

# Germany and the Monetary Union

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## Introduction

Currently, the European Community is experiencing a remarkable process of intensified economic and monetary integration. This process will include the realization of an economic union in which goods, services and factors of production will move freely across national borders. This transition to stage three of the European Economic and Monetary Union will no doubt be a difficult period. Much will be new and unfamiliar, both for those inside and outside the European Union. The Maastricht Treaty directs that a common European currency be instituted to replace the various currencies of individual nations. A new European Central Bank, governed by directors of member countries, will be responsible for monetary policy, phasing out the ability of national central banks to conduct independent monetary policies. Success and failure will essentially depend on how confident the European population is with regard to the new currency. Therefore, it will be important to rely on what has been tried and tested in committing the European Central Bank to pursue price stability and the granting of independence to this institution for an integrated Europe. (Onno, p. 146)

In this article I discuss Germany's role in the upcoming monetary union. I begin by providing an overview of the precursors leading to the signing of the Maastricht Treaty and outlining the three stages towards monetary union set forth in its text. Next, I present the means for the treaty's implementation and the potential benefits and consequences of its fulfillment. I then examine German support and opposition towards a single currency. I conclude by discussing the issues facing the European Monetary Union and its questionable future.

## Precursors to the Maastricht Treaty

After the devastation caused by World War II, the leaders of Europe believed it was crucial for their nations to develop strong interrelations in order to prevent a recurrence of war and to establish a market of free trade. To facilitate these goals, the European Community (EC), also known as the Common Market, was created to head the economic and political integration of Europe. This organization and its purposes were formally written into the Treaty of Rome in 1958. For the next fifteen years, only the six founding nations of the EC - Belgium, France, West Germany, Italy, Luxembourg and the Netherlands - participated in this union. In 1973, Denmark, Ireland and the United Kingdom joined the EC. Greece, Portugal, and Spain followed during the 1980s. In early 1990, the EC pledged to create a common European foreign and defense policy by the end of 1992. The reunified Germany officially joined the EC in 1991. Also, during this year the European Economic Area, a large free-trade zone, was formed to take effect at the onset of 1993. (Compton's)

In December of 1991 the member states met in Maastricht, the Netherlands, to inaugurate a plan for

European economic and monetary integration. The details of this strategy are set forth in the Maastricht Treaty, which contains a formal agreement among the member states to create a European Central Bank (ECB). The treaty defines the next stages towards accomplishing monetary union, which are intended to institute a common European currency, central bank and exchange rate mechanism (ERM) by 1999. In addition, the EC's members plan to establish a common foreign and defense policy, to provide aid for destitute EC countries and to increase the powers of the EC parliament in economic and social policies while limiting these same powers of each national state. The EC took the name European Union (EU) in November of 1993. Austria, Finland and Sweden became members of the EU in 1995, and currently several other nations have officially applied for membership into the union. (Compton's)

## **The Stages of Monetary Union**

The Maastricht Treaty outlines the three chronological stages of progression toward European monetary and economic integration. The first stage of monetary union began in mid-1990. The European Monetary System (EMS), a group of EC countries formed in 1979 to achieve monetary union, initiated this transition by eliminating all remaining capital controls and developing cooperative ties between its central banks. Increased negotiations among member states launched the formal documentation of the Maastricht Treaty, officially defining the subsequent steps towards monetary union. The first stage continued through 1993, during which the participating countries were permitted to adjust interest rates in order to exert some control over exchange rate parities. (De Graue, pp. 146-47)

In compliance with the second stage set forth in the treaty, the European Monetary Institute (EMI) was created in early 1994 to serve as the predecessor to the future European Central Bank (ECB). The EMI is intended to operate only during this phase of monetary union. Its purpose is to improve and enhance monetary collaboration among member states' central banks and to prepare the European community for the establishment of the ECB. (De Graue, p. 147)

The third stage is not expected to begin until January of 1999. At this time, the exchange rates between national currencies will become irrevocably fixed, and the ECB will begin operations and circulation of the European currency unit (ECU). This final step along the path to monetary union is contingent upon the member states meeting several convergence criteria, however. (De Graue, p. 147) The following requirements were created to affirm each nation's compatibility with the objectives of European Monetary Union (EMU) and determine whether a country may join the monetary union:

