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**The German Unification and the  
Crisis of the EMS:**

An economic historical analysis of the events  
that changed Europe in the early 1990s.

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## Abstract

La fine della guerra fredda in Europa molto spesso viene associata con la cosiddetta rivoluzione pacifica avvenuta in Germania tra l'ottobre e il novembre 1989. Il 3 ottobre 1990 veniva proclamata la nuova Germania ossia la riunificazione della Repubblica Federale Tedesca con la Repubblica Democratica Tedesca. Da allora si sono impiegate diverse politiche e iniziative di vario genere con lo scopo di rendere omogenee le due aree. Tuttavia ancora oggi si riscontrano problemi legati a due diverse economie, ad ovest e ad est, le quali derivano direttamente dalla separazione storica della Germania. Gli strumenti e le politiche utilizzate dall'anno 1990 al 1994 circa sono stati fondamentali per l'evoluzione dello stato tedesco come lo si conosce oggi.

Nello stesso periodo in cui si dava inizio alla riunificazione della Germania, l'integrazione a livello europeo assumeva una connotazione più specifica e una velocità più sostenuta. Già dal 1954 alcuni paesi europei avevano iniziato a collaborare e mettere insieme le proprie forze e risorse per superare la crisi del secondo dopoguerra. Un esempio di tale collaborazione è riscontrabile nelle politiche economiche e monetarie. Quello che più interessa per lo scopo di questo lavoro è il sistema monetario europeo (SME) in relazione al momento storico precedentemente accennato, la riunificazione della Germania.

L'Europa è oggi una delle entità politiche più importanti e potenti al mondo e riunisce in sé non solo diverse storie e culture ma diverse economie e velocità. Nata per promuovere la cooperazione tra stati a livello economico e sociale, oggi l'Europa è diventata un capro espiatorio a causa della crisi persistente nell'area. Alcuni commentatori, infatti, individuarono nella Germania, soprattutto per le politiche economiche adottate dalle istituzioni vigenti, uno degli attori le cui scelte hanno portato alla stagnazione per diversi paesi europei, in particolare quelli situati a sud.

Le tematiche della Riunificazione tedesca avvenuta nei primi anni novanta e della crisi che sta dividendo l'UE oggi possono sembrare disgiunte ma in realtà si possono individuare alcune relazioni comuni di causa ed effetto. Questo lavoro intende, innanzitutto, analizzare e scoprire le dinamiche che sono state alla base della

riunificazione della Germania, dal punto di vista storico economico. In più, ci si prefigge di capire come tale episodio storico abbia influito in un più largo contesto, quello europeo. Per fare ciò, si è preso in considerazione lo SME e la crisi dello SME tra il 1992 e il 1993. Si, a tal proposito, affermato che l'unificazione tedesca ha avuto una grande influenza nella crisi dello SME, se non addirittura che ne ha rappresentato la causa principale. Obiettivo primario è in che misura questa ipotesi si può ritenere corretta o se, invece, possono esistere eventuali altre ragioni della crisi dell'integrazione europea.

La curiosità per approfondire questo tema nasce durante il percorso di studi da me intrapresi e dalla percezione che il problema delle due velocità a livello economico in Germania sia ancora attuale. E' possibile altresì notare che l'UE ha stabilito un rapporto particolare con lo Stato tedesco oggi: la politica restrittiva applicata all'eurozona da parte della Banca Centrale Europea segue infatti l'esempio di quella della Bundesbank. Questo lavoro si prefigge anche di risalire alle origini di questa collaborazione o almeno di capire perché la Bundesbank e lo stato tedesco possano avere così tanta influenza sulle politiche economiche e monetarie in Europa.

Per raggiungere tale obiettivo, in questo lavoro si è in primo luogo ricostruita la linea cronologica degli eventi. Si è voluto iniziare prendendo in considerazione il background storico alla soglia della riunificazione e la fine della guerra fredda. In particolare, si è sottolineato come le politiche e le intenzioni contrastanti delle varie parti di alleati alla fine della seconda guerra mondiale portarono alla separazione dello Stato tedesco per 40 anni. Nella Repubblica Federale di Germania vennero create le istituzioni e promosse le politiche caratteristiche del libero mercato e libera concorrenza, anche se in principio erano state molto limitate dalle potenze alleate. Dall'altro canto, nella Repubblica Democratica di Germania l'Unione Sovietica decise di favorire le proprie politiche economiche socialiste, facendo diventare la Germania Est il primo partner commerciale dell'USSR in prodotti industriali tecnologici e avanzati. Non mancarono i tentativi di riconciliazione, ma a causa delle divisioni a livello internazionale tali tentativi furono vani o andarono a incrementare la separazione.

Nonostante ciò, verso la fine degli anni ottanta una nuova corrente pacifica si era sviluppata non solo tra la popolazione europea ma anche a livello internazionale. L'ascesa di Gorbachev in Unione Sovietica può essere considerata una dimostrazione di questo mutamento, che culminò con la caduta del muro di Berlino il 9 novembre 1989. Da quel momento, le sorti dell'area tedesca non potevano più essere le stesse di prima. Il cancelliere della Germania ovest, Kohl, fu uno dei più attivi fautori della riunificazione, soprattutto tramite la sua campagna elettorale nell'est a sostegno del suo partito nella vecchia Repubblica Democratica. Un problema cruciale a cui Kohl e tutte le altre autorità tedesche dovevano far fronte era la migrazione di massa dall'est all'ovest. Centinaia di rifugiati avevano attraversato il muro, o ci avevano provato, durante i 40 anni di separazione. Ma con la caduta del muro il problema non sembrava essere del tutto risolto.

Anche per questo motivo, le autorità politiche e parte di quelle economiche tedesche premevano per una unificazione monetaria da avviarsi nel più breve tempo possibile. Una delle più importanti difficoltà fu lo sviluppo e la realizzazione dell'unione monetaria. Il marco dell'est, Ostmark, fu ritirato e al suo posto viene consentito l'accesso al Deutschemark, il marco dell'ovest. Molti furono i dibattiti tra politici ed economisti per quanto riguardava il cambio. Da notare è la posizione della Banca Centrale di Germania, Bundesbank, contraria al cambio 1:1 sostenuto da Kohl e dalla maggior parte delle autorità tedesche. Secondo questi ultimi, infatti, un cambio favorevole all'est avrebbe abbassato la probabilità di migrazioni verso ovest e avrebbe dato la possibilità ai tedeschi dell'est di iniziare un nuovo percorso nella nuova Germania. Al contrario, la Bundesbank sosteneva il cambio 2:1, che avrebbe permesso di mantenere sotto controllo il livello di inflazione e la stabilità monetaria interna. I conflitti tra il governo tedesco e la banca centrale non furono in realtà poche, non solo alla soglia dell'unificazione ma anche negli anni precedenti e seguenti. Particolarmente importante per l'unione monetaria fu il trattato che stabiliva l'unione monetaria ed economica o GEMSU. Pertanto, venne preferito il cambio 1:1 sostenuto da Kohl per poter raggiungere non solo i suoi scopi elettorali ma anche per dare più respiro in campo sociale ai cittadini dell'est.

Tuttavia, le difficoltà per le autorità non riguardavano solo la moneta. Grossi problemi si riscontravano in diversi altri ambiti, dai diritti di proprietà, ai debiti accumulati dalla Germania Est, ai trattati commerciali con l'est, alle politiche sanitarie e di welfare. Questo ambito venne coperto da un ulteriore trattato, il trattato sulla riunificazione. Venne adottato il metodo di unificazione tramite l'articolo 23 della Legge Fondamentale della Repubblica Federale, per cui la Repubblica Democratica cessava di esistere e al suo posto vennero istituite 5 regioni o Bundesländer, le quali, a loro volta, vennero inglobate nella RFG. Questa metodologia venne applicata a tutti i campi di cui si accennava sopra. Ad esempio, i regolamenti riguardanti i sussidi e, in generale, il welfare nell'est venivano armonizzati ed adattati a quelli dell'ovest.

Un'attività particolarmente controversa fu quella della Treuhandanstalt, un'agenzia istituita nella 'vecchia' Germania est per prendersi cura delle proprietà immobiliari e industriali e della loro riqualificazione e vendita. La Treuhand si rivelò un trust poco elastico e dispendioso per le finanze pubbliche ma soprattutto viene ricordato ancora oggi come motivo di risentimento per i cittadini dell'est.

Dal punto di vista di questo lavoro, il ruolo più interessante fu quello della Bundesbank. Come è stato detto, non furono pochi i punti di conflitto tra le autorità politiche tedesche e il consiglio direttivo della banca centrale tedesca. Ma la Bundesbank ha avuto un ruolo fondamentale nella creazione dell'Europa di oggi. La sua caratteristica principale è il possesso di un elevato grado di autonomia, fatto che le consente di entrare in contrasto con le autorità politiche. Spesso questa sua caratteristica non viene compresa a pieno a livello internazionale, dato che le altre banche centrali sono generalmente più legate al potere politico e di governo. La sua indipendenza fu essenziale durante la crisi dello SME. Molti indizi infatti indicano che la ragione della crisi è da ricercare nelle politiche restrittive della banca centrale tedesca. Il Sistema Monetario Europeo prevedeva tassi di cambio fissi ma aggiustabili tra le monete dei Paesi membri, ed era uno strumento introdotto e sostenuto dalla Germania stessa in collaborazione con la Francia per poter raggiungere un maggior livello di stabilità nei paesi che volevano farne parte. Nei primi anni '70 era stato tentato il sistema del 'serpente' o *snake*, che tuttavia, non era riuscito nel suo scopo

a causa di squilibri monetari, soprattutto provenienti dagli Stati Uniti d'America. L'idea dello SME nacque alla conferenza di Brema nel luglio 1978 per poter portare l'integrazione europea a un livello superiore e per mantenere sotto controllo i livelli di inflazione, cambio e tassi di interesse su scala internazionale. Lo SME venne istituito nel Marzo 1979 e dopo pochi mesi si riscontrarono i primi scompensi, quando i primi riallineamenti divennero necessari. Tra il 1979 e il 1987 undici riallineamenti furono posti in atto, fino a quando il trattato di Basel-Nyborg contribuì al riequilibrio e alla stabilità tra i paesi membri. Di determinante importanza è capire che il sistema veniva anche sostenuto dalla moneta più forte tra i paesi partecipanti. Questa moneta era il DM e la banca centrale che ne regolava la politica monetaria era la Bundesbank.

Durante i primi anni novanta, il governo tedesco e la sua banca centrale stavano sopportando il peso dell'intervento finanziario verso l'est, con lo scopo di normalizzare la situazione economica e sociale. Per la Bundesbank tale spesa pubblica fu motivo di tensione a causa di un'impennata dell'inflazione. Come si è detto lo scopo principale della Banca Centrale tedesca era quello di assicurare un basso grado di inflazione e stabilità interna. Le spese per la riunificazione provocarono un'impennata del tasso di inflazione e quindi l'intervento della Bundesbank sui tassi di interesse. Poiché il marco era la moneta forte all'interno del sistema, la politica tedesca doveva essere seguita anche dagli altri paesi partecipanti, se non volevano rimetterci in competitività e quindi termini di bilancia commerciale e di crescita. Si può immaginare il motivo della criticità della situazione tra il 1992 e il 1993 quando lo SME venne messo sotto attacco da speculazioni e la sua stabilità non poté più essere garantita a livello generale.

Nello stesso periodo il trattato di Maastricht per una piena integrazione economica a livello europeo stava prendendo forma. Tuttavia, al momento della ratifica, i cittadini Danesi si espressero negativamente e ciò creò aspettative negative per gli speculatori europei. Lo stesso destino si temeva per la Francia, che era chiamata ad esprimersi al riguardo qualche mese dopo. Tali pressioni si allargarono a tutti i paesi membri portando con sé un ulteriore motivo di squilibrio in Europa.

Questo lavoro dimostra che la crisi del sistema monetario europeo non fu solamente causata dallo squilibrio apportato in Europa dalla riunificazione della Germania. Al contrario, fu un concorso di molteplici eventi e aspettative che nello stesso lasso di tempo minarono la fiducia in una Europa più unita.

## Introduction

Since the recent economic crisis spread in the Eurozone, it has been said by the media and politicians that one of the most economically powerful countries in Europe was Germany. Moreover, it has also been hinted that the German economic area was not affected by the crisis as some other parts of Europe, for instance Italy, Greece, Spain or Portugal. Today, the media are claiming that Europe is divided into two different areas, on the one hand the north, which is included Germany and other strong economic countries like Sweden or Denmark. On the other hand, there are the southern countries like Greece, that has recently experienced financial and economic difficulties, Cyprus, which was also affected by a grave financial crisis, Italy, Spain, etc..

Personally speaking, two years ago, in 2012, I have spent some months in Germany, near Frankfurt, in the beating heart of the EU Central Bank. Thanks to the Erasmus experience, I could begin to understand the perspective of the German population, their worries and points of view towards not only EU or international arena, but also towards internal problems.

In particular, my interest in the German Unification originated from the perception of the economic and social problems that still torn today's Germany at the political level. Specifically, the German Unification did represent a crucial point of change in the world and German history itself, but its repercussions are continuing to be felt in the East and the West. Moreover, German politicians are finding it difficult to manage the situation resulting from the Unification process in the most appropriate manner even today in certain cases.

In addition, thanks to my master studies, I could understand the importance of economic interrelations not only at a global level but also within a smaller area, such as European one. Therefore, my attention and interest was attracted by the developments and the implementation of the European integration from the late 1980s and the peculiar connection that the European authorities seemed to have established with the German country.

Because of the recent crisis, in which the European Union was claimed to have fallen, I decided then to analyse and understand the economic and historical features that characterised our recent history. Specifically I wished to find the answers, or at least some answers, to the following questions:

- Germany underwent a political and physical division for 40 years: why is Germany regarded as the most economic-powerful country in EU today?
- Moreover, how could Germany implement such massive economic and political changes in the East?
- What were the economic strategies of the German authorities to overcome the difficulties that might have arisen from the Unification process?
- Why is Europe and the EU Central Bank so dependant from German authorities?
- How much influence had Germany and the German Unification in the European Integration process, which has been occurring since the late 1950s?
- As far as the central banks are concerned, why and how could the Bundesbank force the establishment of the Maastricht criteria, which are regarded as particularly controversial today?
- The media of some countries blame the Euro, the European Union currency, for the long lasting crisis in some countries. Are there any other examples of European Monetary Integration before the Euro? More importantly, did such systems work?

These were only a few of the questions that I wished to analyse in order to obtain a better understanding of today's interrelations inside the EU, with a focus on the relationship between the German history, the German economy and Europe.

The main aim of this work is to gain an understanding of the economic and historical events that framed the architecture of Europe in the early 1990s. Specifically speaking, this work is intended to understand to what extent the German Unification influenced the European Monetary System, in particular referring to the crisis of the EMS that occurred in the early 1990s, since criticism was raised against the behaviour of the German Central Bank and about the Unification being the cause of the EMS crisis. Namely, in Europe, the European Monetary System has been crucial

for the development of the today's economic system. Furthermore, it will try to identify some connections and whether there are relationships and related problems with today's crisis. I chose to focus on German recent history, on its Unification and on the European economic integration process since it might be an essential way to understand how economic patterns have changed and shaped today interpretation of Europe, both internally and externally.

This work is divided into four main chapters and it will follow the chronological order of the events. However, at certain crucial points the unravelling of the events will be interrupted to allow more room for economic explanations. In addition, throughout the work the insertion of several tables containing essential numerical data would be useful not only as an exemplification of the described events but also to give a more specific and practical idea of the concerned numbers. There will be also a few pictures, which have been widely used by the media during the 1990s in order to help in the understanding of the background and the events themselves.

First of all, this work gives an overview of the economic and historical patterns and events that characterised the division of Germany. Namely, in order to understand the future decision-making policies and the events that followed the Unification it is essential to start this work with an overview of the historical events and a general economic background of the two divided Germanys. Therefore, this will be done in a brief way taking into consideration first the history of the German Democratic Republic and second the history of the Federal Republic of Germany. This will be useful in order to have some information on the historical background on which the Peaceful Revolution took place.

In order to highlight the importance of the 1989 events, the second chapter will take into consideration the Peaceful Revolution that occurred between October and November 1989. Therefore, the chapter will focus on the events before and especially during those days that changed the course of contemporary history and contributed to put an end to the Cold War.

The third chapter will deal with the German Unification process more attentively. In fact, the latter was matter of various international and national

agreements between the parts, which were mainly the GDR and the FRG. However, it must not be forgotten the influence of the Allied countries in the development of such process. Moreover, the German Unification affected other different areas within the country itself, from the healthcare and insurance to the army and legal right. Specifically, the third chapter will provide, first of all, the historical overview of the process in order to understand its first dynamics and the policies that were to be implemented.

Secondly, it will continue with a detailed account of the policies applied before and during the monetary union and the instruments used to achieve it. Third, the Unification Treaty itself will be analysed briefly, focusing on the main economic areas and instruments. Fourth, strictly connected to the monetary union and the Unification Treaty itself is the case of the privatisations and propriety rights. In the fourth section of the chapter it will be dealt with the actions and the problems arising from the privatizations carried out by means of the Treuhandanstalt. In addition, the difficulties created by the Treuhand implied a general confusion in the propriety rights in East Germany, a fact that sometimes has repercussions in the today's Germany.

Moreover, the fifth section will consider the social policies and the problems connected with the harmonisation of the policies in the East with the ones in the West. Furthermore, the sixth section of the third chapter will discuss the continuous raise of the deficits due to the fiscal effort and the social policies that were implemented in the East, the connected difficulties and results.

Finally, the third chapter will end focusing on the roles of the Bundesbank and the German government in the policy making decisions during the German Unification. It will also try to underline the commitment of the German Central Bank towards stability oriented policies and conflicts arising from the different point of views of the government in the path to be followed.

