and the end of 1989.

16. A discussion of the complications that the EMS/ERM has presented for its members, including West Germany, can be found in Francesco Giavazzi, Stefano Micossi, and Marcus Miller, eds., The European Monetary System, the record of a conference held under the sponsorship of the Centro Interuniversitario di Studi Teoretici per la Politica Economica (STEP) and the Center for Economic Policy Research (CEPR), in October 1987 (Cambridge: Cambridge University Press, 1988). See especially pp. 5-20.

17. Kaufmann, loc. cit., p. 43.

18. Elke Thiel, "West European Economic and Monetary Integration and the Atlantic Relationship," Paper presented at the Woodrow Wilson Center for International Scholars, Washington, August 17, 1989, pp. 8-9.

19. Bundesbank, loc. cit., pp. 32-33.

20. Tommaso Padoa-Schioppa, Financial and Monetary Integration in Europe: 1990, 1992 and Beyond (New York: Group of Thirty, 1990), pp. 18-19.

21. Christian Deubner, Die Konkurrenzfähigkeit der französischen Industrie und die deutsche Europapolitik (Ebenhausen: Stiftung Wissenschaft und Politik, 1991), pp. 5-8.

22. A summary brief and comment on the Delors report is in The Economist, April 22, 1989.
23. The Independent, London, December 13, 1989, quoted in Deutsche Bundesbank, Auszüge, December 14, 1989, pp. 1-2.
24. For further information on the meetings and on the rules governing cooperation among the central bankers, see Monthly Report of the Deutsche Bundesbank, July 1990, pp. 34-37, and Auszüge, April 3, 1990, pp. 10-11.
25. The Economist, May 19, 1990, pp. 87-88.
26. Pöhl speech, December 29, 1989, reported in Auszüge, January 2, 1990, pp. 1-2.
27. Leonhard Gleske speech, November 27, 1989, reprinted in Auszüge, December 4, 1989, pp. 1-4.
28. Claus Köhler, "The Single Market in Financial and Professional Services," Auszüge, March 30, 1990, p. 2.
29. Samples of Bundesbank views are in two speeches by Pöhl, December 11, 1989, and January 16, 1990, reprinted in Auszüge, December 12, 1989, pp. 1-5, and January 16, 1990, pp. 1-6.
30. The report of the Advisory Council is reprinted by the West German Ministry of Economics as Europäische Währungsordnung: Gutachten des Wissenschaftlichen Beirats beim Bundesministerium für Wirtschaft, Studien-Reihe 61 (Bonn: Federal Ministry for Economics, 1989).
31. The Financial Times, October 16, 1990.
32. The text of the Bundesbank statement and the accompanying press and other commentary are carried in Auszüge, September 25, 1990, pp. 1-9, and in Monthly Report of the Deutsche Bundesbank, October 1990, pp. 40-44.
33. Speech presented at the IDEA 1990 Conference, London, September 27, 1990, reprinted in Auszüge, October 1, 1990, pp. 1-5.
34. These positions were expressed respectively in the Sachverständigenrat's 1990/91 Report, pp 430-437; BDI, Wirtschafts- und Währungsunion (Köln: BDI, 1989), pp. 32-33; Financial Times, November 16, 1990; Die Zeit, October 19, 1990.
35. Jacques Delors, "A new Frontier takes Shape," Europe, December 1990, pp. 25-26.
36. The Economist, March 9, 1991, pp. 43-45; Financial Times, February 27, 1991.

37. Financial Times, February 12 and March 23/24, 1991.
38. Text of speech in Auszüge. April 17, 1991, pp. 1-7.
39. The text of the Maastricht Treaty has been translated into many languages, and the information on it contained herein is drawn from the English-language version published by the European Community in 1992. A shorter version of the principal elements of the treaty was published in The Economist, October 17, 1992.
40. See Bundesbank Monthly Report, February, 1992, pp. 43-53, for the bank's official statement and supplementary comments.
41. There are countless reports on the ERM crisis in the Fall of 1992, especially in the Financial Times during the crucial weeks of September 7 through 19. A summary account of the Pound devaluation, and especially of the Anglo-German bitterness it provoked, is in the Financial Times of October 2, 1993.
42. Auszüge, October 13, 1992, pp. 1-6.
43. Auszüge, October 13, 1992, p. 4.
44. Cited in Auszüge, January 4, 1993, p. 2.
45. Auszüge, November 23, 1992, pp. 18-23.