- \* In an attempt to achieve price stability among the union, the rate of inflation of a member may not exceed 1.5 percent of the average of the three lowest inflation rates in the EMS. (Oisson, p. 1)
- \* A nation's long-term interest rate must not exceed the average observed long-term interest rate of the three member nations with the lowest inflation rates by more than 2 percentage points. (Olsson, pp. 1-2)
- \* To ensure that there is economic compatibility within the states, a nation's currency is not allowed to experience a devaluation during the two years preceding the entrance into the union; also its currency may not fluctuate more than 2.5 percent above or below the ECU. (oisson, p. 2)
- \* In order to assess the relative strength of a country's economy, economic policies and monetary system, a government's budget deficit may not be greater than 3 percent of its gross domestic product (GDP).
- \* The last criterion provides another determinant for evaluating the strength of a nation's economy: a government's debt may not exceed 60 percent of the nation's GDP. (Oisson, p. 2)

When the Maastricht Treaty was signed, most member states were not in adherence with one or more of the convergence criteria. The treaty grants a time allowance to provide members several years to

improve their economic policies towards compliance. Also, the EMI was designated to advise and help coordinate nation states' monetary policies if nations so desired. The treaty provides that the European Council will decide whether a majority of members are in compliance with the various requirements prior to the end of 1996; if a majority qualify, the ECB will take over monetary policy from their respective central banks as soon as policy makers see fit. Since a majority were not expected to be ready in 1996, the members have planned for full monetary union by the beginning of 1999, as provided by the treaty. Other countries may also join at that time if they meet the convergence criteria. (Whitt, p. 19)

## **Plans for Implementation**

Within the provisions of the Maastricht Treaty there are two underlying objectives to be noted. First, it is stated that the transition to monetary union should be a gradual process in order for member states to absorb the economic and social shocks of such a progression. Second, it is not intended that all countries simultaneously join the union. The EU perceives the differences in economic capabilities across national borders and therefore recognizes that national readiness for monetary union will occur on a country-specific basis. The treaty also states that the convergence criteria are not to be interpreted as "rigid rules" but rather as guidelines which allow for leeway. (De Grauwe, P. 148) Country qualification will be decided by a majority vote of the European Council in early 1999. Regardless of country admittance, the European Central Bank and a European System of Central Banks will be established no later than July 1998. (Wise, pp. 304-305)

Currently, as set forth by the Maastricht Treaty, global efforts are in process to prepare the new European Currency Unit (ECU) for circulation. In Frankfurt the EU ministers of finance have initiated the production of new coins, bills and notes. Additionally, they are formulating a method to determine the exchange rate mechanism at the time of the ECU's introduction. Meanwhile, in Brussels a group of experts has been assigned the task of smoothing out all technical difficulties encountered by banks, stores, vending machines, automated teller machines, etc. All such functions must be completed and functional before the ECU is circulated. (Walters, p. 36)

## **The Consequences of a Single Currency**

There are numerous benefits to creating a single monetary unit for the European Union. Lower transaction costs will be experienced on all cross-border trade in Europe. No longer will businesses need to expend resources to determine exchange rate fluctuation impacts on their profits and losses for each sale conducted across national lines. Countries will be able to identify price variations more easily since all EU countries will be valuing their goods and services in the same currency. Individual travelers will benefit from a single currency as they will no longer be required to exchange currencies in order to engage in transactions while traveling across borders. Estimated savings are predicted to range from 0.3 to 0.4 percent of annual GDP, according to European Commission statistics. The Commission, a group of government economists, used the bid-ask prices in the markets to evaluate savings, most of which will result from the redirection of resources currently used for converting money values. The reduction in exchange rate costs is also expected to boost international trade, thereby further improving the social and economic welfare of Europe. (Whitt, pp. 15-16)

Monetary union also carries with it some drawbacks. First and foremost among the potential drawbacks is the loss of autonomy each country would experience with respect to monetary policy. No longer would the governments of EU countries be able to engage in monetary practices to adjust the values of their respective currencies. A central European bank would likely assume responsibility for this task. Additionally, countries would lose the exchange rate as a tool for economic stabilization. Given that only intra-community exchange rates will be discontinued, the size of the loss would depend on several

factors, including the alternative adjustment tools available to a country to stabilize its economy. Some alternative means of stabilization may be to change fiscal policy or to change wage rates or prices. (Abraham, p. 16)

## **German Support of European Integration**

Within Europe, many communities are questioning the feasibility of the economic transition set forth in the Maastricht Treaty. A drastic change of political disposition will be required by each of the members of the European Union. A common theme across borders is the unwillingness to give up national identity, especially in Germany. Many countries also believe that the stages leading toward monetary union must include additional political direction in order to facilitate the integration of such a diverse continent. (Bluth, p. 54)

A majority of countries object to the Maastricht Treaty and its strategy; yet the Germans have supported an integrated Europe since the end of the Second World War. Following the War, Germany was in need of political restoration, as it had lost its sense of patriotism due to the Hitler era. The Nazis had successfully defaced German pride and identity, so the nation refocused by pledging to restructure its form of government and its economy. (Malcolm, p. 51)