The fourth and last chapter will take into consideration the European repercussions of the German Unification, focusing on the European Monetary System. Firstly, as it was done in the previous chapter, it will begin with the

examination of the historical and economic background of the European integration process, which had begun in the late 1950s and continued through the decades of the Cold War until the German Unification. It is still an essential issue in the development of EU policies today. Secondly, the chapter will consider the institution of the European Monetary System and its precursors in history, like *the snake in the tunnel* and *the snake in the lake*. The analysis will focus not only on the institution and development of the EMS during its existence, but also it will explain how the EMS worked, its instruments and difficulties. The third section will consider the EMS in the framework of the German Unification, the EMS crisis and the problems that were triggered internationally as a consequence.

The fourth and final part of the chapter will deal with a brief overview of the main debates and controversies over the EMS and how the crisis might have been managed differently.

## Chapter 1

### East and West Germany

#### **Brief History of the GDR and its Economy**



Figure 1: The German Democratic Republic, <http://www.maps-of-germany.co.uk/images/map-of-east-west-Germany.gif>, updated 2009, consulted November 2013.

The German Democratic Republic (orange in figure 1) was a state established in 1949 as a consequence of Soviet occupation in the aftermath of the Second World War. It is also known as Deutsche Demokratische Republik, DDR or even with the term East Germany. The territory of the GDR was divided into 15 regions or ‘Bezirke’ with 24 city districts, 192 rural districts and 9208 communal districts.<sup>1</sup> The capital of GDR was Berlin, in particular the democratic or east part of Berlin, and it counted around one million inhabitants in the estimates of a 1963 socialist propaganda

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<sup>1</sup> Lega per l’amicizia tra I popoli della Repubblica Democratica Tedesca, *La RDT si presenta*, Dresden, Zeit im Bild Verlag, 1963, pp. 4-5.

brochure.<sup>2</sup> Public data estimates, however, count 4.1 million people in 1971 census and 4.2 million people in 1980 census overall in the GDR.<sup>3</sup>

Already during the Teheran Conference in November 1945 and the Yalta Conference in February 1945, the Soviet Union, the USA and Great Britain were debating about the future of Germany, in particular about the division of the state into occupation zones. Moreover, Stalin, the Secretary General of the Communist Party of USSR, was meditating of enlarging and increasing his power internationally.<sup>4</sup> In July 1945 at the Potsdam Conference, problems about the amount and the divisions of reparations were solved.<sup>5</sup> The Allies established a commission or council, in Berlin, with the aim to control the activities of the four zones. Furthermore, the Berlin issue was discussed at Potsdam, because the capital of Germany stretched at the core of the Soviet area; the city was divided into other four zones with specific regulations regarding movements within and among them.

In the Soviet area, the activities of ‘restructuring’ began soon afterwards. The 9<sup>th</sup> June 1945 the “Sowietische Militäradministration in Deutschland” or Soviet Military Administration in Germany (SMAD) was created in order to take care not only of the Soviet interests, but also to help in developing the area economically, politically and socially. The Berlin-based SMAD ceased to exist in October 1949.<sup>6</sup> The day after its creation, the SMAD issued the so called “Befehl Nr. 2”, a directive that allowed the establishment of parties but only “unter der Kontrolle der SMAD” and specifically a multiparty system.<sup>7</sup> As a consequence the KPD or Kommunistische Partei Deutschlands, SPD or Sozialdemokratische Partei Deutschlands, CDU or Christlich-Demokratische Union, LDP or Liberal-Demokratische Partei were founded. Nonetheless, the Sozialistische Einheitspartei Deutschlands (SED) was founded later, on the 20<sup>th</sup> and 21<sup>st</sup> April 1946 as an incorporation of the KPD and SPD parties due to

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<sup>2</sup> *Ibidem*.

<sup>3</sup> Statistische Ämter des Bundes und der Länder: Forschungsdatazentren, <http://www.forschungsdatenzentrum.de/bestand/volkszaehlung/index.asp>, last update 24 April 2013, consulted on November 2013.

<sup>4</sup> Weber Hermann, *Die DDR: 1945-1990*, München, Oldenbourg Verlag, 1993, pp. 4-5.

<sup>5</sup> Corni Gustavo, *Storia della Germania da Bismarck alla Riunificazione*, Milano, Il Saggiatore, 1995, pp. 323-326.

<sup>6</sup> Weber, *Die DDR*, cit., p. 5.

<sup>7</sup> *Ivi*, p. 6.

political tensions continuing since their institution. Rapidly the SED became the most powerful party as it counted, only one month after its establishment, 1,3 million members<sup>8</sup> and for this reason it began to fear competition of the other parties. The party conference of the SED would be in January 1949 and it was the first of many other conferences in the history of the GDR. The SMAD supported the SED policy through communal elections and the institution of the “Deutsche Wirtschaftskommission” in June 1947, an apparatus aimed at coordinating the activities and the administrative offices in the Soviet zone.<sup>9</sup> This authority was founded four days after the establishment of the “Wirtschaftsrat” in Frankfurt am Main in the American and British zone, a further step towards the division of Germany.

The purpose of the Allies and Soviets was from the beginning the final economic and political unification of the four areas, or the two blocks; however, none of the powers were able to agree on this topic as a result of the rising tensions between the USA and the USSR. The rising pressure and stressful atmosphere in Europe deriving from the opening of confrontation between the two blocks did not help to pursue the unification policies in the late 1940s.<sup>10</sup> For all these reasons the 7<sup>th</sup> October 1949 the German Democratic Republic was proclaimed, just after few months from the establishment of the Federal Republic of Germany (FRG) or West Germany. The very tight connection between the two establishment dates could suggest that the GDR was proclaimed in response to the establishment of the West German state. Moreover, there is evidence that the Western policies in Germany were directed not towards a unification, but towards the creation of a ‘partial state’ in spite of the fact that they agreed it to be a temporary situation.<sup>11</sup>

The first GDR Constitution was announced the same day and was created taking into consideration and as an example the Weimar Constitution.<sup>12</sup> The leader

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<sup>8</sup> *Ivi*, p. 17.

<sup>9</sup> *Ivi*, p. 5.

<sup>10</sup> Corni, *La storia della Germania*, cit., p. 346.

<sup>11</sup> *Ibidem*.

<sup>12</sup> Dokument Archiv, Die Verfassung der Deutsche Demokratische Republik vom 7. Oktober 1949, <http://www.documentarchiv.de/ddr/verfddr1949.html>, last update 3<sup>rd</sup> March 2004, consulted on October 2013.

authorities were the “Deutsche Volksrat” as a provisional Volkskammer or Parlament, the “Ministerrat” or Council of Ministers, the “Staatsrat” or State Council (it substituted the president from 1960).<sup>13</sup> The first President of GDR, Wilhelm Pieck, was elected by the Volkskammer some days later as well as the first Chairman of the Ministerrat, Otto Grotewohl. Walter Ulbricht, future first Secretary of the SED, was deputy in the Ministerrat under Otto Grotewohl initially. The first Volkskammer elections were held the 15<sup>th</sup> October 1950 using the system of the predetermined lists.<sup>14</sup> In these lists, the parties decided the candidates that may have been elected and seats were distributed through a predetermined scheme. However, already in January 1949 (before the declaration of the new state, GDR) the SED was undergoing a deep change in its system, a change that was described and labelled as “a new type of party”, which meant that it was directed towards Marxism-Leninism.<sup>15</sup> The discrepancy between the Constitution and the SED policy became soon visible: in the first GDR Constitution there was, in fact, no sign of the term “socialist”. Only in 1968, under the government of Ulbricht, the new Constitution will be adopted, a document that declared itself “socialist”.<sup>16</sup> The power was centred on the party (the politburo), on the principle of “democratic centralism” and very similar to the other communist parties at the time. Every disagreement between party members was banned. Moreover, trust relationships among leaders and the intermediate agents were assured by police controls, in particular the Staatssicherheit Ministerium, and a number of material benefits were also granted to the ruling group, such as permission to live in wealthier houses or the authorisation to travel outside the GDR.<sup>17</sup> On the other hand, the loyalty of the masses was gained even with means of indoctrination, of which young people were the target, more than any other.<sup>18</sup>

Another very important aspect of GDR that must be taken into account is its dependence from the Soviet Union. The USSR maintained the influence in East

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<sup>13</sup> *Ivi*, Articles 48-80.

<sup>14</sup> Thomanek Jürgen, Niven Bill, *Dividing and Uniting Germany*, London, Routledge, 2001, p. 43.

<sup>15</sup> *Ibidem*.

<sup>16</sup> Corni, *La storia della Germania*, cit., pp. 406-407.

<sup>17</sup> *Ivi*, pp. 408-409.

<sup>18</sup> Weber, *Die DDR*, cit.,p. 39.

Germany through its army and the SED appeared to be dedicated to Stalin in the early 1950s. The continuing implementation and intensification of Soviet policies and procedures, the “Neuer Kurs”, brought to a crisis in 1953. In addition, the death of Stalin on the 5<sup>th</sup> of March 1953 alarmed the leadership of the SED, as many other communist parties in the East. For these reasons and because of the widely shared discontent towards the low economic conditions, workers began to strike in Berlin on the 16<sup>th</sup> June 1953. The day after, the strikes spread to other German regions and they became politically directed and radicalised: fearing a deterioration of the situation, the Soviet panzers intervened in the afternoon and in few hours the insurgencies were suppressed.<sup>19</sup> This opposition to the SED regime was born spontaneously but lacked of a political leadership and detailed programs. From this moment on, the SED became more careful with its policies towards the population and the regime stabilization, using “the stick and the carrot”, a technique that consented the leadership to rule until 1989.<sup>20</sup>

Meanwhile, the flow of migration from the GDR did not stop. In 1953 around 331,000 people fled and two years later there were 252,000 migrants to the Bundesrepublik.<sup>21</sup> It was already clear to the leadership that this flow had to be contained and limited. Due to the continuing economic difficulties and the political rigidity, between 1960 and 1961 a new crisis exploded. The flow of emigrants grew once again: only on April 1961, 30,000 people left the GDR. The Soviets, lead by Khrushchev, had been increasing their pressure on GDR: in 1955 the GDR became member of the Warsaw Pact and, therefore, their influence in East Germany was very high and intrusive. The Soviets were trying to force the Allies to abandon West Berlin but they met the resistance of Kennedy leadership. Internationally, the tension between the United States and the Soviet Union was very high and its consequences were perceived in Germany in particular.<sup>22</sup> During the night between the 12<sup>th</sup> and 13<sup>th</sup> August 1961 the GDR police and soldiers traced moats and erected barbed wire

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<sup>19</sup> Corni, *La storia della Germania*, cit., pp. 411-412.

<sup>20</sup> *Ibidem*.

<sup>21</sup> Weber, *Die DDR*, cit., p. 41.

<sup>22</sup> Schulze, Hagen, *Storia della Germania*, Roma, Donzelli Editore, 2001, pp. 209-211.

fences around the border of Eastern sector. After some weeks a wall was built around West Berlin, no one could cross the wall without risking his or her lives to go to the western part of Berlin. Travelling freely outside the GDR grew incredibly difficult.

In April 1968 the new Constitution was adopted, it described and reaffirmed strongly the hegemonic role of the SED in ruling the state.<sup>23</sup> However, the USSR was undergoing a change in policy and in leadership in those years. In fact, in 1964 Leonid Brezhnev succeeded Nikita Khrushchev as leading role of the USSR. In spite of the connection between the GDR and the USSR, Ulbricht was firmly affirming the autonomy of the GDR economically and politically though his many ideological pronouncements. In addition, he avoided Willy Brandt talk offers and reacted negatively when the Soviet leader suggested to accept such offers, in order to soften relations with BRD.<sup>24</sup> For all these reasons and because of his illness, Ulbricht was substituted with Erich Honecker in May 1971, who intensified the centralisation of the state power in the SED and the propaganda about the East-West differences. On the other hand, Honecker soon began a relaxation in the relationships with the Bundesrepublik: in 1972 there was the first agreement on the reciprocal recognition of sovereignty.<sup>25</sup> Amendments to the Constitution of 1968 were added in October 1974, even though they aspired at underlying the demarcation line between the two Germanys.

In the 1970s Honecker was able to maintain the regime political stability and try to consolidate the economy. The migration patterns seemed also to lower and stabilise, even if it remained a continuous flow.

Now, let us turn the attention towards the economics of the German Democratic Republic.

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<sup>23</sup> Dokument Archiv, Die Verfassung der Deutsche Demokratische Republik vom 6. April 1968, <http://www.docu.mentarchiv.de/ddr.html>, last update 3rd March 2004, consulted in November 2013, Articles 1-8.

<sup>24</sup> Corni, *La storia della Germania*, cit., pp. 418-419.

<sup>25</sup> *Ivi*, pp. 423-424.

One very important aspect that must be taken into account, as far as the economy of the GDR is concerned, that is its social policy. According to the SED ideology, there were great social achievement in consequence of the denial of nearly every private business and thanks to the development of a planned economy.<sup>26</sup> The social policy was very important in socialist states and in the GDR it had several functions. The social policy encompassed provisions of public and seemingly public goods and services, subsidies for some specific private goods, which were defined as necessary, the use of income support measures such as expenditures for medical care, education, price subsidies and housing subsidies.<sup>27</sup> Some important areas of welfare expenditures during the 1970s and 1980s were the continuous growing housing constructions, modernization and benefit payments as part of social security programmes (pensions or disability payments). However, what is interesting is the massive expenditure for subsidisation of necessary goods in order to maintain prices of such goods low and constant, as for example children clothing, drinking water or public transportation.<sup>28</sup>

First of all, the social policy aim was to boost social and political order. Secondly, it aimed at raising the state productivity of the workers and in this way strengthening their motivation towards working. Social policies, such as insurances for emergency aids, were offered to the working population first, in order to diminish inequality between classes and to provide a minimum subsistence.<sup>29</sup> During the 1950s and early 1960s, under the government of Ulbricht, the social policy in East Germany was considered to be a matter of the capitalistic economic system.<sup>30</sup> The first social institution was created already in 1945, when the Soviet Military Administration in Germany (SMAD) permitted the establishment of a form of social insurance fund.<sup>31</sup> Nevertheless, at the beginning of the GDR social policies were

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<sup>26</sup> Schmidt, Manfred G., Ritter Gerhard A., *The Rise and Fall of the Socialist Welfare State: The German Democratic Republic (1949-1990) and German Unification (1989-1994)*, Heidelberg, Springer-Verlag, 2013, pp. 6-27.

<sup>27</sup> Bryson, Phillip J., "GDR economic Planning and social policy in the 1980s", *Comparative Economic Studies*, (1987), 2, p. 30.

<sup>28</sup> *Ibidem*.

<sup>29</sup> Schmidt, Ritter, *Rise and Fall of Socialist Welfare state*, cit., p. 29.

<sup>30</sup> *Ivi*, p. 30.

<sup>31</sup> *Ivi*, p. 40.

restricted because of Soviet Influence in GDR affairs. Under the government of Honecker, the social policy agenda was improved and through the new Constitution of 1968, amended in 1974, it rested on the basic “right to work”.<sup>32</sup> Improvements in social policies happened during party Congresses and Anniversaries as gifts and not on regular basis as it was done in the Federal Republic.<sup>33</sup> A very important event, which must be remembered when talking about welfare, is the insurrection of 17<sup>th</sup> June 1953. From this moment on, the SED worked trying to avoid the return of the same circumstances that caused the insurrection, often using the means of social policies.

The cost of welfare policies had grown during the 1970s and 1980s, though. The subsidies became gradually a burden on the GDR budget. In ILO (International Labour Organization) data the amount of GDP spent for some welfare programmes reached from 12,7% in 1960 to 16,8% in 1978.<sup>34</sup> The function of such an expansive social welfare was, on one hand, to help citizens, workers above all, into their subsistence needs and on the other hand to increase labour productivity and workers performance. Broadly speaking, western critics regard GDR social welfare as an attempt to legitimate increases in productivity and to promote trade and they are worried that simply it had an economic function.<sup>35</sup> During the 1980s, but in particular since the oil shocks of the 1970s, European economies underwent a recession, with a rise in interest rates and a trade stagnation, which was felt in GDR as well.

At the end of the Second World War, the main objectives of the Allied powers were to reshape the German industries and to restart the whole economy. In the Soviet zone, the industrial sector was dismantled with bigger emphasis than in the West area: some statistics say it was between 25% and 40% of the previous economic potential, although critics argue the numbers may be higher.<sup>36</sup> These manoeuvres

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<sup>32</sup> Dokument Archiv, Die Verfassung der Deutsche Demokratische Republik vom 6. April 1968, <http://www.docum.entarchiv.de/ddr.html>, last update 3rd March 2004, consulted in November 2013, article 24.

<sup>33</sup> Schmidt, Ritter, *Rise and Fall of Socialist Welfare state*, cit., p. 60.

<sup>34</sup> “ILO numbers do not take into account subsidies but only provisions against risks connected to old age illnesses and disabilities”: Schmidt, Ritter, *Rise and Fall of Socialist Welfare state*, cit., p. 70.

<sup>35</sup> *Ivi*, p. 34.

<sup>36</sup> Corni, *La storia della Germania*, cit., p. 336.

and the acquisition of part the production of the biggest firms or the acquisition of the firms themselves, were considered to be part of the reparations that East Germany had to deliver to the Soviet Union. In Hermann Weber opinion, it has been calculated that the reparations paid by East Germany were around 66 billion Marks overall, even if the GDR itself thought it ought to be 18 billion Mark (4,3 billion dollars).<sup>37</sup> It may be added that other critics do not agree about the amount of reparations, which in fact were settled in the Versailles Treaty, and about the numbers of firms dismantled by the Soviets. Figures vary according to sources and for this reason, it may have been implied that the reparations had not heavy consequences on GDR economy.<sup>38</sup>

Already in 1946 the Allied had established a “Bi-Zone”<sup>39</sup>, because American, British and later French governments aimed at stabilising and developing the German economy in contrast with Soviet purposes. The subsequent implementation of the Marshall Plan in the Allied zone, which was strictly connected to American aids, contributed further to the separation into two blocks. From September 1950 the GDR intensified its relations with the USSR and other communist states entering in the Council for Mutual Economic Assistance (COMECON), which was maintained throughout the regime existence at various levels.

