# Deutsche Mark Politics

## Germany in the European Monetary System

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# Preface

> Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency.
>
> —John Maynard Keynes,
> *Essays in Persuasion*

> The central banker's field of action is the ever changing stream of economic history, where every day may pose new problems requiring new solutions. He will use economic science as a commander of armies uses military science, namely as collected pieces of information and wisdom that, though often useful and sometimes indispensable, can never provide a recipe for victory. In fact, such a recipe would be a contradiction in terms, because opposing armies could use it, but only one can win. . . . In monetary policy, as on the battlefield, it is the unexpected that counts most. This treatise may thus end on a note of humility: however far monetary theory progresses, central banking is likely to remain an art.
>
> —Jörg Niehans,
> *A Theory of Money*

What justifies state intervention in monetary matters? If one believes Keynes, there appears to be some justification for the state to intervene in monetary affairs. The state is responsible for securing the stability of the currency, and thereby securing the overall stability of society. However, on further reading of Keynes, one finds that he appears to give some justification for minimizing the role of the state in monetary affairs. When the state becomes too involved or plays an overtly political role in monetary decisions, the value and stability of a nation's currency, and its societal foundations, may suffer. One need only examine the impact on German society of the hyperinflationary period during the Weimar Republic to understand this point. Yet, leaving a nation's currency to find its value in the global financial markets may not be a desirable option for some states.

From Indonesia to Mexico, allowing currency to float in the markets has produced dramatic social upheaval.

To draw a fine balance between these two interpretations, states created central banks that would supervise, regulate, and protect the value of a nation's money. However, central banks have never been immune to political pressures—whether domestic or international—and their powers, both theoretical and institutional, are not insurmountable. Indeed, monetary policy remains more an art than a science and more an instrument of state power than a neutral, apolitical, determination of central bankers. Undeniably, there exists a politics of monetary policy that necessitates a political examination of governmental authority, power, and interest centering on monetary policy. At bottom, most economic and monetary issues are political issues.

For political scientists to understand the complexities of political decisions such as those surrounding the processes of European monetary integration, or the deeply political negotiations surrounding the Group of Seven (G7) finance minister meetings, we must study the institutions, actors, and interests that influence monetary policy. Interest rates, exchange rates, and money supply targets, however technical, all have serious impacts on elections, politicians, interest groups, and the processes of international cooperation, among many other things. It was this awareness that attracted me to examine German monetary policy. Having witnessed the monumental monetary reform in Germany during the summer of 1990, there appeared to be tremendous opportunities to explore this challenging and engaging topic. Understanding deutsche mark (DM) politics—the politics of German monetary policy—became the central objective of this study.

The decision to examine deutsche mark politics returned me to some personal roots as well. My father owned a small assembly plant that imported goods and parts from a moderate-sized German electronics and lighting firm during the 1970s and early 1980s. I worked closely with him during my high school and early college years, gaining an appreciation for running an internationally minded business. In particular, I was fascinated that we could gain or lose a large amount of money based on the current value of the U.S. dollar to the DM. The cost of items that we would import from Germany fluctuated wildly during this period (the era of benign neglect, double-digit inflation rates, interest rates at or around 20 percent, Paul Volcker, and so on). I scanned the currency quotations in the newspapers daily to gain some further understanding, often in vain, of the phenomenon. Not only would the currency fluctuations affect our planning and our competitiveness here in the United States, but we would also play the currency odds, hoping to land a more favorable exchange rate, perhaps waiting an extra week to pay our German account. I never knew then what forces were exerting pressure on the DM. *Deutsche Mark Politics* is my attempt to develop a comprehensive account of such forces.

Nowhere is the politics of monetary policy more pronounced than in Germany. The DM has become a powerful symbol for the German nation; Germans are proud of their economic wealth and economic and political stability, and it is the DM that is the source and focus of this respect. The DM has also gained the admiration of other nations, though at the same time Germany's political and economic partners often negatively perceive Germany's ability to translate political power demands into more respectable avenues of economic discourse and monetary diplomacy. This ambivalence poses unique difficulties for Germany's monetary authorities, and understanding how Germany attempts to resolve them is one important part of the story that is deutsche mark politics.

Given these themes, the overarching question guiding this study is, Why was Germany prepared to sacrifice the DM for European Monetary Union (EMU)? Seeking an answer, I propose that what is needed is an analysis both of the institutional relationship between the Bundesbank and the federal government and of Germany's bargaining strategies toward European and global monetary governance structures. Thus, *Deutsche Mark Politics* examines the powerful integrating forces of the interdependent international political economy on the one hand, and the almost heroic attempt by political-economic actors within Germany to retain some measure of domestic sovereignty and autonomy on the other. Although the book does at times focus on the minutiae of monetary and exchange rate policy, deutsche mark politics is translated for the most part into the language of foreign policy and monetary diplomacy.