The nation's decision to revamp its economy has strengthened Germany's commitment to European integration, making it the most significant element of German foreign policy. Besides benefitting its economy, there are three additional reasons for Germany's strong support of European integration. The EU would likely have similar positive economic and political effects throughout eastern Europe. An alleviation of hostilities with France also contributed to the decision to seek European integration. Finally, many Germans believe that such a consolidation of Europe would eliminate any future rivalry concerning the domination of Europe. Without integration, German foreign policy experts believe Germany would become Europe's leader by default, thus rekindling old hostilities with its neighbors and other central European countries. (Bluth, p. 54)

## **German Apprehension towards a Single Currency**

While the majority of Germans support European integration, approximately 60 percent oppose the ECU. This split is uniquely characteristic of Germany; most countries either support or oppose both ideas. ("Super Salesman Required," p. 58) It is evident why so many Germans object to the ECU when their nation's historically impressive economy is directly tied to its D-mark. Throughout its history, western Germany has maintained a highly competitive and varied industrial base while supporting open and free international trade. It has effectively controlled inflationary problems and stabilized its economic growth. Germans fear that sacrificing their precious D-mark for the EU poses a high risk to their country's stable financial position. (Schroeder Munchmeyer Hengst & Co.)

The apprehensiveness of German citizens is recognized by German politicians who voice opposition to the EU's mission of a single currency. The German public has been disturbed by the idea ever since the early 1990s, when the idea of a Euro-currency was first introduced. Polls conducted during early 1995 have evidenced the population's continuing opposition to European Monetary Union. These surveys show that 80 percent of German college students object to the ECU. (Schroeder Munchmeyer Hengst & Co.) It was also found that more than 50 percent of all Germans believe that the use of the ECU will inevitably result in a devaluation of their savings. (Gumbel, p. A9)

With regard to the currency transition, there are a number of potential consequences for Germans that may be inferred, the foremost being the risk of market instability of the new currency. Another

consequence is the possibility of increased inflation within Germany and the rising interest rate differentials between it and other countries joining the EU. Finally, since capital markets diminish the future risks of a country's debt, the German rates on long-term obligations would most likely begin to demand premiums due to the uncertain consequences of unification. (Schroeder Munchmeyer Hengst & Co.)

German investors have become anxious while contemplating the possible repercussions of a single currency on their portfolios. Many are trying to secure their monies by investing in other countries using funds previously withdrawn from domestic securities. During the first six months of 1995, for example, Germans withdrew almost 11 billion marks (approximately \$7.73 billion) from German investments in Luxembourg. In addition, the recent inflow of German investments into Swiss-franc assets despite the lower Swiss returns illustrates the potential impact of a single currency on the European market. Currently, German bankers are at a loss for a course of action because even though they support a single currency, they cannot disregard their customers' concerns. (Gumbel, p. A9)

Whether or not an EMU is established is an issue currently affecting the capital markets and the European economy. General investors, foreign speculators and other individuals with a stake in the German economy and financial markets are requesting an immediate resolution of EMU consequences on their investments. (Schroeder Munchmeyer Hengst & Co.) Based on reports provided by the German Chamber of Industry and Trade, mid-sized businesses, a major component of the German economy, are upset with the transition to a single currency. This market segment's recent experience of absorbing eastern Germany's deficit in 1990 provides justification for its displeasure. West German financial aid for its eastern counterpart, derived from increased taxes and interest rates, totaled \$329 billion from 1991-1994. (Tagliabue, p. D7) Since prices are predicted to rise and funds are expected to flow from the wealthier to the poorer EU members, it is anticipated that Germany will have to take similar measures to aid other members of EMU. (Schroeder Munchmeyer Hengst & Co.)

Europe's existing monetary system has caused German businesses much anxiety, as an appreciating mark and currency devaluations throughout the continent have effectively depleted their export profits. Moreover, the Germans do not wish Italy to be an initiating member because of its high deficits and debt. Germany has also repeatedly warned France to reduce its deficit if it wishes to be included. Germany plans to uphold stringent monetary regulations over the rest of Europe, even after 1999. In late 1995, German Finance Minister Theo Waigel proposed a "stability pact" which, if accepted, would mandate the regulation of every nation's fiscal policy even after the onset of the EMU, and would additionally require members to achieve budget deficits even lower than those required by the current convergence criteria for admission. Germany also proposes that countries which do not "stay in line" should face sanctions or fines. (Javetski, p. 54)