One of the most important economic issues that may be mentioned is the agricultural reforms that took place before and during the early years of the GDR establishment. Already after the war, the very large estates (more than 100 hectares) owned by the Junkers,<sup>40</sup> by war or Nazi criminals were expropriated without compensation and redistributed to old and new farmers, 5 hectares each.<sup>41</sup> Due to the reform, the large estate farmers, who did not want to lose their properties, escaped into the West.

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<sup>37</sup> Weber, *Die DDR*, cit., p. 12.

<sup>38</sup> Collotti Enzo, *Storia delle due Germanie 1945-1968*, Torino, Einaudi, 1968, p. 104

<sup>39</sup> Weber, *Die DDR*, cit., p. 12.

<sup>40</sup> “Any of the aristocratic landowners of Prussia who were devoted to maintaining their identity and extensive social and political privileges, a German nobleman”. Oxford Dictionaries, Junker, <http://www.oxforddictionaries.com/definition/english/Junker>, updated 2013, consulted on November 2013.

<sup>41</sup> Collotti, *Storia delle due Germanie*, cit., pp. 111-112.

As far as the industrial sector was concerned, the GDR had to deal with scarcity of raw materials if compared with the western zone and in particular with scarcity of energy sources like coal. GDR was rich in lignite, though, and it was exploited as much as it could. In the first years after the war, the recovery was gradual and slow, due to all dismantlement and reparation efforts that hindered the process. The GDR economy was a planned economy, this means “an economy in which production, investment, prices, and incomes are determined centrally by the government”<sup>42</sup> and the major decisions were taken by the core leadership, the SED. The first East German plan was a “Halbjahresplan”, a six months plan in 1948 and later a “Zweijahrplan” was announced, two year plan for 1949-1950. From 1951 to 1955, the first five year plan began in GDR. The main purpose of the planned economy was the complete dismantlement of the capitalistic system and, in particular, plans started giving more importance to production in heavy industry, like iron and steel or the mechanics sector and the energy industry, rather than consumption goods.<sup>43</sup> The main aims of the first economic plans, both in the industrial and agricultural sectors, were self-sufficiency, lowering of production costs and increase of labour productivity and of national income.<sup>44</sup> Not to forget is the East German ambition to increment the use of advanced technology in industrial production and in research, in part due to the sensible diminishing of labour in the country.

The 17<sup>th</sup> June 1953 was a watershed for SED, for it caused a substantial change in policies of future economic plans.<sup>45</sup> The consequence was an attempt to diminish the discrepancy between heavy industry and consumption goods and continue raising the use of technology, an issue that was implemented in the second quinquennial plan from 1956 to 1960.

In 1959, Ulbricht was forced to modify the course of the plan, transforming it into a seven-years-plan 1959-1965. To the enhancement of general life conditions,

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<sup>42</sup> Oxford Dictionaries, Planned Economy, <http://www.oxforddictionaries.com/definition/english/planned-economy?q=planned+economy>, updated 2013, consulted on November 2013.

<sup>43</sup> Collotti, *Storia delle due Germanie*, cit., p. 117.

<sup>44</sup> *Ivi*, pp. 914-921.

<sup>45</sup> Weber, *Die DDR*, cit., p. 40.

Ulbricht added an intensification of the foreign exchange, not only with other socialist states but, even with capitalistic ones and newly independent areas (like Africa or Asia).<sup>46</sup>

In January 1963, a new economic policy “Neues Ökonomische Systems” was introduced, with a reform of the bureaucracy, which reduced its influence and developed the responsibilities and powers of single enterprise administrations. This process may be referred to as a “decentring” because it transferred some of the previous public powers to the private and single firm, whilst the state retained the ability to control their developments. In addition, new economic instruments were introduced in order to ease the organizational processes in mid 1960s. Therefore, the seven-years-plan was transformed to acquire the last reforms, becoming not a rigid economic plan anymore but a guide for enterprises.<sup>47</sup> However, for fear of a new insurrection that may have spread from the Prague Spring in 1968, the new programmes were silently abandoned.

From 1971 on, Honecker continued Ulbricht economic policy but without the introduction of further reforms. His policy was characterised by continuous increase in livelihood standards and in labour productivity, persisting on rigid economic programmes while developing the social policy. The main objective was raising the consumption of goods and make consensus to the regime more secure.<sup>48</sup> One very important feature that Honecker introduced into the GDR economic and political policy was its connection with the Bundesrepublik Deutschland. Thanks to this renewed relationship, the GDR could exploit the foreign trade not only with the FRG but even with other Western states, which turned to be essential to the GDR balance of payments in the 1970s. The two energy crisis of the 1973 and 1979 were felt by GDR economy as well: in fact its growth rates diminished substantially in this period. The lignite was used massively in the industrial sectors and consequently the pollution derived from the use of this raw material worsened the already disastrous ecological situation of eastern regions. A further problem that arose during the 1970s

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<sup>46</sup> Collotti, *Storia delle due Germanie*, cit., pp. 926-927.

<sup>47</sup> Ivi, pp. 930-934.

<sup>48</sup> Corni, *La storia della Germania*, cit., p. 417-421.

and early 1980s was the scarcity of investments inside the GDR, a problem that began to be partially solved with the help of credits from the FRG and, subsequently, with an increase in foreign debt.<sup>49</sup>

At the beginning of the 1980s a particular characteristic of GDR economy became prominent, the so called *Kombinat*. Traditionally, the entity that was in charge of maintaining and developing connections between the ministry and the individual enterprise was the Association of National Enterprises, or VVB.<sup>50</sup> In the first years of this decade, this authority was abolished and the *Kombinat* were institutionalised: these were “a group of nationalised firms, in which several economic and technological fields were united under a central leadership.”<sup>51</sup> Its function was to ameliorate coordination and communication within and between firms and to reduce problems arising from ministerial plans, therefore to solve organizational problems. In addition, through this restructuring of the industrial sector, the Director General (of the *Kombinat*) was supposed to have decisions making power regarding R&D and the marketing functions, which was particularly revolutionary in a socialist economy.<sup>52</sup> A function that became vital was the export production: in fact, a huge percentage of the production of a *Kombinat* was oriented towards foreign market. Moreover, new instruments of measurement began to be used, such as net revenues and profitability.<sup>53</sup>

An additional and very important issue that must be considered is the monetary policy and the banking sector of the GDR. Soon after the end of the Second World War the Soviet Military Administration in Germany subjected the zone to important changes in the system, which can be summarised in two phases. During the 1945-1948 the pre-existing frameworks were destroyed and the banks were nationalised, along with the industry sector as it has already been explained. The

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<sup>49</sup> Ivi, pp. 424-428.

<sup>50</sup> Bryson, “GDR economic Planning and social policy in the 1980s”, cit., pp. 26-32.

<sup>51</sup> DDR Lexicon, Kombinate, <http://www.ddr-wissen.de/wiki/ddr.pl?Kombinat>, updated March 2007, consulted on December 2013.

<sup>52</sup> Bryson, “GDR economic Planning and social policy in the 1980s”, cit., pp. 22-25.

<sup>53</sup> Ivi, p. 27.

banking system was restructured in each Länder, the banks were seen as “public-law institutions of the respective Länder governments and acted as all-purpose banks”<sup>54</sup>: as an example they gave loans to industry and held deposits. In this phase, banks had an essential role in the nationalisation of private properties, deposits and enterprises. It is in this very period that the fear of rising inflation emerged, because of new cash, deriving from confiscations or new script money, was being put into circulation.<sup>55</sup> The ‘Emissions- und Girobanken’, which managed the money stocks and payments, began to be instituted in the Länder from 1947, with reference to a future banking and currency reform. An year afterwards, the ‘Deutsche Emissions- und Girobank’ was made the head bank of the new banking system. After the currency reform of 1948 it was called ‘Deutsche Notenbank’ and could issue banknotes as well as controlling the system. Other types of banks that were established during the reforms are the ‘Deutsche Investitionsbank’, the ‘Deutsche Bauernbank’ and further, in 1956, the ‘Deutsche Handelsbank AG’, which were substituted with ‘Deutsche Außenhandelsbank AG’ in 1966, which was in charge of the international transactions.<sup>56</sup> The banking system underwent a new reform in 1968. Since the end of the war the GDR banking system had been a one-tier system. However, now it was being transformed into a two-tier system<sup>57</sup> (decentralised). The ‘Deutsche Notenbank’ was named ‘Staatsbank der DDR’ and it was charged with central bank powers, but only until 1974. Other banks were established, whose attention depended on the sector: the ‘Industrie- und Handelsbank’ (former ‘Investitionsbank’ for the industrial sector), the ‘Bank für Landwirtschaft und Nahrungsgüterwirtschaft’ (former ‘Landwirtschaftsbank’ for farmers and food industry), several savings banks for individuals and the already cited ‘Deutsche Außenhandelsbank AG’.<sup>58</sup>

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<sup>54</sup> Deutsche Bundesbank (edited by), *Fifty years of Deutsche Mark: Central Bank and the Currency in Germany since 1948*, New York, Oxford University Press, 1999, p. 577.

<sup>55</sup> “Currency issued by a private corporation. Historically, companies short of cash have paid scrip dividends instead of cash dividends.” Investopedia Dictionary, USA, <http://www.investopedia.com/terms/s/scrip.asp>, updated in 2013, consulted on December 2013.

<sup>56</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mar*, cit., pp. 578-594.

<sup>57</sup> A two-tier system implied a separation of formation between two different categories of banks, usually forming respectively on retailing deposit and credit to individuals and on investments.

<sup>58</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mar*, cit., pp. 578-594.

Nonetheless, the two-tier bank system was eliminated in 1974, due to its decentred powers.

As far as money circulation is concerned, the currency used in Germany at the end of the Second World War was the 'Reichsmark', but war inflation and black market were causing several problems both in East and West. Still, because of divergent political ideas about how the currency and the economic system should look like, the efforts for a unified reform ceased. The currency reform in the Soviet zone took place in June 1948 and it was considered essential to the stability and the implementation of the central planned economy. The conversion occurred in four days, in which East German citizens were allowed to change their old money, RM, for the new Ostmark.<sup>59</sup> Interestingly, exchange rates did reflect the political ideology of the leadership, "assets acquired by state owned companies [...] were exchanged at 1:1, private companies were given a rate of only 10:1, for the same assets."<sup>60</sup> The aim of such decisions was to take away money and assets from the capitalist class, to nationalise them and to promote public companies. It was a currency reform ideologically and politically motivated. A vital principle regarding currency until 1971 was that money should have been backed by gold, whose equivalence was decided to be 0,399902 grams of gold for an Ostmark, a principle that had been supported by Marx in the 19<sup>th</sup> Century.<sup>61</sup>

As far as foreign economic affairs were concerned, the GDR continued keeping two balances of payments, one for internal relations and the other for external ones. Credit flows were registered on an external credit inventory account, which made part of a number of subordinate accounts and were identified according to groups of countries, such as COMECON or OPEC countries. The method used to convert the foreign currency was through the "valuta mark": it was an invented international accounting unit used to convert external currencies. Thanks to this method, the various exchange rates that fluctuated with time, were kept secret by the

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<sup>59</sup> *Ivi*, pp. 580-581.

<sup>60</sup> *Ivi*, p. 582.

<sup>61</sup> *Ivi*, p. 589.

leadership.<sup>62</sup> Generally speaking, transactions with foreign countries were made at world prices and the conversion was later adjusted in order to match the central plans.<sup>63</sup>

Many critics have pointed out the disastrous economic situation of the GDR during the final years of its existence, caused by the economic stagnation of living condition and productivity, the continuous increase of foreign debt, poor ecologic conditions, massive spending on welfare, scarcity of investments and poor infrastructure.<sup>64</sup> One important fact that may be underlined is that the GDR did not have particular problems regarding the economic relations with the other socialist countries. Deficits began to appear in the East German balance of payments towards the Soviet Union in the 1970s due to raise of oil and other related raw materials, while the GDR earned surpluses with other socialist countries. On the other hand, with reference to the West, it has been calculated that the GDR accumulated deficits for nearly US\$ 14 billion in 1989. However, the amount of the foreign currency reserves abroad was thought to be around US\$ 10 billion by the same year, an information that was kept secret even to the majority of the SED members.<sup>65</sup> This meant that the GDR was solvent at the time of the popular revolution in 1989, even though its whole economy was quickly declining.<sup>66</sup>

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<sup>62</sup> *Ivi*, p. 594.

<sup>63</sup> *Ivi*, p. 598.

<sup>64</sup> Weber, *Die DDR*, cit., p. 100.

<sup>65</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 613

<sup>66</sup> *Ibidem*.

## Brief History of FRG and its Economy

The Federal Republic of Germany (violet in Figure 1) or West Germany was a state established in 1949 under the authority of the Allied powers, the United States, the United Kingdom and France. It was composed of eleven states and around 50 million inhabitants at its foundation year.

As it has been said in the previous chapter, the future of Germany was decided during the two conferences of Yalta in February 1945 and Potsdam in July-August 1945. At the beginning, Germany was divided into three zones, but at the conference of Yalta, France was charged with the control of its own zone, obtained from parts of US and UK ones. For instance, the French zone had less than 6 million, the British had 22,7 million and the American 16,7 million inhabitants.<sup>67</sup>

The American zone was composed of the regions Hessen, Baden-Württemberg, Bavaria and the city of Bremen. Here the American intentions were visible in allowing the Germans to develop locally (in the *Bezirke*) their own parties and leaders. As it happened for the Soviet zone, generally the influence of the Allied powers in their occupations zones was felt in various fields, from the political to the educational one.<sup>68</sup>

The British zone was the most industrially endowed of all. In fact, it was composed of North Rhine-Westphalia, Lower Saxony and the city of Hamburg. The British authorities preferred to decentre the administration controls at local level and tried to limit the powers of the *Länder* in contrast with the American intention. It is here, in Köln, that the 'Christlich-Demokratische Union' began to move its first steps in 1946, following the visions of Konrad Adenauer, one of the promoters of the early CDU. The dilemma of the British zone concerned the future of the Ruhr, one of the most industrialised regions of whole Germany, where nearly the 80% of German iron and steel production and the 70% of German coal production were located.<sup>69</sup>

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<sup>67</sup> Collotti, *Storia delle due Germanie*, cit., p. 47.

<sup>68</sup> *Ibidem*.

<sup>69</sup> *Ivi*, p. 57.

The French zone was composed of Rhineland-Palatinate and Württemberg-Hohenzollern. Here the French instituted a government authority in each province and aimed at a higher level of decentring of powers.<sup>70</sup>

During the Potsdam conference, all Allied powers agreed on the principle of a unified and uniform control, in spite of the divisions into zones.<sup>71</sup> On the contrary, this principle soon appeared to be too optimistic. France, in fact, was opposing the view for a unified Germany.<sup>72</sup> The only issue that all powers really agreed on was a de-nazification (*Entnazifizierung*) and democratizations of German citizens.<sup>73</sup>

The authority appointed for controlling and developing the zones was the *Allied Control Council*. Its duty was to choose and decide which manoeuvres were to be adopted and to find a way to implement them. However, difficulties arising from different political views and expectations resulted in the Allied powers implementing the Control Council directives from their own perspectives.<sup>74</sup>

In addition to the nervous political climate of the post-war world, this zonal system influenced the events and contributed to sentence the division of Germany for 40 years.

An issue that required particular attention and tact was the so-called 'Berlin question', which saw the division of the German capital, Berlin, into two zones of occupation, notwithstanding that Berlin was found in the Soviet occupation area. As the American Secretary of State, Byrnes, noticed the events between 1946 and 1947, it made soon clear that there was a deep break within the Allied policies with the USSR contrasting the American will to fuse together all Western zones, re-activate the economy and give German citizens their own provisional government.<sup>75</sup>

The economic unification of the American and British zones occurred the 1<sup>st</sup> January 1947.<sup>76</sup> This event meant an administrative and economic re-organization of

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<sup>70</sup> Ivi, p. 62.

<sup>71</sup> Corni, *La storia della Germania*, cit., p. 325.

<sup>72</sup> Gehler Michael, *Le Tre Germanie: Germania Est, Germania Ovest e Repubblica di Berlino*, Bologna, Odoja, 2013, p. 22.

<sup>73</sup> *Ibidem*.

<sup>74</sup> Ivi, p. 23.

<sup>75</sup> Collotti, *Storia delle due Germanie*, cit., pp. 33-37.

<sup>76</sup> *Ibidem*.

the new *Bi-Zone*. For instance Anglo-American economic Commissions were created, which later turned into all-German authorities. In a second phase, from late 1947, the features of the 'Bi-Zone' administration began to resemble a proper separate government and a consolidation of the status-quo was being developed. The French will adhere to the 'Bi-Zone' from April 1949.<sup>77</sup>

In April 1948, the *Marshall Plan* or *European Recovery Program* was approved at the American Congress. It consisted of a considerable amount of financial aids (12 billion dollars), basic commercial goods and raw materials that were directed to the European states to improve the economic and social situation and to help restarting the economy.<sup>78</sup>

Moreover, as far as the Berlin question is concerned, already during the summer of 1948, a first crisis was underway. The Soviets ordered to stop the communication ways through Berlin, in response to the economic and monetary reforms that were taking place in Western regions. The Soviet block of Berlin affected only the military apparatus at the beginning, but it was extended to the population and its energy resources in few days. It lasted one year, until May 1949 when the Soviets tried for the last time to re-establish the authority of a shared administration of Berlin, meeting the denial of the Western Allied.<sup>79</sup>

The result of the ideological, economic and political differences and misunderstandings between the Western powers and the Soviet Union, also massively conditioned by international imbalances and changes, was the proclaimed definite fracture of Germany.<sup>80</sup>

During the summer of 1948, the Allies decided to give permission to the *Ministerpräsidenten* of each Länder to prepare a first provisional Constitution, *Grundgesetz* or *Basic Law*.<sup>81</sup>

In Bonn, they were reunited into a *Parlamentarischer Rat* according to their party affinity. The text had to be accepted not only by the occupational powers, but

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<sup>77</sup> Ivi, pp. 65-77.