The organization of the book reflects both practical and theoretical purposes. The first two chapters set forth the analytical and theoretical foundations for the empirical analysis to follow. Chapter 1 develops a basic model of deutsche mark politics and a theoretical model of bargaining. Chapter 2 examines the relationship between the Bundesbank and the federal government in the constant tug-of-war over the direction of and influence over deutsche mark politics; special attention is given to the concept of central bank independence and its relationship to monetary policy credibility.

The next five chapters proceed chronologically, addressing the substantive issues of deutsche mark politics. Chapter 3 examines the level of interest rate and exchange rate coordination and intervention pursued by the Germans with the Europeans and by the G7 with the United States between 1985 and 1987. Chapter 4 examines the period 1989–1991, an extremely active stage of German monetary policy best characterized as the export of the DM to Europe (as codified in the Maastricht Treaty of December 1991) and the protection of the DM from the benign dollar neglect of the U.S. administration. Chapter 5 demonstrates the limitations to policy accommodation and cooperation illustrated by the dramatic turmoil within the EMS during 1992 and 1993 and the divergent G7 views on addressing a global recession.

Chapter 6 analyzes the period 1994–1995, notable for the dissolution of G7 consensus and monetary coordination and for the dramatic U.S. dollar volatility brought on by the Mexican peso crisis and renewed dollar neglect; on the European front, the future of EMU remained on unstable footing. Chapter 7 covers 1996–1998, illuminating the critical variables of negotiation heading toward the final stages of EMU, as well as possible changes in G7 summitry. As the DM proceeded toward its fiftieth anniversary in 1998, the Bundesbank undertook one "last stand" against a gold revaluation scheme proposed by the government.

Finally, in Chapter 8, which summarizes and evaluates the primary theoretical and analytical arguments set forth in the book, I also evaluate the lessons of deutsche mark politics for international and European monetary governance.

Because the cases studied here were not chosen randomly, and because they are so atypical of normal monetary policy and monetary diplomacy, some researchers may contend that the arguments and predictions I put forth are not at all plausible or generalizable to other cases or countries. In response, I argue that case studies and a chronological approach, demonstrating the larger political, economic, and historical forces at work in the arena of deutsche mark politics, offer the detail and richness that pure econometric modeling cannot provide.

It will always be a problem in analyses such as these that the conclusions one draws from the lessons of the past may turn out to be irrelevant to today's world or tomorrow's. Given this concern, the time frame for my analysis (1985–1998) was chosen to cover periods before, during, and after reunification so as to more fully illustrate the changing conceptions, pressures, and interests of deutsche mark politics and whether these changes have had any significant impact on policy. This time frame also highlights, as I argue, the final breakdown of the post–Bretton Woods consensus on exchange rate management and the emergence of the German monetary norm of international monetary cooperation. More significant, the time period captures the Europeanization of German monetary policy. Upset with the continued international monetary instability generated by the United States, the Germans focused on developing a coordinated "European" response to influence international monetary governance. This response would manifest itself in the drive toward EMU and the ultimate decision to sacrifice the DM.

In the course of reconstructing the constellation of factors surrounding each case study and especially in evaluating the relationship between the Bundesbank and government and the emphasis they each place on domestic, regional, and international monetary policy, I interviewed more than forty of those elite state actors most involved in the kinds of monetary negotiation, bargaining, and decisionmaking investigated here. The interviews were conducted in an unstructured format in both English and German. Anonymity was given to those interviewed in order to encourage discussion and frankness. Although reliability remains a problem with any anonymous interview, the intent was not to pinpoint specific positions or catch an official slip-up, but rather to elicit open reflections on the role of the Bundesbank and the government in international monetary negotiations, the interaction of these two actors, and the interviewees' individual recollections and opinions of some significant monetary negotiations and issues. The official positions of the Bundesbank and government are readily available from other source material and published interviews in the press (see, for example, the excellent summaries in *Auszüge aus Presseartikeln,* published by the Bundesbank, or visit their Web site at www.bundesbank.de).