Germany insists that the new EMU be made to emulate its stable D-mark, conservative monetary policy, and strong ever-growing economy. Its demands are essentially an effort to instill confidence in its citizens that the EMU will not weaken Germany's acclaimed monetary and fiscal order. This seems most vital to its political leaders, who are not convinced that they will be able to sell monetary union to their own people. All in all, it will prove difficult to persuade German voters that the idea of giving up their dependable D-mark is advantageous in the long term. (Javetski, p. 54)

## **Issues Facing EMU**

With fewer than three years remaining before the scheduled deadline for the implementation of the ECU, the European Union seems threatened by its members' respective domestic problems. Throughout Europe unemployment has averaged twice the level of the United States, and the hope of improvement

seems grim. In France and Italy tax revenues are on the decline and deficits are expanding. Economists feel that the European economies are coming into a recession and attribute this slowed growth to these nations' futile attempts at complying with the Maastricht Treaty's criteria. In an attempt to qualify for union, many governments have restricted their budget deficits, inflation rates, interest rates, and accumulated debt. Since consumer spending and investment is being restrained, European central banks are feeling pressured to accommodate more rapid economic growth. The Bundesbank in Germany seems to be the least affected to date. (Tagliabue, p. D7) As the chairman of a large Swiss bank said while attending the World Economic Forum in February of 1995, "It is like a group of political leaders want this to happen and will not listen to what the public is saying." Others at the conference agreed "that European central bankers, led by the Bundesbank of Germany, were too timid in lowering interest rates - a step that could be expected to lead to more investment and consumer demand, and ultimately to more jobs." (Nash, p. D1)

As the debate over Europe's future continues, German officials pushing towards integration have begun to concede that the proposal deadline may not work because so many countries will be unable to meet the membership criteria. This could produce several different outcomes. The January 1, 1999, deadline may not be met for issuing the new currency, thus creating a setback to the entire European integration system. On the other hand, policy makers could allow monetary union to proceed, leaving some countries out of the union and ultimately dividing Europe into two distinct segments. Finally, if no countries meet the criteria, there is a fear, especially among the German population, that the rules will be bent" and there will be widespread inflation throughout Europe. (Cowell, p. A5)

There is a concern throughout the continent that Germans will vote against European integration unless they are provided with assurance that their growing economy will not be stifled and that union members will fulfill their fiscal responsibilities to secure such a guarantee. Chancellor Helmut Kohl has frequently been quoted in alerting both Germans and Europeans in general that European integration is a "matter of war and peace in the 21st century." (Cowell, p. A10) As Kohl has stated: From bitter historical experience, we know how quickly inflation destroys confidence in the reliability of political institutions and ends up endangering democracy. It is therefore no German hysteria when, in connection with European economic and monetary union, we stress forcibly that the Maastricht criteria must be met at all costs and under no circumstances are open for discussion. (Cowell, p. A10) He additionally has warned that individual countries must submerge their sense of nation in a united continent. (Cowell, p. A10)

Germany and France, the two most integral members for a successful monetary union, have repeatedly argued over the principles and effects of the proposed European Monetary Union. The closer Europe comes to EMU, the more tension will increase between France and Germany. Many questions continue to be debated. Which economic figures will be accepted as reliable to show whether a country qualifies for participation? When should each nation's debt be issued in the new currency? When should the new currency be enforced as legal tender? And how soon will European leaders decide which nations are in compliance with the convergence criteria? (Nash, p. D7)

## **The Future of EMU**

The Maastricht Treaty has been officially ratified, and its qualifying members have pledged to embark upon monetary union no later than January 1, 1999. Even so, a feeling of uncertainty prevails regarding the timing of monetary union and the preservation of national identities. It is important that the period of uncertainty be minimized since it is likely to create turbulence in the foreign exchange markets. It is generally believed that it would be best for those countries capable of meeting the requirements to proceed with monetary union as early as possible. The treaty's allowance for early admission to the EMU by a majority in 1996 has been canceled since most countries are not in conformity with the

convergence criteria. It may happen that this uncertain period of transition will continue into the next century if none of the EU members satisfy all of the treaty's criteria for EMU by 1999. More likely to occur, though, is the initiation of only a few members into the EMU by the end of this century. Britain, Italy, Greece, Portugal, Spain and Belgium are expected to be among those EU participants left out. If this were to occur, the EMU would most likely be controlled more by the reunified Germany rather than by the EMS. In such a union Germany may be confronted with additional French hostility. (Whitt, p. 27)

In any case, it is evident that the road to monetary union will be much more difficult than was envisioned when the Maastricht Treaty was signed in 1991. Additional turmoil is likely, at least as long as it remains uncertain which countries will end up unifying their currencies and at what exchange rates. However, barring the occurrence of another such major event as German reunification in the next few years, the Maastricht Treaty's goal of monetary union by the end of the decade will be realized.

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