<sup>78</sup> Gehler, *Le Tre Germanie*, cit., p. 54.

<sup>79</sup> Collotti, *Storia delle due Germanie*, cit., pp. 132-136.

<sup>80</sup> *Ibidem*.

<sup>81</sup> Corni, *La storia della Germania*, cit., p. 348.

also by each Länder administration. Finally, on 23<sup>rd</sup> May 1949 the text was approved and officially entered into force. This event meant the birth of the Federal Republic of Germany (Bundesrepublik Deutschlands) or West Germany.<sup>82</sup>

The new document settled the question of Länder borders, and a few days later the population elected the new federal Parliament, which saw a CDU majority. Theodor Heuss was named first President, while Konrad Adenauer became the first Chancellor of FRG in September 1949 and formed a coalition government between CDU, FDP (Freie Demokratische Partei) and DP (Deutsche Partei).<sup>83</sup>

The FRG was a representative democracy through the *Bundestag* or federal Parliament. The day after the Basic Law came into force, the *Occupation Statute* became law. This document attributed full legitimacy to the German legislative, executive and judiciary powers, even though Western occupational powers applied some restrictions to it, such as decisional powers regarding the Ruhr or war reparations.<sup>84</sup>

The Adenauer government is generally associated with the peak years of the Cold War and his politics was characterised by a Western social, political and economic integration in order to compensate for the loss of the East area. Moreover, at the core of his ideal stood the estrangement from the 'other Germany'. Some critics argue that, through his politics, Adenauer was able to restrict the opposition powers, re-define them as making part of democracy, but without real strength. His government was identified as an authoritarian-like democracy and as a rigid system.<sup>85</sup>

Some critics saw a particular ambivalent connection between Adenauer and the USA politics: on the one hand, the first German Chancellor was an admirer of American strength in all fields. On the other hand, he could not but be suspicious about USA objectives.<sup>86</sup>

The relationship with France, and in particular with General Charles De Gaulle, was not a good one from the start. However, it soon began to change direction, the

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<sup>82</sup> *Ibidem*.

<sup>83</sup> Collotti, *Storia delle due Germanie*, cit., p. 151.

<sup>84</sup> Gehler, *Le Tre Germanie*, cit., p. 67.

<sup>85</sup> Collotti, *Storia delle due Germanie*, cit., pp. 176-178.

<sup>86</sup> *Ibidem*.

two countries becoming increasingly dependent on one another.<sup>87</sup> The connection with London, instead, was rapidly fading, as British interests in Germany did due to the steady progression of UK isolationism.<sup>88</sup>

During the Adenauer government the European integration began to be transformed into reality. Between 1950 and 1952 West Germany became member of the European Council and in April 1951 France, Italy, West Germany and the Benelux (Belgium, Netherlands and Luxemburg) signed the treaty for the institution of the European Coal and Steel Community, the first approach to today's European Union.<sup>89</sup> In 1955 the Federal Republic of Germany became member of the North Atlantic Treaty Organisation (NATO), an event strictly dependent to its own rearmament.<sup>90</sup>

The rearmament issue was diplomatically intricate. One of Adenauer main objectives was to convince the three Western Allied powers and the German population that a West German army, the *Bundeswehr*, was needed, in order to make the boundaries towards the East more secure.<sup>91</sup>

Thanks to the Korean war of 1950 and to the endless rising East-West tensions, the German Chancellor could convince the USA, UK and France that a West German army was going to be helpful in Europe in confining the Soviets and the German Democratic Republic.<sup>92</sup> For this reason, the *Bundeswehr* was established, finally, in November 1955.

By means of a specific protocol called *Deutschlandvertrag* or *General Treaty*, operative from May 1955, the FRG ceased to be officially an occupied state and acquired its full sovereignty.<sup>93</sup>

As far as relations with the USSR were concerned, the Soviet government offered the FRG to unify the two Germanys twice, first in 1952 and second in 1955,

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<sup>87</sup> *Ibidem*.

<sup>88</sup> Corni, *La storia della Germania*, cit., p. 356.

<sup>89</sup> *Ibidem*.

<sup>90</sup> *Ivi*, p. 358.

<sup>91</sup> *Ivi*, p. 359.

<sup>92</sup> *Ibidem*.

<sup>93</sup> Dokument Archiv, Vertrag über die Beziehungen zwischen der Bundesrepublik Deutschland und den Drei Mächten, „Deutschlandvertrag“, <http://www.documentArchiv.de/brd/dtlvertrag.html>, last update 3rd March 2004, consulted in December 2013.

provided that it remained a neutral country.<sup>94</sup> However, both Adenauer and the Western Allies firmly opposed to the Soviet offers. The relationships between the two German countries settled as the recognition of one another separate existence.<sup>95</sup>

As a consequence, communications and interrelations between the FRG and the GDR were kept at a minimum level. A famous exemplification of this condition is the so-called *Hallstein Doctrine*,<sup>96</sup> a foreign policy named after the FRG state secretary Walter Hallstein, even though some critics argue that the real advocate was Wilhelm Grewe, a Foreign Department diplomat under Hallstein. Every country that officially recognised the GDR was to be regarded as unfriendly from the FRG point of view, and moreover, the Bonn government would cut every relation with the country that was making such an acknowledgment.<sup>97</sup>

This was the official behaviour line of the FRG authorities towards the sovereignty recognition of the GDR since December 1955 until the election of Willi Brand as mayor of West Berlin first and to the West German Chancellery in 1969. Many critics consider the Hallstein Doctrine as a means to consolidate the FRG in the international arena and as an example of Adenauer's anti-communist politics in the 1950s.<sup>98</sup>

The hardest crisis during the Adenauer government might be identified with the construction of the Berlin Wall in 1961. Ever since the establishment of the two Germanys, many GDR citizens escaped the East and migrated to West Germany. This flow had been steady since 1949, with peak points during particular events, such as the strikes in GDR in 1953.

Between 13<sup>th</sup> and 14<sup>th</sup> August 1961, the Soviet and GDR leaders decided to encircle West Berlin and separate it from East Berlin by means of a wall. This seemed

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<sup>94</sup> Corni, *La storia della Germania*, cit., p. 362

<sup>95</sup> *Ibidem*.

<sup>96</sup> *Ivi*, p. 363.

<sup>97</sup> 100(0) Schlüssel Dokumente zur Deutschen Geschichte im 20. Jahrhundert, Bayerische Staatsbibliothek, Interview des Ministerialdirektors, Professor Dr. Wilhelm G. Grewe mit dem Chefredakteur des Nordwestdeutschen Rundfunk, Hans Wendt ["Hallstein-Doktrin"], 11. Dezember 1955, [http://www.1000dokumente.de/index.html?c=dokument\\_de&dokument=0019\\_hal&object=facsimile&st=Hallstein&l=de](http://www.1000dokumente.de/index.html?c=dokument_de&dokument=0019_hal&object=facsimile&st=Hallstein&l=de), consulted on December 2013.

<sup>98</sup> Corni, *La storia della Germania*, cit., pp. 364-365.

to be consequence of the repeated opposition of West powers to the Soviet and East German requests to help stopping this migration flow through West Berlin.<sup>99</sup>

Adenauer's reaction to the 1961 Berlin crisis remained the one of rigidity and strong anti-Communist conduct, an exemplification of his leadership at the FRG government.

In September 1961, general elections took place in the FRG and Adenauer was barely able to form his fourth government. However, the end of the *Adenauer era* occurred only two years later, proving a change in the West German mood towards his leadership.<sup>100</sup>

The peak point of the government crisis is generally considered to be the so-called *Spiegel Affair* of October 1962.<sup>101</sup> The newspaper *Der Spiegel* published a critical article concerning some deficiencies of the West German army (Bundeswehr) and about NATO manoeuvres. The Spiegel journalists and editors were arrested for crimes against the German country after the request of the Minister of Defence, Franz Josef Strauss, and the approval of Chancellor Adenauer. Protests soon exploded in the main West German cities and Strauss was forced to resign, when proof of the Minister lying to the Bundestag was found.<sup>102</sup>

Adenauer himself was forced to announce that he would resign in Autumn 1963. In October 1963, the Bundestag elected Ludwig Erhard, former Minister of Economy, as Chancellor of the FRG.<sup>103</sup>

Two transition governments followed the Adenauer era: the Erhard government (1963-1966) and the Kurt Georg Kiesinger government (1966-1969). Erhard was considered the promoter of the *Wirtschaftswunder*, the miraculous economic growth of the 1950s.<sup>104</sup>

His leadership did not last long, also due to the sudden recession of the FRG economy in the second half of 1960s. On the other hand, Kiesinger was elected by

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<sup>99</sup> *Ivi*, p. 364.

<sup>100</sup> Gehler, *Le Tre Germanie*, cit., p. 145.

<sup>101</sup> Spiegel Online, Chronologie: Die Spiegel Affäre, <http://www.spiegel.de/politik/deutschland/spiegel-affeerdie-chronologie-a-850071.html>, updated in 2002, consulted on December 2013.

<sup>102</sup> *Ibidem*.

<sup>103</sup> Gehler, *Le Tre Germanie*, cit., p. 146.

<sup>104</sup> *Ibidem*.

the Bundestag in order to consolidate the coalition government and take the FRG economy out of the recession. By means of several structural reforms, as in the fields of justice or education, West Germany was able to limit the economic crisis and begin a modernization process, even though the foreign policy was strictly maintained within the directions of the Hallstein Doctrine.<sup>105</sup>

At the Parliamentary election of 1969, the parties FDP (Freie Demokratische Partei) and SPD (Sozialdemokratische Partei Deutschlands) created a coalition and Wili Brandt, member of the SPD, was elected Chancellor of the FRG.<sup>106</sup>

Soon afterwards, Brandt began implementing new essential internal and external changes in the East German policies, the most renown of which is the *Ostpolitik*. This policy implied the recognition of the GDR “as the other German state”<sup>107</sup> and the opening of communications and negotiations between the two parts. The main aim of Brandt’s *Ostpolitik* was to keep connections opened with East German citizens and to maintain West Berlin alive.<sup>108</sup>

This change in the FRG policy was possible also because of the reduction of international tensions, a *détente period*, between the two superpowers, the USA and the USSR, as exemplified by the signing of treaties, for instance the SALT I Treaty in May 1972.<sup>109</sup>

Thanks to all these particular conditions, Brandt not only began to improve relations with the GDR, but even with the Soviet Union. His policy changes were directed above all towards the external affairs, while the internal policy directions did not change considerably. The main sector that was reformed by the Brandt government was welfare, with corrections of social pensions for retired people, working women and students.<sup>110</sup>

In 1972, some very important treaties were signed between the FRG and the GDR: the *Transit treaty*, which regularised the traffic and transit of people between

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<sup>105</sup> *Ivi*, p. 165.

<sup>106</sup> *Ivi*, p. 174.

<sup>107</sup> *Ibidem*.

<sup>108</sup> *Ivi*, p. 175.

<sup>109</sup> Corni, *La storia della Germania*, cit., p. 383.

<sup>110</sup> *Ivi*, p. 386.

FRG and West Berlin and the *Basic Treaty* or *Grundlagenvertrag*, which improved movements of GDR's citizens towards the FRG in certain particular cases.<sup>111</sup> In 1971 Brandt obtained the Nobel prize for Peace for his activities in relaxing tensions and enforcing peaceful coexistence in Europe.

In May 1974, Helmut Schmidt succeeded Brandt at the Chancellery, following a scandal concerning his secretary being revealed to be a Soviet spy. His government was very different from Brandt's one, as far as reform policies were concerned, but he succeeded in the economical and political fields to develop and improve the international condition of the FRG.<sup>112</sup>

Schmidt was a graduate in economic and political sciences with excellent knowledge of military issues and international economy. Thanks to the economic power the country had acquired, Schmidt could cultivate and reveal the political capabilities of the FRG. This was symbolised by the US offer to become the economic supervisor of Guadeloupe in 1979. From this moment on, the FRG gradually emerged as a world international power, not only limited to Europe.<sup>113</sup>

Schmidt's policy was heavily criticised because of his relationship with the USA and his support to the German nuclear project. It is during this period that the first ecological movements were born in the FRG.<sup>114</sup>

In 1982 following the abandonment of the coalition by the FDP, the Bundestag elected Helmut Kohl to the FRG Chancellery, the politician that would be known as 'Chancellor of Unity' some years later. Internally, the following Bundestag elections saw the emergence of a new party *die Grüne* or *Green Party*, which transformed the political debate in the FRG.<sup>115</sup>

Kohl's new government remained on the same political path of his predecessor, on the one hand strengthening the relationships with the Atlantic allies

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<sup>111</sup> Gehler, *Le Tre Germanie*, cit., pp.179-180.

<sup>112</sup> *Ibidem*.

<sup>113</sup> Corni, *La storia della Germania*, cit., p. 390.

<sup>114</sup> *Ivi*, p. 394.

<sup>115</sup> *Ibidem*.

and on the other hand maintaining contact with East Germany, even through the means of economic aids.<sup>116</sup>

At the end of 1987, Honecker, the East German communist leader, visited the FRG officially, symbolizing the establishment of stable and friendly political and economic relations between the two Germanys. The aim of Bonn was to encourage the European integration process and a feasible German unification.<sup>117</sup>

With reference to the European History, since the Second World War, Europe and the European integration process had become gradually more and more important. As it has already been said, a first step towards the European integration started in the 1951 with the institution of the European Coal and Steel Community (ECSC). In 1957, the *European Economic Community* (EEC) was created by means of the *Treaty of Rome* and, moreover, during the same years the *European Atomic Energy Community* (EAEC or Euratom) was established.<sup>118</sup>

These three institutions, the ECSC, the EEC and Euratom, were instituted by six countries, one of which was West Germany. In 1967, the *Merger Treaty* came into force, implying that these separate three communities and their separated bodies were fused together as one body encompassing the European Communities.<sup>119</sup>

From the 1970s, the number of member states began slowly to rise, with the joining of Great Britain, Denmark and Ireland. In the 1980s Greece, Spain and Portugal joined the Community, but the enlargement continued ceaselessly until today.<sup>120</sup>

However, it is in the 1990s that the European integration became more rapid and this occurred in particular thanks to the *Maastricht Treaty on European Union* in

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<sup>116</sup> *Ivi*, p. 397.

<sup>117</sup> *Ibidem*.

<sup>118</sup> European Union, The History of the European Union, [http://europa.eu/about-eu/eu-history/index\\_en.htm](http://europa.eu/about-eu/eu-history/index_en.htm), consulted on December 2013.

<sup>119</sup> *Ibidem*.

<sup>120</sup> European Union, Countries, [http://europa.eu/about-eu/countries/index\\_en.htm](http://europa.eu/about-eu/countries/index_en.htm), consulted on December 2013.

1993, when the *European Community* (EC) was established. In 2007, the *Treaty of Lisbon* transformed the EC into the *European Union* that we know today.<sup>121</sup>

Now, consider the economy of the Federal Republic of Germany.

As it has already been said, the Allied powers decided to divide the German area into four zones of occupation. The zones were similar in size but not from the economic perspective. The British zone was profoundly industrialised and the main industries were steel, coal mining and iron. The American zone, on the other hand, comprised the manufacturing industries, such as the vehicles or precision engineering industrial sectors.<sup>122</sup> The French area was not greatly populated and it was characterised by agricultural production. Finally, the Soviet zone, as already said, was not particularly endowed with raw materials, but it comprised the mechanical and chemical industry of Germany. In addition, it must be mentioned that all occupational zones were dependent on the food stemming from the eastern part of Germany and from abroad. Trade between and within the zones was suffering from difficulties arising from destroyed infrastructure, a vital component of a modern country.<sup>123</sup>

The main problems in the West areas after the war were food scarcity despite of a raising industrial productivity, scarcity of housing derived by war destruction and the spreading of the black markets.<sup>124</sup> Food scarcity, in particular, triggered strikes in 1947 and 1948 starting from Krupp workers in Essen and the development of black market trades. The situation did not improve soon after the unification of the American and British zones. An additional difficulty complicating the already poor economic conditions of West Germany was the presence of a worthless currency, the *Reichsmark*.<sup>125</sup>

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<sup>121</sup> European Union, The History of the European Union, [http://europa.eu/about-eu/eu-history/index\\_en.htm](http://europa.eu/about-eu/eu-history/index_en.htm), consulted on December 2013.

<sup>122</sup> Kramer Alan, *The West German Economy: 1945-1955*, Worcester, Berg Publishers Limited, 1991, p. 8.

<sup>123</sup> *Ibidem*.

<sup>124</sup> *Ivi*, pp. 71-88.

<sup>125</sup> *Ivi*, p. 80.

In fact, peasants and workers were not willing to be paid with a currency that was regarded as worthless, which meant that it soon could not be used to buy goods.<sup>126</sup> The method used for the distribution of goods was the rationing<sup>127</sup> through a planned economy, which was applied since the Bizone establishment.

The main aim of restructuring the German economy was to “destroy the excessive concentrations of economic power,”<sup>128</sup> but the ways differed depending on the zones.