* * *

Among the faculty in the Department of Political Science at the University of California, Santa Barbara, I would like especially to acknowledge the support, guidance, and criticism of the late Wolfram Hanrieder—"Doktor Vater," critic, teacher, and friend. His influence on my intellectual and professional development is greater than perhaps he ever realized. His approach to the study of international relations will be sorely missed in the discipline. I thank Benjamin J. Cohen, whose commitment to detail and style enhanced not only my knowledge of monetary affairs but also my writing style, for his extraordinary time and effort in bringing this study to fruition. I am grateful to Peter Merkl for his guidance on all things relating to German politics, as well as his help in securing funding for my various research trips to Germany. I would also like to express appreciation for the encouragement and guidance of John T. Woolley and Stephen Weatherford during earlier stages of this manuscript. As for the editors at Lynne Rienner, especially Bridget Julian, their support and help in finalizing this project, were invaluable.

There are several universities, programs, and institutions that also deserve special acknowledgment. I greatly appreciate the generous institutional and staff support of the University of California, Santa Barbara, and West Chester University. I am particularly indebted to the Center for German and European Studies at the University of California, Berkeley, and the Institute on Global Conflict and Cooperation at the University of California, San Diego; without their support I could not have spent a year of study in Germany. I would also like to acknowledge Helga Haftendorn at the Free University of Berlin for welcoming me into her research seminars; Hans-Eckart Scharrer at the Hamburger Welt und Wirtschaft Archiv for taking the time to discuss my project in its initial stages; and the staff of the German Academic Exchange Service (DAAD) for their fellowship during a crucial period in the development of the project. Particular mention and thanks go to the employees and officials of the Bundesbank, all of whom made me feel welcome and maintained an open door and open mind during our discussions. The concrete facade on the outside masks the character of this truly unique institution.

Finally, this book is dedicated to my parents, William and Ingeborg, for their unceasing support; to my family in Germany, who repeatedly opened their doors for my visits; to my wife, Belinda, for her patience; and to my children, Christian and Katarina, for their motivation.

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# 1

# The Political Economy of Deutsche Mark Politics

> Fundamentally, the Bundesbank can only use the instruments of monetary policy in an overall way, with a view to doing justice to the needs of the economy as a whole. A differentiation between individual groups of the economy is a matter for general political decisions and belongs to the tasks of the government and parliament. The Bundesbank would exceed its sphere of responsibility were it to take part in this political activity.
>
> —Helmut Schlesinger, former Bundesbank president, quoted in *Monetary Policy and Economic Developments in West Germany*

## Part 1: A Political History of Deutsche Mark Politics

During the carnival celebrations in 1992, one of the floats that passed by the onlookers provided a biting commentary to the recently completed negotiations on European Monetary Union (EMU). The float consisted of a large milk cow labeled "EG" feasting on a basket of German deutsche marks (DMs).[1] The audience could only speculate as to what the cow might manufacture from these DMs—namely, worthless European currency units (ECUs).[2] The people watching the parade laughed apprehensively. The Maastricht Treaty's stipulations that Germans might have to relinquish their treasured DM to the management of a potentially inflationary-prone European Central Bank (ECB) caused some uneasiness that day, as it still does today, among the German public. With the ECU, or euro, coming into circulation, Germans can no longer poke fun at the image of a feasting cow, for they are now an intricate part of it. The DM, as a symbol of the nation, would soon cease to exist.

Similar monetary images have often framed the political debate in Germany. The image of thousands of East Germans streaming across the border shortly after the Berlin Wall was pulled down in November 1989 and seeking their DM 100 visitation money revealed the inherent dangers to some German politicians, especially Chancellor Helmut Kohl, that a gradualist approach to reunification might hold. Shortly thereafter, tens of thousands of East Germans lined up at midnight on July 1, 1990, in front of hastily erected Deutsche Bank branches waiting impatiently for newly printed DMs. German Economic and Monetary Union (GEMU) undoubtedly generated inflationary nightmares for the Bundesbank and left budget gaps for the finance ministry. More recently, Chancellor Kohl's attempt to revalue gold reserves in order to achieve budgetary targets aimed at EMU also struck a forceful resistant chord among the German public, to say nothing of the Bundesbank. Under a wither of criticism and domestic political backlash, the Kohl government had to back down.

As these examples illustrate, Germany's engrossment with the DM (some would contend an obsession) is linked directly to Germany's foreign policy. Monetary policy is foreign policy to the Germans. The DM has become an instrument of wielding Germany's influence in European and global affairs, as the strength of the DM has become synonymous with the strength of the German state. For example, following the Black Wednesday European currency crisis of September 1992, some German newspapers proudly carried banner headlines such as "Starke Mark: Was jetzt alles billiger wird," translated roughly as "The Strong mark: Everything That Is Now Cheaper." Others commentated on the desirability of the Italian and British exit from the European Monetary System (EMS). Although perhaps not representative of elite German opinion, these instances struck a powerful chord with the general public's long-held concerns, fears, hopes, and pride, all centered on the revered DM. The DM had become a symbol of pride for the German people, both at home and abroad.