In the British area of influence, the *socialisation* way was chosen, in which the British army took possession of the industries and industrial assets and there were placed under the control of the British authorities. In contrast, in the American zone, an *Americanization* method was preferred, which implied the use of de-concentration and de-cartelisation policies,<sup>129</sup> such as the dismantlement of powerful German cartels.<sup>130</sup> A famous example of German cartel was the steel and iron cartel in the Ruhr, including Krupp, Vereinigte Stahlwerke and many other firms.

In addition, dismantlement was to be applied also in West Germany, but even this occurred in different ways and at different speeds. The British, in fact, did not start soon their dismantlement policies, as the Americans did and completed by the end of 1947.<sup>131</sup>

The person that is generally regarded as responsible for the *Economic Miracle* is Ludwig Erhard, Minister of the Economy since the first free elections in the FRG.<sup>132</sup> One of the first reforms implemented was the currency reform in 1948, but a very important instrument, which must be remembered here, was the *Marshall Plan* aid.

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<sup>126</sup> *Ivi*, p. 85.

<sup>127</sup> “The artificial restriction of raw materials, goods or services. Rationing commonly occurs when governments fear a shortage and want to make sure people have access to necessities, such as after a natural disaster or during a war”: Investopedia Dictionary, USA, Rationing: Definition, <http://www.investopedia.com/terms/r/rationing.asp>, updated in 2013, consulted on December 2013.

<sup>128</sup> Kramer, *The West German Economy*, pp. 114-115.

<sup>129</sup> *Ibidem*.

<sup>130</sup> “An organization created from a formal agreement between a group of producers of a good or service, to regulate supply in an effort to regulate or manipulate prices. A cartel is a collection of businesses or countries that act together as a single producer and agree to influence prices for certain goods and services by controlling production and marketing”: Investopedia Dictionary, USA, Cartel: Definition, <http://www.investopedia.com/terms/c/cartel.asp>, updated in 2013, consulted on December 2013.

<sup>131</sup> Kramer, *The West German Economy*, cit., pp. 118-119.

<sup>132</sup> *Ibidem*.

The *European Recovery Program*, also known as *Marshall Plan*, was an initiative prepared and implemented by the USA, in which the US government gave economic support to Europe, provided that European countries underwent some precise reforms.<sup>133</sup>

The Soviet Union did not accept to receive aids from the USA in order to avoid to be absorbed within the influence of the USA. The ERP was applied in West Germany with 1,5 billion dollars overall. Nevertheless, capitals themselves were not the reason for the improvement of living conditions, as it was the confidence deriving from receiving aid from the USA. West German people, in fact, did not feel abandoned, and it was this very idea that contributed into transforming and boosting the country economy.<sup>134</sup>

As far as the economic reforms were concerned, Erhard was involved in developing the economy and boosting growth already before the birth of the Federal Republic. He supported a liberal approach to the market economy, *Soziale Marktwirtschaft*, which meant the State authorities non-impediment towards the market system.<sup>135</sup> The State would then provide legislation without interfering with the market flows. In order to achieve this, the rationing method had to be dismissed. Nevertheless, it was maintained for certain goods, such as agricultural fertilisers, fuel or steel and iron for a precise period of time. The change of policy, from a planned and rationing economy to a free market-oriented one, announced the begin of a new period in German History.<sup>136</sup>

However, the *Economic Miracle* cannot be understood without taking into consideration the currency reform. The monetary reforms started in 1948 with the establishment of the *Bank Deutscher Länder* responsible for issuing the new currency. The exchange rate was fixed at 30 cents US dollars to one Deutsche Mark and the DM became valid officially the 21<sup>st</sup> June 1948. People received 60 DM overall, but divided in two instalments of 40 DM immediately and 20 DM in two months time.<sup>137</sup>

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<sup>133</sup> Corni, *La storia della Germania*, cit., p. 337.

<sup>134</sup> *Ibidem*.

<sup>135</sup> *Ivi*, p. 343.

<sup>136</sup> Kramer, *The West German Economy*, cit., pp. 140-148.

<sup>137</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, pp. 90-93.

However, the negative aspect of the currency reform was the heavy cut in savings. The credit balances<sup>138</sup> of local or regional authorities or owned by Nazi's organisations were cancelled, while the other credit balances in RM were converted into DM at the rate of 10:1, but the single account owner could dispose freely only of half the amount.<sup>139</sup> All the measures applied with the currency reforms left savers 'empty handed' and participated in spreading a feeling of expropriation and a drop in the confidence in the DM.<sup>140</sup>

A consequence of the monetary reform was an increasing rapidity in money circulation. Most of the banking deposits and capital amounts went into consumption soon after the implementation of the reforms, resulting in a general price rise and popular unrest as a consequence. Moreover, the *Bank of Deutscher Länder* was unable to counter the velocity of money circulation.<sup>141</sup>

Between 1948 and mid 1949 the economy began slightly to grow again. A uniform exchange rate was fixed and the prices structure were reformed to adapt to the new business structure of the country. Slowly the labour productivity grew by around 30%<sup>142</sup> and the monetary reform did not trigger a recession, as some economists have thought at the beginning, even though unemployment rate had rose, presenting a pressing problem for the West German government policies.<sup>143</sup>

A further help in recovering German economy occurred in autumn 1949, when the DM was devaluated from 30 cents to 22.5 cent per dollar in order to boost exports following the devaluation of the Sterling.<sup>144</sup>

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<sup>138</sup> "In a margin account, the amount of funds deposited in the customer's account following the successful execution of a short sale order. [...]": Investopedia Dictionary, USA, Credit Balance: Definition, <http://www.investopedia.com/terms/c/creditbalance.asp>, updated in 2013, consulted on December 2013.

<sup>139</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, p. 93

<sup>140</sup> *Ibidem*.

<sup>141</sup> *Ivi*, p. 96.

<sup>142</sup> *Ivi*, p. 97.

<sup>143</sup> *Ibidem*.

<sup>144</sup> Kramer, *The West German Economy*, cit., p. 166.

Still a more significant impulse to West German exports was triggered by the Korean War in 1950.<sup>145</sup> The increased industrial production led also to a reduction and disappearance of public deficits because of lower tax revenues.<sup>146</sup>

During the 1950s the FRG growth rate was very high, reaching its peak in 1955 with a rate of 11,6%. On the other hand, the agricultural sector behaved in a different way: it experienced a rapid modernisation path while losing labour and a slow growth. A great quantity of workforce moved into the industrial sector, which was expanding, and where wages were increasing faster than in the agricultural one.<sup>147</sup> The agricultural sector transformed itself and became vital for the FRG economy also thanks to the European Economic Community legislation and aids.<sup>148</sup>

Although the increase in real wages seemed fast, they did not grow considerably if compared with the rate of growth of productivity and profits of German industries. Generally, at the end of the 1950s the German workers could enjoy a higher standard of living than other Europeans.<sup>149</sup>

These years saw the implementation of a new social system, established by the Chancellor Adenauer in 1957, which was regarded as essential for the stability of the country and the improvement of workers' standards of living.<sup>150</sup> During the mid 1960s Erhard pictured the German society as a 'Formative Society'. In Erhard words:

The formative society is a society no longer composed of classes and groups, which try to achieve their separate objectives; on the contrary, it dissociates itself from all classes and estates, its essence is in co-operation. It is founded on a system of interaction and collaboration of all groups and interests.<sup>151</sup>

Eventually, in the late 1960s the FRG became the European country attracting more investments from other European states but also from the USA. Some critics have argued that the amount of investments was completely flooding the German economy with dollars.<sup>152</sup>

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<sup>145</sup> *Ibidem*.

<sup>146</sup> Riha Thomas, *German Political Economy: the History of Alternative Economics*, Bradford, MCB University Press, 1985, p. 218.

<sup>147</sup> *Ivi*, p. 190.

<sup>148</sup> *Ibidem*.

<sup>149</sup> Riha, *German Political Economy*, cit., pp. 212-218.

<sup>150</sup> Corni, *La storia della Germania*, cit., p. 370.

<sup>151</sup> Riha, *German Political Economy*, cit., p. 220.

<sup>152</sup> Collotti, *Storia delle due Germanie*, cit., p. 736.

Dollars continued to flow into German economy, mainly because of speculative attacks to the Bretton Woods system, in particular directed against the dollar. The flow became unsustainable in between 1966 and 1968 and the DM went floating. Later a new parity was established. Moreover, in the same years the FRG was suffering from a recession caused by a sudden fall in production and demand.<sup>153</sup> Some critics have claimed that the reasons may be two. Firstly, economic changes were occurring, for instance, Germany was nearly achieving full employment and was continuously relying on foreign labour and still there appeared to be major imbalances within economic sectors, favouring the export industry in particular. Secondly, the economic policy was considered to be inflexibly orthodox, due to the refusal of decision makers to intervene in the markets and business cycles.<sup>154</sup>

The loss of confidence was mirrored by the change in leadership from Erhard, the 'economic miracle' maker, to Kiesinger Chancellery. Namely, it was only in 1967 that Karl Schiller, the new Minister of Economy, introduced the possibility for policy instruments to achieve economic objectives such as full employment, price stability or growth. This Act enabled the government to use fiscal policy for anti-cyclical purposes.<sup>155</sup>

Furthermore, in 1971 the Bretton Woods system collapsed and the dollar went floating. The EEC integration was based on the BW system and its collapse created inconveniences between European members. A first provisional solution was found in the *European Snake*, which was soon abandoned in 1973 because of a further devaluation of the dollar. In addition, another event complicated the situation, the first oil shock in 1973. It implied a sharp rise in oil prices and related products, resulting in difficulties in the balance of payments of oil importing countries.

The FRG decided to react to the high prices with a substantial reduction of imports and consumption, a restrictive policy.<sup>156</sup> The use of depressing policies led

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<sup>153</sup> Riha, *German Political Economy*, cit., p. 221.

<sup>154</sup> *Ivi*, p. 221.

<sup>155</sup> *Ibidem*.

<sup>156</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, p. 423.

to a serious crisis between 1974 and 1975, with a raise in unemployment rates and a decrease of investments. The surplus created by exports was then invested to sustain the exporting sectors and accumulated in foreign accounts.<sup>157</sup> Behaving in this way, the FRG improved its situation towards the foreign exchange and reduced the inflation by means of a re-evaluation of the DM. Inflation was stemming from the raising prices of raw materials.<sup>158</sup> Notably, this policy is considered to have aggravated the economic crisis of the early 1970s and it was used by the FRG government in a more restrictive way even during a further recession between 1976 and 1977.<sup>159</sup>

In 1979, the Iranian national crisis developed into a second oil shock with a new sharp rise in oil prices. The European countries reacted coherently to this second energy crisis. Germany, in particular, applied the same depressing policies<sup>160</sup>, reducing imports, while this second time re-organizing the industry. The industrial sector was reorganised towards high technology and capital-intensive production, but with a distinct focus on energy saving innovations and incentives.

With respect to the monetary policy, in April 1978 the German Chancellor Helmut Schmidt and the French President Giscard d'Estaing proposed the establishment of the European Monetary System in order to provide support to the EEC member countries towards economic stabilisation. The EMS was an “attempt to stabilize inflation and stop large exchange-rate fluctuations between European countries.”<sup>161</sup>

Generally speaking, the growth rate did not recover fast after the economic crisis of the early 1970s: the growth rate will reach pre-1973 levels only in the late 1980s. In the early 1980s unemployment continued to create problem and social

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<sup>157</sup> *Ibidem*.

<sup>158</sup> Valli Vittorio, *L'economia tedesca. La Germania Federale verso l'egemonia economica in Europa*, Sonzogno, Etas Libri, 1981, pp. 45-68.

<sup>159</sup> *Ivi*, pp. 68-73.

<sup>160</sup> *Ivi*, p. 117.

<sup>161</sup> Investopedia Dictionary, USA, The European Monetary System: Definition, <http://www.investopedia.com/terms/e/ems.asp>, updated in 2013, consulted on December 2013.

discontent, while the FRG presented and maintained a surplus in its current account until the late 1980s.<sup>162</sup>

To conclude this brief analysis of the FRG economy, it is worth to consider the phenomenon of the *Gastarbeiter*. *Gastarbeiter* literally means a “guest worker”, and it refers to the people that moved to the FRG in order to find a job during the ‘miracle’ and booming years. This type of immigration was part of a program aimed at attracting workers from abroad, because of the achievement of full employment domestically.<sup>163</sup> Nonetheless, the presence of immigrants created very controversial effects during the economic crisis in the 1970s. A great part of the social problems deriving from the depressing policies was directed towards the *Gastarbeiter*. This triggered the nearly total abolition of the immigration program in 1973, and consequently immigrants were forced to return to their countries of origin.<sup>164</sup> Still, it must be highlighted that the FRG was regarded as the second country for immigration numbers, eventually adding the continuous flow of *Flüchtlinge* from the GDR since after the Second World War.<sup>165</sup>

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<sup>162</sup> Giersch Herbert, Paquè Karl-Heinz, Schmieding Holger, *The fading Miracle: Four decades of market economy in Germany*, Cambridge, Cambridge University Press, 1992, p. 236-250.

<sup>163</sup> *Ibidem*.

<sup>164</sup> Valli, *L'economia tedesca*, cit., p. 10.

<sup>165</sup> *Ivi*, p. 11.

## Chapter 2

### The Peaceful Revolution of 1989

The 9<sup>th</sup> November 1989 is widely known as the final phase of the Cold War period. Some authors may trace back the 1989 peaceful revolution origins to the protests of June 1953 in East Berlin. At the time, the discontent was forcefully settled by Soviet troops in a few days. These were soon followed by the uprisings in Poland and Hungary in 1956. A further event that affected not only the GDR, but also all European countries was the Prague Spring of 1968.<sup>166</sup>

Czechoslovakia was part of the Warsaw Pact already since 1949 and, as the other member countries, it was dependent from Soviet leadership and policies. Between January and August 1968, Czechoslovakia experienced a period of reforms within the Communist Party, when Alexander Dubček was elected First Secretary.<sup>167</sup> The Soviet panzers intervened in August and occupied the country in order to stabilise and take control of the situation. The disagreement and protests against the occupation soon spread to whole Europe, while also European socialist and communist parties took part in the demonstrations.<sup>168</sup> During the same year, other demonstrations occurred internationally arising from political repression and social injustices, marking an important phase in the development of Human Rights movements worldwide.

In order to understand the premises of the 1989 change in Germany, all the waves of demonstrations through the 1950s and 1960s.<sup>169</sup> However, an additional development towards 'die Wende' occurred during the 1980s. Mikhail Gorbachev became Secretary General of the USSR in 1985 and he imposed vital changes in Soviet policies, usually known as *Perestroika* (restructuring) and *Glasnost* (transparency). The majority of Warsaw Pact members were offended by the change in the Soviet

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<sup>166</sup> Bernocchi Pietro, *Oltre il Muro di Berlino: Le ragioni della rivolta in Germania Est*, Roma, Erre Emme, 1990, p. 8.

<sup>167</sup> Stefansky Michal, "Il 1968 in Cecoslovacchia: l'anno della speranza" in F. Leoncini, C. Tonini (eds.), *Primavera di Praga e dintorni: alle Origini dell'89*, San Domenico di Fiesole, Cultura della Pace, 2000, p. 55.

<sup>168</sup> *Ivi*, pp. 55-64.

<sup>169</sup> Corni, *La storia della Germania*, cit., p. 435.

political direction. In the German Democratic Republic, dissatisfaction towards the intransigence and stagnation of East German leadership was felt abundantly by means of the continuous flows of migrants to the West. In Poland the first free elections were held in 1989, just a few months before *die Wende* in Germany.<sup>170</sup>

In August 1989, the flow of people escaping to the West began to increase, thanks to the liberalisation policies in Hungary, which enabled East Germans to reach the West through Hungarian borders by waiting in the FRG embassies in Prague and Budapest. The very first step was the decision taken by the new Hungarian government of opening the borders to 60.000 East Germans on 10<sup>th</sup> September 1989.<sup>171</sup>

The opposition of the GDR leadership, led by Honecker, was immediate and it signalled the narrow vision of the old German leaders. Gorbachev, meanwhile, was trying to calm Honecker and to change the direction of his policies in Germany. The GDR found support in the Czechoslovakian leaders, who soon blocked their borders towards Hungary, while the Hungarian government was assisted by Poland.<sup>172</sup>

During the same period a new political organization was being established, called 'Neues Forum', which would be influential for the November uprising. The Neues Forum was in opposition to the GDR government and was founded by several dissident groups under the umbrella of the Evangelical Church.<sup>173</sup> What is to be highlighted is that this organisation did not aspire at following liberal and capitalistic ideas, but they had a socialist inspiration providing a real democratic dialogue between parties and freedom of choice.<sup>174</sup>

The 25<sup>th</sup> September 1989 all dissident groups gathered in Leipzig. During previous weeks hundreds of people were assembling out of the Nikolaikirche in order to make clear their dissent and challenge the police forces. The change in that Monday 25<sup>th</sup> was in the number of participants: it was known as the "Monday Demonstration in Leipzig", one of many others between September and November

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<sup>170</sup> *Ivi*, p. 436.

<sup>171</sup> Bernocchi, *Oltre il Muro di Berlino*, cit., pp. 118-119.

<sup>172</sup> *Ivi*, p. 121.

<sup>173</sup> *Ivi*, p. 123.

<sup>174</sup> *Ibidem*.

1989, and it counted between 5,000 and 8,000 people.<sup>175</sup> In the meanwhile, Honecker was appearing publicly once again, in order to restore order in the GDR, even if his health conditions were bad. The 2<sup>nd</sup> October the demonstration in Leipzig saw an enormous increase in numbers, it was around 20-25,000 people.<sup>176</sup>

During the same period the flow of migrants out of the GDR did not stop. The embassies in Warsaw and Prague continued to be filled with East Germans. In October, the GDR government after long negotiation was able to permit migrants to leave the country by means of trains reaching the FRG. The borders with Czechoslovakia continued to be blocked.<sup>177</sup>

The 6<sup>th</sup> and 7<sup>th</sup> October Gorbachev was in Berlin to celebrate the 40<sup>th</sup> Anniversary of the GDR establishment. Moreover, the Soviet leader met the East German leaders and literally taught them the principle of perestroika.<sup>178</sup> Several demonstrations occurred during Gorbachev parade and speeches to the population. The SED, and Honecker in particular, were reluctant to consider and apply Gorbachev reforms. The rigidity of the SED leader was becoming unbearable for the moderate part of the Communist party.<sup>179</sup>

On Monday 10<sup>th</sup> October the Leipzig demonstration counted 60-70,000 participants. All demonstrators seemed to be united by the slogan “Wir sind das Volk”, highlighting the desire of popular sovereignty over the SED absolute rule.<sup>180</sup> The 16<sup>th</sup> October the numbers of the demonstration in Leipzig rose once more to 120-150,000 people, while spreading in other cities of East Germany. Two days after, Honecker was substituted with Egon Krenz, younger and more moderate. Even if, Krenz was trying to implement some reforms, it was already too late to alter the situation. Krenz became the target of Leipzig and other cities protests.<sup>181</sup>

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<sup>175</sup> Ivi, p. 125.

<sup>176</sup> Bernocchi, *Oltre il Muro di Berlino*, cit., p. 125.

<sup>177</sup> Gehler, *Le Tre Germanie*, cit., p. 254.

<sup>178</sup> Bernocchi, *Oltre il Muro di Berlino*, cit., p. 129.

<sup>179</sup> Corni, *La storia della Germania*, cit., p. 437.

<sup>180</sup> Ivi, pp. 438.

<sup>181</sup> Bernocchi, *Oltre il Muro di Berlino*, cit., pp. 131-135.

The first days of November, thousands of migrants approached the Prague FRG embassy. The government was starting to admit that the constant migration flow was endangering the GDR economy gravely. For instance, in the hospitals 1,100 doctors and nurses had abandoned their jobs to move to the West, a fact that contributed to worsen the situation. The 4<sup>th</sup> November in East Berlin 500,000 people were protesting and two days later in Leipzig 300,000. A new slogan began to spread: "Wir sind ein Volk, we are one people".<sup>182</sup> The 7<sup>th</sup> November the Council of Ministers guided by Willi Stoph resigned and the same did the whole SED politburo the day after.

The GDR economic condition was worsening fast. Kohl, FRG Chancellor, offered further economic aids to the GDR government, provided that some reforms were to be made. The 8<sup>th</sup> November Krenz realised that the reforms awaited were going to be rejected by the majority in the Volkskammer.<sup>183</sup> Surprisingly, Krenz decided to act the day after, 9<sup>th</sup> November. At the press conference, Günter Schabowski, the spokesman of the SED, announced that people were allowed to travel to the FRG showing only their Identification document. In Schabowski's words:

So, we want... through a number of changes, including the travel law, to [create] the chance, the sovereign decision of the citizens to travel wherever they want. (um) We are naturally (um) concerned that the possibilities of this travel regulation—it is still not in effect, it's only a draft.

A decision was made today, as far as I know (looking toward Labs and Banaschak in hope of confirmation). A recommendation from the Politburo was taken up that we take a passage from the [draft of] travel regulation and put it into effect, that, (um)—as it is called, for better or worse—that regulates permanent exit, leaving the Republic. Since we find it (um) unacceptable that this movement is taking place (um) across the territory of an allied state, (um) which is not an easy burden for that country to bear. Therefore (um), we have decided today (um) to implement a regulation that allows every citizen of the German Democratic Republic (um) to (um) leave the GDR through any of the border crossings.<sup>184</sup>

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<sup>182</sup> Corni, *La storia della Germania*, cit., p. 438.

<sup>183</sup> Gehler, *Le Tre Germanie*, cit., p. 259.

<sup>184</sup> Guenter Schabowski, "Guenter Schabowski's Press Conference in the GDR International Press Center," *Making the History of 1989*, <http://chnm.gmu.edu/1989/items/show/449>, updated in May 2008, consulted in January 2014.

At the question “When does it come into effect?” the spokesman answered: “(Looks through his papers...) That comes into effect, according to my information, immediately, without delay (looking through his papers further)”.<sup>185</sup>

The announcement was immediately applied and thousands of people crowded by the Berlin Wall and other crossing places in the whole country. The Wall had collapsed at first formally, after few days physically.



Figure 2: 9th November 1989, Berlin, Die Welt, <http://img.welt.de/img/debatte/crop101613061/8030719574-cj3x2l-w580-aoriginal-h386-l0/ddr-9-11-mauerfall-1-DW-Bayern-Frankfurt-Main-Archiv.jpg>, consulted in January 2014.

During the first days, two million people visited West Berlin, a whole new world for East German citizens. However, the majority did not remain in the West but came back at their homes in the East.<sup>186</sup>

As far as the political question is concerned, the fall of the Berlin Wall produced chaos, not only in the SED, but also within the other new parties. The old Council of Ministers was dismissed and a new one was formed, guided by the

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<sup>185</sup> *Ibidem*.

<sup>186</sup> Bernocchi, *Oltre il Muro di Berlino*, cit., p. 139.

reformist Hans Modrow. In December 1989, after a sudden step back of the SED leadership about reforms and because of renewed protests and demonstrations in East Germany, Krenz resigned and many old party members were forcefully expelled.<sup>187</sup> The SED was forced to transform in order not to be dissolved: the name was changed into SED-PDS and a new slogan was created "Democratic Socialism".<sup>188</sup> The newly formed leftist parties, the organisations for social rights and the green parties did not agree on the future of East Germany. For this reason, the majority of the population lost confidence in those opposition groups.<sup>189</sup>

On the 7<sup>th</sup> December 1989, the Round Table Talks, which consisted of the government, all Volkskammer parties, the opposition parties and movements, was instituted and met for the first time in East Berlin.<sup>190</sup> The Round Table developed into an important instrument for the government, but in particular for the society as a whole. Most importantly, it decided to program free election for the Volkskammer in March 1990 and communal elections in May 1990. The East German CDU resulted to be the winner of the first free Volkskammer election with 41%, while the PDS (old SED) received 16,4% of votes.<sup>191</sup> On the other hand, the economy of the GDR was in disaster and it became clear that the Round Table was unable to stop East German decline.<sup>192</sup>

With regard to the international arena, in December 1989 the GDR Prime Minister Modrow met the FRG Chancellor Helmut Kohl in Dresden. At the beginning, the unification approach was not considered: in fact, Modrow and Kohl did underline the existence of two German states. Nevertheless, the social pressures for a German unification were not to be neglected.<sup>193</sup> The Soviet Union remained silent during the events of November and soon after the fall of the Wall it suspended the economic aids that were usually given to the GDR due to its worsening economic situation.<sup>194</sup>

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<sup>187</sup> Gehler, *Le Tre Germanie*, cit., p. 265

<sup>188</sup> Oldenburg Fred S., "The October Revolution in the GDR-System, History, and Causes" in Oldenburg F.S., Vale M. (eds.), *Eastern European Economics*, XXIX (1990), 1, pp. 55-77.

<sup>189</sup> Gehler, *Le Tre Germanie*, cit., p. 265.

<sup>190</sup> *Ivi*, p. 264.

<sup>191</sup> *Ivi*, p. 371.

<sup>192</sup> Oldenburg, "The October Revolution in the GDR", cit., p. 66.

<sup>193</sup> *Ibidem*.

<sup>194</sup> Gehler, *Le Tre Germanie*, cit., p. 265,

Already in May 1990, during the first meeting of the Allied powers, Gorbachev for the Soviet Union, Mitterand for France, Thatcher for the United Kingdom and Bush for the United States, it was clear that the unification of Germany was unavoidable.<sup>195</sup>

In conclusion, the events occurred in November 1989 are generally known as the “Soft Revolution”. For the majority of the critics it was the result of a period of changes, to which the SED leadership did not want to adapt. Fred S. Oldenburg divide the most important factors that triggered the change into two different groups: the exogenous and the endogenous factors.<sup>196</sup> To the first category belong the Gorbachev reforms in the Soviet Union that inspired transformation not only in East Germany but also in other countries of the Warsaw Pact. Moreover, the Federal Republic continued the dialogue with the GDR, leaving open the possibility for Eastern citizens for a stabilisation and a possible unification of the German area by means of economic aids from Bonn to East Berlin. On the other hand, to the second category Oldenburg adds the demonstrations and the “revolution from below”<sup>197</sup>, with the SED feeling that the even the GDR army might not have been loyal to the leadership orders to intervene against the protestors. In addition, a decisive factor was the numbers of migrants during the final months of SED rule, which saw in November 1989 more than 130,000 people fleeing from the GDR. In spite of the initial changes after the Fall of the Wall, the migration did not stop, but continued: 60,000 refugees were still moving Westward during the month of January 1990.<sup>198</sup>

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<sup>195</sup> Thomanek Jürgen, Niven Bill, *Dividing and Uniting Germany*, London, Routledge, 2001, p. 66.

<sup>196</sup> *Ibidem*.

<sup>197</sup> Oldenburg, “The October Revolution in the GDR”, cit., p. 72.

<sup>198</sup> *Ivi*, pp. 68-77

## Chapter 3

### The Unification

The unification process affected not only all the fields, from the social policy to the foreign policy, but also European neighbours and non-neighbouring countries from its very beginning. In fact, since the peaceful revolution of 1989 the German population, in the East in particular, were expecting their politicians to work towards this aim. Nonetheless, it was considered a process highly controversial for how it was implemented, the time and actors involved, and as a breaking point for the past Cold War period and the whole European History.

This Chapter will deal with the historical, economic and social aspects of the Unification of Germany and, in particular, it will consider the problems arising from the Unification trying to take an international point of view.

#### **An historical overview of the Process**

As already said in the previous chapter, the Round Table Talks instituted in December 1989 in East Berlin were a first step of the discussion for the future of the GDR in the next frenetic and chaotic months. In spite of its political importance as a transition period towards parliamentary democracy, the Round Table Talks did not achieve any significant economic or social common policy.

In contrast, already in November 1989 the FRG Chancellor Helmut Kohl had a clear idea about what had to be done in the next few months. His idea was perfected and it was announced at the 28<sup>th</sup> November discourse in the Bundestag (FRG Parliament) through his famous “Ten-Point-Plan”. It consisted of a program in ten steps that would lead to the unification of Germany.<sup>199</sup>

First of all, emergency measures were going to be taken by the FRG government in order to calm the situation, in particular the flow of East German

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<sup>199</sup> Kohl Helmut, “Zehn-Punkte-Programm zur Überwindung der Teilung Deutschlands und Europas“: Rede von Helmut Kohl vor dem Deutschem Bundestag am 28. November 1989, Auszüge, [http://www.hdg.de/lemo/html/dokumente/DieDeutscheEinheit\\_redeKohlZehnPunkteProgramm/](http://www.hdg.de/lemo/html/dokumente/DieDeutscheEinheit_redeKohlZehnPunkteProgramm/), consulted on January 2014.

refugees. It was considered important, through, the intervention and cooperation of GDR authorities in this field.<sup>200</sup>

Second, the GDR should enhance the coordination with the FRG in the most important practical fields, for instance economic, scientific or technological. Telephone networks and railway infrastructures had to be modernised and connected to ease communications.<sup>201</sup>

Thirdly, the absolute rule of the SED party should be abolished and the government should commit to apply fundamental changes in its economic and political policies, in particular to implement a market based economy and to reform the Constitution with free elections.<sup>202</sup>

Fourth, as suggested by Modrow, the cooperation and special relation between the GDR and the FRG that was developed during the 1980s in various fields should become official by means of an agreement. In addition, the same could be programmed for the two countries own single authorities.<sup>203</sup>

Fifth, a confederation composed by the two German states, GDR and the FRG, might be established in the future, provided that the German population had agreed through a fully legitimised and democratic elected government.<sup>204</sup>

Sixth, the future of the German area was strictly connected to Europe's future. For this reason, inner German relations and East-West European relations should be safeguarded within the framework of a future full European integration.<sup>205</sup>

Seventh, the European Community and the Common Market was essential to the development of a united Germany. Therefore, the FRG would hope for a strict economic relation with the GDR, which might soon be transformed into a solid EC membership.<sup>206</sup>

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<sup>200</sup> *Ibidem.*

<sup>201</sup> *Ibidem.*

<sup>202</sup> *Ibidem.*

<sup>203</sup> *Ibidem.*

<sup>204</sup> *Ibidem.*

<sup>205</sup> *Ibidem.*

<sup>206</sup> *Ibidem.*

Eighth, the Conference on Security and Co-operation in Europe (CSCE) process was a vital instrument in the European framework and it might be improved considering new institutions and new, maybe ecological, policy directions.<sup>207</sup>

Ninth, a further step for a peaceful future would take into account the disarmament and arms control globally. It could be advantageous not only for Western powers, but also for the GDR and for the other Warsaw Pact member countries to prepare for such a process.<sup>208</sup>

Tenth, the Re-unification of Germany was the main political aim of Kohl's government: this meant an opportunity for Germany to take control of its own destiny and to be part of peaceful European coexistence.<sup>209</sup>

The main objectives of the FRG Chancellor's plan were to attract attention on the possibilities for the future of Germany, to raise political awareness at home in foresight of a possible German unification before FRG Bundestag election in 1990 and finally to support the GDR population indirectly and influence their prospects.<sup>210</sup> Nevertheless, not every West German party could agree with Kohl's Plan. For instance, the Greens strongly opposed the Plan and the Social Democrats remained uncertain about it because the Chancellor forgot to mention the inviolability of Poland's Western border.<sup>211</sup>

Internationally, the Western Allied powers were convinced of the importance of a united Germany, but especially of the need to provide the GDR with a liberal democratic constitution.<sup>212</sup> The French President François Mitterrand was one of the supporters of a united Germany, in spite of his fears and caution regarding the future of Gorbachev's leadership and German Unification itself. Essentially, Mitterrand foresaw the German unification process as strictly connected to the European market integration and, moreover, with the establishment of a security system in the whole

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<sup>207</sup> *Ibidem.*

<sup>208</sup> *Ibidem.*

<sup>209</sup> *Ibidem.*

<sup>210</sup> Ritter Gerhard A., *The Price of the German Unity: Reunification and the Crisis of the Welfare state*, New York, Oxford University Press, 2011, p. 7.

<sup>211</sup> *Ibidem.*

<sup>212</sup> *Ibidem.*

Europe.<sup>213</sup> On the other hand, the British Prime Minister, Margaret Thatcher, was not particularly convinced about German Unification. Proofs have been found in 1990 telegram exchanges between her and President Mitterrand: “Kohl is capable of anything. He has become another man. He doesn't know himself any more. He sees himself as the master and is starting to act like it”.<sup>214</sup>

It is clear that the British authorities did not support Kohl ideas and intended to work for stopping the unification process. Mitterrand shared a part of the British Prime Minister's fears, but he thought that the process could not be stopped. Thatcher's preoccupation concerned the consequences of German Unification in terms of balance of power, not only in Europe, but also in the Soviet Union and within the NATO.<sup>215</sup>

Nevertheless, France and UK could not find an agreement due to different interests: France was promoting and European integration, meanwhile the UK was firmly opposing to it.

Kohl made profound attempts in order to prevent and avoid any delay in the unification process. Recent data acquired by the German newspaper *der Spiegel* have highlighted the nearly break point in the relations between Germany and France in 1989-1990, as France's approval of German unification would have depended on Germany granting the implementation of a European monetary union.<sup>216</sup>

A vital aid to Kohl's policy came from the United States. The day after Kohl's Ten-Point-Plan declaration, the American secretary of State, James Baker, agreed with the reunification and at the same time expressed some basic principles that should have been taken into particular account, as self-determination, a continuous commitment to NATO, the inviolability of other countries' borders and ultimately, a peaceful and gradual process.<sup>217</sup>

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<sup>213</sup> *Ivi*, p. 8.

<sup>214</sup> Allen Peter, “Margaret Thatcher was 'horrified' by the prospect of a reunited Germany”, *The Telegraph*, 2 November 2009, <http://www.telegraph.co.uk/news/worldnews/europe/germany/6480413/Margaret-Thatcher-was-horrified-by-the-prospect-of-a-reunited-Germany.html>.

<sup>215</sup> Ritter, *The Price of the German Unity*, cit., p. 9.

<sup>216</sup> Sauga Michael, Simons Stefan, Wiegrefe Klaus, “The Price of Unity: Was the Deutsche Mark Sacrificed for Reunification?”, *Der Spiegel Online*, 30 September 2010, <http://www.spiegel.de/international/germany/the-price-of-unity-was-the-deutsche-mark-sacrificed-for-reunification-a-719940.html>.

<sup>217</sup> Ritter, *The Price of the German Unity*, cit., p. 11.