This characterization of the DM illustrates what I label deutsche mark politics; the role that money plays in society, the value of the currency, as well as the government's external monetary diplomacy, are all highly political and volatile issues in Germany. As part of the German national subconscious, monetary policy retains a prominent and consequential role in the political economy of Germany.[3] In fact, the writing of German history can be punctuated by monetary affairs. The social and political consequences, to say nothing of the financial and economic ruin, of the hyperinflationary period in 1923, for example, led to the undermining of the Weimar government's credibility and legitimacy, exacerbating the attacks of extremist movements on the left and right.[4] Following World War II, the historic currency reform of June 20, 1948, launched the German Wirtschaftswunder (Economic Miracle) that helped lay the foundations for the globally admired economic and political ascent of the Federal Republic of Germany (FRG) and its internal social stability and economic dynamism.

GEMU would also mark a new era in German politics, as will EMU when the euro replaces the DM in the year 2002.

These highly visible periods in German political and economic history illustrate the political nature of monetary policy and its importance as a fundamental socioeconomic and political foundation or pillar of the FRG. In fact, as these examples show, the stability and, in extreme cases, the very existence of the democratic order itself may depend on politically sensitive monetary decisions.[5] Hans Herbert von Arnim sets forth a theory of democracy that posits the primary importance of central bank independence to the stability and democratic order of the German political system. In other words, the Bundesbank has become the guarantor of German democracy by acting as a guide and protecting the German government from an irresponsible policy that could destabilize the democratic order. Arguably, then, monetary stability and social stability are one and the same. It is the confidence of the people in the large German middle class (to say nothing of the upper class) in the money they have earned after years of hard work that provides the building blocks of German democracy. German monetary policy should, therefore, be examined for the political and social character it represents rather than in strictly economic terms. This study thus incorporates both political and economic factors that shape deutsche mark politics.

To examine deutsche mark politics is to examine the quasi-independent Bundesbank, which commands a towering and lofty position within the political economy of Germany. For many Germans from all socioeconomic strata, the Bundesbank guarantees the soundness, stability, and foundations not only of the currency but also of the democratic and stable political order. Without a sound and stable DM, society could easily be buffeted by undemocratic forces bent on subverting the established political-economic order of which the Germans are so proud. The Germans learned their bitter lesson about defacing and devaluing a nation's currency and entrusted to the Bundesbank the task of defending the stability of the currency.

However, there are many Germans who strongly believe that a proper arranging of society and the political economic order also require an accountable, democratic, pluralistic, and representative federal republic—the concept of the *Rechtsstaat*. Political power and the decisions exercised by government authorities, including those decisions surrounding a nation's monetary policies, come from the consent of the people. This consent is granted through free, competitive, and democratic elections. In addition, the government must obtain the ongoing consent and legitimacy from the people and must be responsive to the people's will as expressed by a majority of its citizens. Hence, politically and socially sensitive monetary questions, such as those surrounding GEMU in 1990 or the decision to proceed with EMU, are decided by the people's representatives in the federal government. Only these sovereign elected officials, the chancellor and leaders in the finance and economics ministries, for example, can ultimately resolve the conflicting requirements and clashing demands that would surround such momentous monetary decisions. Those who would like to see the independence of central banks diminished can accurately point out how inflation is not merely a simple technical issue but a deeply political one. One can further argue that it is wrong that the unelected can overturn the desire of elected officials, as with Chancellor Helmut Kohl's desire to see European unity as a German overriding foreign policy goal undercut by Bundesbank policy. Finally, an independent central bank does not, in and of itself, guarantee price stability. In politics, nothing is guaranteed. Examining the role of the Bundesbank's relationship to the government is the first step in developing an analytical framework for understanding deutsche mark politics.

Not only does there exist a national struggle for monetary control between the Bundesbank and the government over the direction of Germany's monetary policy, but there also exists the pressures, demands, and forces that are foisted upon national actors by the international political economy. A well-functioning international monetary system is the crucial nexus of the international economy. Moreover, the international monetary system, with the norms, rules, and conventions that govern it, have important distributive effects upon the power of nations and on the welfare of groups within those states. As a result, the international monetary system cannot be a neutral mechanism, for every nation will seek to influence the system to meet its own objectives of national policy. And, as I argue, these objectives of national policy may at times differ between the two primary German monetary actors in the international monetary system: the Bundesbank and the federal government. Each actor tries to carve out its own policies that will accommodate its primary goals, objectives, or interests. These interests may converge, but they may also diverge.