As expected, a determined opposition and preoccupation toward the process stemmed from the Soviet Union. Specifically, Gorbachev did not accept the Ten-Points-Plan, as he was not consulted before Kohl's speech. Furthermore, he did not agree on the rapidity that the FRG was transmitting to the unification discussions, in spite of the agreements between them.<sup>218</sup>

Nevertheless, the Soviet behaviour towards the German issue was ambiguous. On the one hand, the Soviet leadership underlined the relevance of maintaining two separated German states, while on the other it focused on the application of the principle of self-determination to the German population. Besides, he raised several questions that had to be clarified before the unification process was implemented, for instance membership of alliances, presence of the Allied forces on the German soil and the future for a possibly integrated Europe.<sup>219</sup>

To be underlined is also the political role of Gorbachev in the Soviet Union. He had been able, in fact, to implement several reforms and was uncommonly open minded within the Soviet Politburo. The chance that Gorbachev's leadership offered to the implementation of a reunification should have been taken in serious account.<sup>220</sup>

Internally speaking, the main target of Kohl's political talks and policies ideas was the population and notably, the GDR population. As already said in the previous chapter, the Volkskammer elections in the GDR were scheduled in March 1990. These were first scheduled for May 1990, the same day of the communal elections, but the political and economic issues that required the intervention of a popular legitimised government were constantly increasing in importance and number. For this reason, the Modrow's government, GDR Prime Minister since December 1989, decided to anticipate the election date in March 1990, when the coalition of parties named *Alliance for Germany* (CDU, DSU and DA) won the majority in the Volkskammer.<sup>221</sup>

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<sup>218</sup> *Ivi*, p. 12.

<sup>219</sup> *Ibidem*.

<sup>220</sup> Giacchè Vladimiro, *Anschluss, l'Annessione: L'unificazione della Germania e il future dell'Europa*, Reggio Emilia, Imprimatur Editore, 2013, p. 38.

<sup>221</sup> Gehler, *Le Tre Germanie*, cit., p. 263.

The political and economic situation was deteriorating rapidly before the March 1990 elections. The flow of unemployed migrants that sought prosperity and work in the FRG did not stop after the opening of the borders in November 1989. Some calculations had shown that between January 1990 and the election date in GDR around 184,000 people moved to the FRG. In addition, Kohl's policy regarding the issue was relatively ambiguous. First, his aim was not to favour the stabilisation of Modrow's regime, in order to speed the process of unification and European market integration. However, he did not seek to radicalise the GDR population excessively, as it might have led to armed forces intervention.<sup>222</sup> All the demonstrations, mass migrations and the clear lack of legitimacy and power of the SED-PDS regime transmitted political power to FRG unification policy. Besides, this feeling was confirmed by the March elections in the GDR with the success of the CDU among other parties.<sup>223</sup>

In February, some weeks before the Volkskammer elections, some international newspapers stated that the GDR was near bankruptcy, among them the *Pittsburgh Press*, an American local and national newspaper, the 9<sup>th</sup> of February, as informed by Reuter News Service and Associated Press sources in Germany.<sup>224</sup> This belief played a crucial role in the future choices, as it spread the fear of insolvency through East Germans. Just before the fall of the Berlin Wall, an economic commission had been instituted in order to understand the economic, fiscal and monetary situation of the GDR. The result was a deficit of 49 billion eastern Mark (26 billion dollars) towards Western countries in 1989. The interesting point was that the data and calculations used to produce the report had been not complete. Consequently, the GDR debt that resulted in the report had been much higher than the real one, which had amounted at less than 38 billion eastern Mark (around 20 billion dollar).<sup>225</sup>

However, many critics said and say even today, that this misunderstanding on the analysis of data was used for a purpose: Kohl's East electoral manoeuvre in order

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<sup>222</sup> Ritter, *The Price of the German Unity*, cit., p. 14.

<sup>223</sup> Ivi, p.15.

<sup>224</sup> Press News Services, "East Germany Nearly Bankrupt", *Pittsburgh Press*, 9<sup>th</sup> February 1990, <http://news.google.com/newspapers?id=QpQcAAAAIAJ&sjid=sGMEAAAIBA J&hl=it&pg=6846%2C4285662>.

<sup>225</sup> Giacchè, *Anschluss, l'Anessione*, cit., p. 25.

to remove every obstacle to the reunification.<sup>226</sup> His electoral campaign in East Germany touched the diplomatic field as well, when he met Gorbachev on 10<sup>th</sup> February.<sup>227</sup>

As already said, the elections in GDR gave the majority to conservative parties at the Volkskammer, which chose Lothar de Maizière as head of the last independent government in East Germany.<sup>228</sup>

With regard to the political discussion about reunification, but leaving apart the FRG election campaign and economic issues, the “Two-Plus-Four” multilateral negotiations must be taken into account. Its name derive from the participation of the two Germanys, the FRG and the GDR, and the four allied powers, the USA, the Soviet Union, the UK and France. The six foreign ministers met four times in May, June, July and concluding on 12<sup>th</sup> September 1990 in Moscow with the signature of the “Two-Plus-Four Treaty on Germany”.<sup>229</sup> This forum was regarded as the most important multilateral negotiations on the issue of the German reunification. An essential aspect related to it is the participation of the two German states as equal on the political level and the negotiations with the Polish government about the question of German-Polish borders.<sup>230</sup>

The result of the Talks was the Treaty on the Final Settlement with Respect to Germany, in which it is stated that the four WWII Allied powers abandon their rights and responsibilities in Germany and Berlin. The Treaty comprise ten articles: Article 1 about definite external German borders; Article 2 on the peaceful attitude and conduct of the country; Article 4 and 5 deals with the general future relationship and organisational matter between the united Germany and the USSR, particularly on the presence of Soviet troops on the German soil during and after the reunification. In

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<sup>226</sup> *Ivi*, p. 44.

<sup>227</sup> *Ibidem*.

<sup>228</sup> Thomaneck, Niven, *Dividing and Uniting Germany*, cit., p. 65.

<sup>229</sup> Dokument Archiv, Vertrag über die abschließende Regelung in bezug auf Deutschland „Zwei-plus-Vier-Vertrag“ vom 12. September 1990, <http://www.documentArchiv.de/brd/2p4.html>, last update 3<sup>rd</sup> March 2004, consulted in January 2014.

<sup>230</sup> Ghaussy A. Ghanie, Schäfer Wolf, *The Economics of German Unification*, New York, Routledge, 1993, p. 5.

addition, Article 7 declare that the united Germany would have the full sovereignty over its own internal and external affairs.<sup>231</sup>

In addition, the announcement of the united Germany joining the NATO was given in July 1990, sanctioning the conclusion of the Talks.<sup>232</sup>

The Treaty would come into force in March 1991, after the completion of the political and economic reunification. Nevertheless, another document was signed regarding the suspension of the previous by mentioned Allied rights on Germany during the interval time between the official unification of Germany, 3<sup>rd</sup> October 1990, and the coming into force of the “Two-Plus-Four Treaty”, March 1991.<sup>233</sup>

Furthermore, the European Commission, guided by the former French Foreign Minister Jacques Delors, took a further step towards German unity nearly suddenly. For weeks, during the multilateral negotiations and internal German discussions, the issue of the unity of Germany was strictly connected to European integration. This focus led the President of the European Commission to advocate the accession of the GDR into the European Community, saying that the GDR met the fundamental requirements to become member as a part of a future united member state.<sup>234</sup>

On 28<sup>th</sup> April 1990 in Dublin, the European Council accepted the Commission plan, which did not involve any change in admission procedures of the EC treaties. On 17<sup>th</sup> May 1990 the European Parliament finally approved East Germany as part of the European Community.<sup>235</sup>

Meanwhile, the GDR and the FRG authorities were discussing the practical questions for the unification. Kohl’s brilliant international diplomacy, even thanks to multilateral and bilateral negotiations, and internal political strategy was able to overcome the main obstacles arising from starting the process. Already in February

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<sup>231</sup> Dokument Archiv, Vertrag über die abschließende Regelung in bezug auf Deutschland „Zwei-plus-Vier-Vertrag“ vom 12. September 1990, <http://www.documentArchiv.de/brd/2p4.html>, last update 3<sup>rd</sup> March 2004, consulted in January 2014.

<sup>232</sup> Gehler, *Le Tre Germanie*, cit., p. 278.

<sup>233</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., p. 7.

<sup>234</sup> *Ivi*, p. 12.

<sup>235</sup> *Ibidem*.

1990, before the GDR elections, the FRG government was trying to transmit a rapid policy to the unification process.<sup>236</sup>

In April, the first free elected government was formed in the GDR, guided by de Mazière. Soon he demonstrated the will to cooperate with the FRG and to transform the Eastern economic system into a market oriented economy. However, the main objective the new leadership was not only the German unity, but also to represent the Eastern population desires in front of the FRG power.<sup>237</sup>

Kohl and de Mazière believed in two different approaches to German unity. Kohl, as already said, supported the rapid economic and political unification, while GDR Prime Minister believed in an ordered, gradual and secured approach to the process.<sup>238</sup> The majority of economists underpinned the latter, asking for an exchange rate union and a longer transitional period in order to gain time for finding the correct exchange rate and for implementing administrative and functional integration. Meanwhile, the former was underpinned by politicians, who saw in the immediate and complete monetary union an instrument to stop, or at least reduce westward mass migrations.<sup>239</sup>

A further problem arising from the debates on the approach to unification was about the legal framework to be followed. On the one side, there were the supporters of the unity via Article 23 of the FRG Basic Law, on the other side the supporters via Article 146 of the Basic Law.<sup>240</sup>

The reunification of Germany via Article 146 of the Basic Law implied the declaration of a new German Constitution, which was to be accepted by the population. This approach would have required extensive agreement and the institution of a Constituent Assembly, further agreement on the procedures and content of the composition of the assembly, etc. These problems would have endangered the whole process and, hence, it would have slowed it down.

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<sup>236</sup> Rödder Andreas, *Geschichte der Deutschen Wiedervereinigung*, Nördlingen, Verlag C.H. Beck, 2011, p. 64.

<sup>237</sup> Ritter, *The Price of the German Unity*, cit., p. 23.

<sup>238</sup> Thomanek, Niven, *Dividing and Uniting Germany*, cit., p. 66.

<sup>239</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., p. 28.

<sup>240</sup> Rödder, *Geschichte der Deutschen Wiedervereinigung*, p. 90.

On the contrary, the unification via Article 23 implied the accession of the new Länder or GDR to the Basic Law. However, the problem about Article 23 was that the GDR was a state and it was not considered to be a group of Länder. The solution was found in transforming the GDR into five Bundesländer, which then could be accessed to the Federal Republic.<sup>241</sup> The FRG and the GDR governments decided for the accession of the GDR into the FRG and FRG Basic Law, allowing only some small changes for an interim period.<sup>242</sup>

In addition, it must be mentioned that even the Federal Constitutional Court aimed at the unification stating that “Constitutional organs of the Federal Republic were under an obligation to work towards the restoration of the unity of the state, [...] refrain from doing anything that might prevent reunification.”<sup>243</sup>

The most important treaties between the German Democratic Republic and the Federal Republic of Germany regarding the unification were two. The first was the economic one, the Treaty on German Economic, Monetary and Social Union (GEMSU) signed on 18<sup>th</sup> May 1990 and it officially came into force on the 1<sup>st</sup> July 1990. The works for preparing the treaty had begun already since February 1990, but they speeded in April, after the free Volkskammer elections in the GDR and after the new government was operative.<sup>244</sup> The second was the political one, the Unification Treaty signed on the 31<sup>st</sup> August 1990.<sup>245</sup>

Moreover, on the 22<sup>nd</sup> August 1990 the GDR Volkskammer approved the bill that allowed the re-enactment of the former five German Länder: Brandenburg, Saxony, Saxony-Anhalt, Mecklenburg-West Pomerania, Thuringia. Thanks to this strategy, the Article 23 could be applied in order to complete the accession of the GDR Länder into FRG. The day after, it approved the bill for the accession of the GDR into the FRG. The official day of the accession was scheduled on 3<sup>rd</sup> October 1990,<sup>246</sup>

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<sup>241</sup> Giacchè, *Anschluss, l'Annessione*, cit., p. 72.

<sup>242</sup> Ritter, *The Price of the German Unity*, cit., pp. 54-56.

<sup>243</sup> *Ibidem*.

<sup>244</sup> Giacchè, *Anschluss, l'Annessione*, cit., p. 51.

<sup>245</sup> Thomaneck, Niven, *Dividing and Uniting Germany*, cit., p. 66.

<sup>246</sup> Rödder, *Geschichte der Deutschen Wiedervereinigung*, p. 90.

which was celebrated in Berlin (Figure 3 below). The Volkskammer of East Germany met for the last time the previous day, 2<sup>nd</sup> October.

The first united German elections were scheduled on the 1<sup>st</sup> December 1990 and gave the majority to the CDU-CSU coalition with 43,8% of the votes, re-confirming Helmut Kohl as Chancellor of the Bundesrepublik Deutschlands.<sup>247</sup> Many critics argue that the SPD results were the worst since 1957.<sup>248</sup>



Figure 3: Reunification celebration on 3rd October 1990, Berlin, Spiegel Online, <http://www.spiegel.de/politik/ausland/bild-719608-17505.html>, consulted on January 2014.

## The GEMSU and the Monetary Union

The State Treaty between the FRG and the GDR on the creation of a Monetary, Economic and Social Union (GEMSU) is the first of two most important treaties for the fulfilment of the German Unification. As mentioned above, the Treaty came into force the 1<sup>st</sup> July 1990. The costs and the consequences of such shock economic unification will be discussed later, but a point must be taken into account now. Some

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<sup>247</sup> Thomaneck, Niven, *Dividing and Uniting Germany*, cit., p. 67.

<sup>248</sup> *Ibidem*.

authors pointed out that the monetary, economic and social unification, which was being attempted and implemented in Germany, had no historical precedent.<sup>249</sup> Moreover, many politicians complained that there was lack of information from the East to foresee the possible consequences, although many others did not agree with this position completely. Hence, criticism is generally directed towards the neglect of the consequences of such a rapid and massive change in the GDR.<sup>250</sup>

Before looking at the economic conditions and consequences of the treaty, consider the treaty itself.

The aim of the State Treaty was to transform the GDR planned economy into the *social market economy* of the FRG by extending its principles and instruments to the East. The treaty would come into force from the 1<sup>st</sup> July 1990 and it would build a monetary union between the FRG and the GDR with the Deutsche Mark (DM) as currency and the Deutsche Bundesbank as central bank. The economic system adopted would be the so-called *social market economy* of Adenauer.<sup>251</sup>

This economic system was different from the complete free market system. In fact, it comprised a “dense system of laws, regulations and associated institutions, which not only provides the framework within which competitive markets operate, but is designed also to impose social responsibility on the market.”<sup>252</sup>

Article 2 lists the principles that the contracting parties, in particular the GDR, would follow, for example freedom of contract, freedom to exercise trade, freedom of movement of German people in the entire currency area and freedom of association in the defence of the working conditions.<sup>253</sup>

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<sup>249</sup> Lange Thomas, Pugh Geoffrey, *The economics of German Unification: an Introduction*, Northampton, Edward Elgar Pub., 1998, p. 8.

<sup>250</sup> *Ibidem*.

<sup>251</sup> Bundesministerium der Justiz, Gesetz zu dem Vertrag vom 18. Mai 1990 über die Schaffung einer Währungs-, Wirtschafts- und Sozialunion zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik, [http://www.gesetze-im-internet.de/wwsug/index.html#BJNR205189990BJNE00290\\_0328](http://www.gesetze-im-internet.de/wwsug/index.html#BJNR205189990BJNE00290_0328), consulted on January 2014, Art. 1.

<sup>252</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 5.

<sup>253</sup> Bundesministerium der Justiz, Gesetz zu dem Vertrag vom 18. Mai 1990 über die Schaffung einer Währungs-, Wirtschafts- und Sozialunion zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik, [http://www.gesetze-im-internet.de/wwsug/index.html#BJNR205189990BJNE00290\\_0328](http://www.gesetze-im-internet.de/wwsug/index.html#BJNR205189990BJNE00290_0328), consulted on January 2014, Art.2.

Interestingly, Article 10 defines the prerequisites of the economic system, which are underlined further in the next article: “The Contracting Parties shall therefore choose conversion modalities which do not cause any inflationary tendencies in the entire area of the monetary union and which at the same time increase the competitiveness of enterprises in the German Democratic Republic.”<sup>254</sup> In Chapter III the Treaty deals with the provisions concerning the economic union, for instance intra-German trade, foreign trade and payments, agriculture, industry and the environment. The object of these articles was to provide the instruments and allow adjustments of the GDR to the new economic and trade regulations.<sup>255</sup>

The Treaty continued with the provisions concerning the social union and it comprised the introduction of new principles in various social fields. Some of them are in the labour law, such as freedom of association or autonomy in collective bargaining; in the social insurance, unemployment insurance and employment promotion, in the health insurance, accident insurance and social assistance. All was to be done in line with the law of the FRG and adapt to it.<sup>256</sup>

The fifth Chapter of the treaty dealt with the budget and finance of the GDR. In particular the budgeting system of the GDR was to be adapted to the market economy and the structure of the FRG. Moreover, “State undertaking” were to be converted into “legally and economically independent enterprises.”<sup>257</sup> The GDR should also limit the deficits abolishing budget subsidies for industrial goods, agricultural products, transport, housing and energy. Part of these areas were administered by the European Community regulations.<sup>258</sup>

Article 27 established a limit to the GDR borrowing: 10 billion DM in 1990 and 14 billion DM in 1991. It also specified that debts in GDR budget would be repaid with the selling of GDR assets by means of a trust.<sup>259</sup> The following article takes into

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<sup>254</sup> *Ivi*, Art. 10.

<sup>255</sup> *Ibidem*.

<sup>256</sup> *Ivi*, Art. 17-25.

<sup>257</sup> *Ivi*, Art. 26.

<sup>258</sup> *Ivi*, Art. 26.