Central to this international process is the issue of system governance. Governing the international or European monetary system entails four primary tasks: enforcement, provision of a system of arbitration, regulation and supervision, and macroeconomic stabilization. We take these tasks for granted at the domestic level, but we cannot take these for granted at the international level. Nonetheless, a system of governance within both the international and European monetary system has emerged in the form of monetary regimes. Whether within the more formally institutionalized forum and rules of the Bretton Woods fixed exchange rate system from 1944 to 1973, within the EMS since 1979, or within the more pluralistic and less supranational forum of the floating exchange rate system governed by the Group of 7 (G7) along with the International Monetary Fund

(IMF) (1975 to the present), these regimes have reduced monetary conflict, uncertainty, and have added a measure of stability and predictability to the system. To some degree, they have even facilitated cooperation among member nations. Such governance mechanisms, of course, are not without controversy, but they do provide the focus for external exchange rate management among the leading industrial nations.

Germany's influence over the process of international monetary governance and monetary cooperation is significant. One of this book's primary objectives is to trace Germany's influence, specifically the pattern of German-G7 monetary interaction and the German-EMS partnership within the framework of monetary governance. My preliminary proposition contends that German insistence upon strict anti-inflationary policies at home and minimal monetary and exchange rate coordination abroad has increasingly become the standard norm and guiding principle for international and regional monetary governance since the early 1980s. More important, German monetary authorities have carefully and skillfully nudged just such a standard onto the international and European monetary system. Indeed, the Germanization of the international and European monetary system has taken place.

This chapter proposes a model that places German state monetary authorities at the center of an analytical framework that underscores the tripartite (domestic, regional-European, and international-G7) dimension of German monetary policy. While emphasizing the importance of domestic political institutions and state actors in German monetary policy (the Bundesbank, the chancellor, and the finance ministry), this framework integrates the regional-European and international sources of influence upon German monetary policy within a theoretical model of negotiating. I argue that during the negotiating process, German monetary authorities will alter their bargaining strategies depending upon the regional-European or international level of the bargaining environment, resulting in differing configurations of cooperation and conflict. These varying strategies in negotiations with European and G7 counterparts depend on two critical factors: (1) the governance structures within which German monetary authorities bargain, specifically the particular formal institutional position and relationship of the Bundesbank to the federal government within European and G7 governance structures; and, (2) the dynamic political tension between the Bundesbank and government over the direction and control of German monetary policy.

## *A Model of Deutsche Mark Politics*

We need to commence our investigation by identifying who or what is acting, making policy, and implementing German monetary policy—in other words, the strategic actors. A solid analytical and theoretical base must then be developed not only for understanding the domestic sources for examining monetary policy but also for investigating how the state balances internal-domestic demands with the pressures the state faces in the international policy arena.

With these caveats in mind, analyzing German monetary policy can best be achieved by an institutional-statist approach. This approach implies that our analysis will focus on the domestic-institutional structure of Germany's political economy and the central role that state actors—the Bundesbank and the federal government (chancellor's office and finance ministry[6])—perform in defining both the internal and external dimensions of German monetary policy. The Bundesbank and government are the "units of analysis," or decisionmaking state. The decisionmaking state is therefore defined as the central governmental actors (for example, Chancellor Helmut Kohl or former Bundesbank president Karl Otto Pöhl) and the institutions (the Bundesbank and government) in which they reside.[7] This definition of the state and its strategic actors allows analysis of who is actually negotiating on behalf of the state and crossing the contested boundary between state and society. Negotiating the proper path between the Scylla of the international monetary system and the Charybdis of the domestic political-economic system remains the overriding goal of the Bundesbank and government.

The focus on the decisionmaking state has theoretical implications as well. Scholars have argued persuasively that large theoretical gains can be made in understanding efforts at international cooperation, or the lack thereof, through the use of domestic-level theories of state behavior.[8] In contrast, I argue that system-level explanations of monetary policy fail to adequately capture the intricacy of state bargaining, where the bargainers and the ratifiers (the Bundesbank and government) to a particular international agreement interact and compete with one another, as is the case in Germany.[9] Each strategic actor, the Bundesbank and the government, often has differing objectives and alternative strategies of achieving those objectives. Such a complex process of policymaking certainly muddles the process of defining any straightforward conception of the national interest. In addition, approaches to international relations emphasizing structural realism are also unable to rigorously conceptualize the interactions among institutional actors such as the Bundesbank and government.[10] Structural realism fails to explain differing bargaining strategies and policies between nation-states, for example Germany and Great Britain, comparably located within the "structure" of economic power. In short, system-level studies do not satisfactorily account for decisions made within monetary policy where domestic interests and institutions play such a decisive role in determining the final outcome of any policy decision. In analyzing German