<sup>259</sup> *Ivi*, Art. 27.

account the money transfer to the GDR in order to balance its budget. They amount to 22 billion DM for 1990 and 35 billion DM for 1991.<sup>260</sup>

Most importantly, the final part of the treaty deals with the relations within the EC, for instance “the German Democratic Republic shall adopt step by step the customs law of the European Communities, including the Common Customs Tariff, and [...]”<sup>261</sup>

From this brief overview of the GEMSU, it might be clear that there was no compromise between the FRG and the GDR. In fact, the central planned economy had to be completely abolished and new basic rules and institutions had to be established in the East.<sup>262</sup> However, the general principles listed in the GEMSU did not provide the solution to several problems. They identified the direction, the social market economy, but did not define how to implement the rules specifically, which was left mainly to political disputes rather than economic studies and experts. This might be said for the privatisation process, which was being allowed in the GDR, the amount of fiscal transfer or the wage policy.<sup>263</sup>

A crucial issue of the State Treaty was namely the currency conversion in the GDR. It was stated that, no historical precedent of such a process was identified. Nevertheless, historically speaking many critics and politicians did compare the 1990 monetary unification with the 1948 monetary reform. The latter had been implemented by the Allied powers soon after the end of the WWII and settlement of the first land control disputes. It was generally seen as one of the reasons that triggered the economic miracle of the 1950s in West German. Hence, especially politicians were convinced of the future success of such a rapid policy, as it was underlined in the New York Times article “Economic Scene” by Leonard Silk in February 1990, at the beginning of the several negotiations towards the formulation of the State Treaty: “The best precedent for such a union was the currency reform of

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<sup>260</sup> *Ibidem*.

<sup>261</sup> *Ivi*, Art. 30.

<sup>262</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 2.

<sup>263</sup> *Ivi*, pp. 4-5.

1948, which set West Germany on its course toward becoming the most powerful economy in Europe."<sup>264</sup>

During the elections campaign in March 1990 there were two different approaches to currency conversion. First of all, the Bundesbank, the Federal Finance Minister and the Federal Economics Ministry promoted the 2:1 (2 Ostmark for 1 Deutsche Mark) conversion rate for saving accounts, debts, cash holdings measuring more than 2000 Ostmarks, wages and pensions.<sup>265</sup>

On the contrary, the Federal Union of German Employers' Association preferred a 1:1 rate for pensions while levelling with the FRG ones. Moreover, all GDR parties were sustaining the 1:1 rate for cash holdings and wages. The trade unions supported the conversion of wages, pensions and part of savings at 1:1 rate. The West German CDU agreed with the 1:1 conversion rate for smaller accounts but did not specify regarding to wages and pensions.<sup>266</sup> As it might be already understood, the Federal Chancellor advocated the 1:1 conversion rate and worked hard during the elections campaign in order to overcome critics and different minds. At the same time, demonstrations in the Federal Republic rapidly spread against a conversion rate of 1:1. As explained in various interviews and in particular in a Special article in the New York Times, the President of the Bundesbank Karl Otto Pöhl "believes that rate could push West German interest rates and inflation sharply higher and [it] is not based on any economic reasoning."<sup>267</sup>

Moreover:

"The one-to-one rate came in the first place from West German politicians, without it being substantiated in any way," he said.

"I regret that our proposals came out in public as they have. They were not made public by the Bundesbank. The suggestions are very differentiated and very complex. It's not a matter that can be summed up in one sentence."<sup>268</sup>

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<sup>264</sup> Silk Leonard, "Economic Scene; German Options on Money Union", The New York Times, 23 February 1990, <http://www.nytimes.com/1990/02/23/business/economic-scene-german-options-on-money-union.html>.

<sup>265</sup> Ritter, *The Price of the German Unity*, cit., p. 152.

<sup>266</sup> *Ivi*, p. 153.

<sup>267</sup> Ferdinand Protzman, "Pöhl Defends His Plan For Mark Conversion", The New York Times, 19 April 1990, <http://www.nytimes.com/1990/04/20/business/pohl-defends-his-plan-for-mark-conversion.html>.

<sup>268</sup> *Ibidem*.

Finally, the two governments achieved a compromise the 2<sup>nd</sup> May 1990.<sup>269</sup>

Consequently, specific rules were applied to conversion rates according to the type of asset that was converted and its amount. Generally speaking the Bundesbank and the government decided for a 1:1 conversion rate with a maximum of 2,000 Ostmarks for people under the age of 15, a maximum of 4,000 for people under the age of 60 and 6,000 for people over 59 years of age.<sup>270</sup> The amounts of cash over these limits were converted at a rate of 2:1. These were making part of the cash holdings' and people savings' conversion rate. Besides, it was decided that even wages, retiring pensions and housing rents were to be converted at a rate of 1:1.<sup>271</sup>

On the other hand, most of the remainder of monetary holdings, such as credits and liabilities<sup>272</sup> of enterprises and individuals (financial claims) and debts were converted at a rate of 2:1. Namely, these latter included firms' debts and housing loans. All the claims coming from individuals living outside the GDR were converted at a rate of 3:1. Overall, it was calculated that the final average conversion rate was 1.81:1.<sup>273</sup>

Practically, the wealth of the GDR people' private accounts was transformed from 193.4 billion Ostmarks into 129.1 billion DM, therefore with the amount of 64.3 billion DM lost in transition.<sup>274</sup> Other authors give slightly different figures, for instance H.W. Sinn identified in 1991 household losses for around 62 billion DM, that was 3,765 DM per person. In the author' opinion the result of individual losses was due to the Bundesbank failure in managing real assets overhang, without forgetting the success of managing the money overhang (typical problem coming from centrally planned economies, since people are not able to spend all the money) by means of

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<sup>269</sup> Ritter, *The Price of the German Unity*, cit., p. 153.

<sup>270</sup> Sinn Gerlinde, Sinn Hans-Werner, *Jumpstart: the economic unification of Germany*, London, MIT Press, 1992, p. 51.

<sup>271</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., p. 36.

<sup>272</sup> "A company's legal debts or obligations that arise during the course of business operations. [...] Recorded on the balance sheet (right side), liabilities include loans, accounts payable, mortgages, deferred revenues and accrued expenses." Investopedia Dictionary USA, Liability, <http://www.investopedia.com/terms/l/liability.asp>, updated in 2013, consulted in February 2014.

<sup>273</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., p. 36.

<sup>274</sup> Giacchè, *Anschluss, l'Anessione*, cit., p. 56.

currency conversion.<sup>275</sup> Here below the possible exchange rates identified by the main authorities. It is now clear the reason why there was not a unique conversion rate between the Ostmark and the DM.

*The Exchange Rates Required to Maintain the Purchasing Power of East German Financial Wealth*

Bundesbank <sup>1</sup>	100 Eastmark = 107 DM	pre-unification basket
DIW <sup>2</sup>	100 Eastmark = 120 DM	expected post-unification basket
DIW <sup>3</sup>	100 Eastmark = 128 DM	actual price change in East Berlin from January to July 1990, pre-unification basket
Joint office of statistics <sup>4</sup>	100 Eastmark = 98 DM	actual price change, October 1990 compared to average 1989, pre-unification basket
Ifo <sup>5</sup>	100 Eastmark = 98 DM	expected price change, pre-unification basket

<sup>1</sup>Unofficial estimate, as reported by K. Kehler, member of the directorate of Deutsche Bundesbank, in his lecture to the Department of Economics, University of Munich, May 5<sup>th</sup>, 1990.

<sup>2</sup>DIW, Wochenbericht 21/90, 25 May 1990, p. 294.

<sup>3</sup>DIW, Wochenbericht 32/90, 9 August 1990, p. 446-450.

<sup>4</sup>Gemeinsames Statistisches Amt, Preisindex für die Lebenshaltung, November 1990. The equation was 100 Eastmarks = 94 DM in July 1990 which is equivalent to a 16 % annual inflation rate in the East.

<sup>5</sup>Ifo Schnelldienst 43, 13/90, 7 May 1990, p. 24-26.

Table 1: Sinn Hans-Werner, *Macroeconomic aspects of German Unification: NBER Working Paper No. 3596*, Cambridge, NBER, January 1991, p. 16.

However, the compromise reached for the exchange rate was seen “overly favourable” by the international press. Besides, it was commonly feared that “the conversion would boost commodity prices and erode the value of the Deutschmark.”<sup>276</sup>

As far as debt was concerned, the discussion about at which rate debts of GDR firms should have been converted was extremely relevant. The Bundesbank President, Otto Pöhl, insisted with Kohl on a conversion rate of 2:1:

A rate of 1:1, the GDR's debt burden, standing at 34,000 million Marks, would also have to be paid off to foreign creditors in DM and the debts of enterprises and combines owed to the GDR national banks, at 260,000 million Marks, would result in annual interest payments of 20,000 million DM. Many East German enterprises would therefore go bankrupt.<sup>277</sup>

<sup>275</sup> Sinn Hans-Werner, *Macroeconomic aspects of German Unification: NBER Working Paper No. 3596*, Cambridge, NBER, January 1991, p. 22.

<sup>276</sup> *Ivi*, p. 14.

<sup>277</sup> Ritter, *The Price of the German Unity*, cit., p. 154.

The agreed debt conversion rate also resulted too optimistic, as GDR enterprises were still in danger of survival and burdened with debts.<sup>278</sup>

When considering the exchange rate, some issues regarding the GDR might be highlighted. As already said in the chapter on the GDR, the East German Mark was not internationally convertible. However, the trade between GDR and the FRG occurred by means of a coefficient that measured the real value of the two currencies. Other coefficients were used for other currencies, mainly the dollar. In 1988, according to this coefficient exchange rate method, one DM was exchanged with 4.4 Ostmarks.<sup>279</sup> When considering the black market, in 1990 the exchange rate amounted at 7:1 or higher.<sup>280</sup>

Gerlinde Sinn and Hans-Werner Sinn identified three aims for implementing the agreed conversion strategy. First of all, such a currency conversion was thought to produce the right amount of liquidity in the East German economy. Second, the conversion of financial claims was supposed to provide some capital asset for the East German people. Third, the wage conversion aimed at the establishment of competitiveness within the all-German firms.<sup>281</sup>

Many politicians had thought that the consequences of the currency unification would be gains for East Germany, while others foresaw a huge raise of the inflation. However, Sinn and Sinn pointed out that this did not occur as foreseen, and, moreover, it was due to neglecting “the values of the East and West currencies in purchasing power terms.”<sup>282</sup>

The authors continued stating that some economists and politicians had foreseen large economic developments for the Eastern Länder with the agreed 1:1 exchange rate, as it was thought to have promising effects when compared to the black market exchange rate. However, these presumptions were made without taking into consideration the political and economic speculations

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<sup>278</sup> *Ibidem*

<sup>279</sup> Giacchè, *Anschluss, l'Annessione*, cit., p. 57.

<sup>280</sup> Sinn, Sinn, *Jumpstart*, cit., p. 52.

<sup>281</sup> *Ibidem*.

<sup>282</sup> *Ivi*, p. 53.

behind the black market exchange rates. Moreover, there were many obstacles when trying to compare purchasing power parities of East and West German currencies.<sup>283</sup> In the words of Sinn and Sinn “the main reason for the mistake [large Eastern economic boom] was that nobody really knew what the values of the East and West German currencies were in terms of their relative purchasing powers.”<sup>284</sup> Firstly, Sinn and Sinn pointed out the extremely different basket of goods consumed, which made it difficult any comparisons.

Here additional explanations are needed. The *Purchasing Power Parities* stem from the PPP hypothesis<sup>285</sup> and they refer to, in OECD words, “the rates of currency conversion that equalize the purchasing power of different currencies by eliminating the differences in price levels between countries.”<sup>286</sup> For the purpose of this work, it suffice to say that the calculation of the PPPs occurs usually taking into account the so-called *basket of goods*. These are products chosen because they are present in the two or more different markets where the exchange rate is needed to be calculated (as they involve the presence of relative prices of the said products).<sup>287</sup> The effect of the relative price effect is “if the baskets of other countries are chosen, then, in general, a rather low PPP value of the deutschmark should be found.”<sup>288</sup> One reason might be found in the Eastern subsidization of certain products. As it was already said in another chapter, subsidies of central planned economies had generally mislead the empirical analysis. Other difficulties in doing comparisons are the availability of goods, which are strictly related to people waiting in lines to receive goods and the speed of East German prices adjustment to West German prices after unification.<sup>289</sup>

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<sup>283</sup> *Ivi*, pp. 52-53.

<sup>284</sup> *Ibidem*.

<sup>285</sup> “The nominal exchange rate will adjust so that the purchasing power of a currency will be the same in every country” in Reinert Kenneth A., *An Introduction to International Economics: New Perspectives on the World Economy*, Cambridge University Press, New York, 2012, p. 223.

<sup>286</sup> OECD, Prices and purchasing power parities (PPP), <http://www.oecd.org/std/prices-ppp/purchasingpower-parities-frequentlyaskedquestionsfags.htm>, consulted on February 2014

<sup>287</sup> Reinert, *An Introduction to International Economics*, cit., p. 223.

<sup>288</sup> Sinn Hans-Werner, *International implications of German Unification: NBER Working Paper No. 5839*, Cambridge, NBER, November 1996, p. 16.

<sup>289</sup> *Ivi*, p. 54.

Having taken into consideration various sources of statistical data and all the problems connected to comparison, the two authors continue assuming that there was not much support to the idea, that the purchasing power of the Ostmark was well below of that of the DM. They continued stating that, from the point of view of East Germans, the purchasing powers of the two currencies were the same or at least, if there was any difference, it was in favour of the Ostmark.<sup>290</sup>

This might be in conflict with the familiar presumption, in which GDR citizens give more value to the DM rather than their own currency. But it must be remembered that data and the comparisons derived from them were made and collected when the DM was scarce and it was the only way to obtain West craved goods.<sup>291</sup> This latter fact was clear to economists and politicians soon after the fall of the Berlin Wall, when East Berliners invaded West Berlin shops looking for Western goods. A theory that Sinn and Sinn regard as paradox of value.<sup>292</sup>

Other authors, such as Vladimiro Giacchè and his quoted sources Ulrich Busch in Bahrmann and Links<sup>293</sup>, explain the paradox in a very similar way, taking into consideration the high purchasing power inside the GDR with a limited basket of goods and its purchasing power regarding the international western markets.<sup>294</sup>

In addition to the previous comparison problems, other types of difficulties arose from the implementation of the GEMSU. Namely, the economic priority of competitiveness with regard to trade and enterprises viability. With the GDR opening to the Western markets and with the difference

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<sup>290</sup> *Ibidem*.

<sup>291</sup> *Ivi*, p.58.

<sup>292</sup> "The paradox of value tries to explain why particular goods (or services) that are very important to human survivability tends to have lower prices, relative to those seen as luxury products. Value or prices are not determined by total but marginal utility." Business Dictionary, USA, Paradox of Value, <http://www.businessdictionary.com/definition/paradox-of-value.html>, updated 2014, consulted on January 2014.

<sup>293</sup> Busch Ulrich, "Die Währungsunion: Politische Weichenstellung für einen ökonomischen Fehlstart" in Bahrmann Hannes, Links Christoph (ed.), *Am Ziel vorbei. Die deutsche Einheit – Eine Zwischenbilanz*, Berlin, Ch. Links, 2005, p. 89.

<sup>294</sup> Giacchè, *Anschluss, l'Annessione*, cit., p. 60.

in price levels emerging, East Germany had begun to face the competitiveness of Western enterprises and goods, not only with the FRG but also with the whole European Community and the world.<sup>295</sup> Generally speaking, many East German products, which were consumed before the fall of the Berlin Wall, were no longer sold in Eastern markets because people preferred the Western better-developed goods.<sup>296</sup>

This did not apply only to agriculture or food related goods (one might think about the German film *Goodbye Lenin*, in which the main character attempts to recover the East Spreewaldgurken in a supermarket but the typical GDR products are no longer sold) but also to the industrial sector. For instance, the East German automobile industry sector incorporated all competitiveness, employment and even investment difficulties. A clear and typical example is the Trabant automobile industry. With the unification of the two Germanies and the opening of Western market, the demand for Trabant automobiles dropped rapidly triggering, therefore, a raise in unemployment.<sup>297</sup> In March 1990, the West German automobile industry, Volkswagen, promoted the establishment of a joint venture with Trabant in East Germany, in order to enhance the production of very popular basic VW autos. However, the production would not have taken place before 1993, with consequent continued loss of jobs in the East German automobile industry.<sup>298</sup> In April 1990, the industrial production was 97.6% of April 1989, but in July 1990 the industrial production sunk to 56.3% of the same month in the previous year. In August 1990, data had revealed that the industrial production reached 48.1% of August 1989.<sup>299</sup>

This is only one example of the impact of the monetary reforms that were being implemented in Germany. Moreover, it is essential to consider also the impacts and consequences on prices and wages in the new Bundesländer.

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<sup>295</sup> Harris, Chauncy Dennison, "Unification of Germany in 1990", *Geographical Review*, (1991), 2, p. 175

<sup>296</sup> *Ibidem*.

<sup>297</sup> *Ivi*, p. 176.

<sup>298</sup> *Ibidem*.

<sup>299</sup> Giacchè, *Anschluss, l'Annessione*, cit., p. 65.

As stated above, one of the main objectives of the currency union was to give a competitive edge to GDR wages while reducing the incentives to migrate to the West. This meant that the East German wages should have to be kept at a low level, in order to boost competitiveness not only in the labour market but also in the enterprises, while, at the same time, granting wages at an adequate height to reduce and stop migration.<sup>300</sup> According to H.W. Sinn and other authors, “the nominal level of East German wages was one-third of that of West Germany [...]”<sup>301</sup> and the productivity in the GDR was assumed to be within one-third and one-half of the West German productivity.

Taking into consideration that the *unit labour cost* is “the ratio of total labour costs to real output,”<sup>302</sup> therefore, with a conversion rate of 1:1, it was thought that the unit labour costs in East Germany would have been slightly lower or equal to the ones in West Germany. However, only afterwards it was realised that the wage levels were too high and the East German industry productivity was lower than the assumed one-third.<sup>303</sup>

In addition, the State Treaty opened East German enterprises to the West German free trade economy in a “sudden and immense shock,”<sup>304</sup> because the former GDR producers did not have a satisfactory experience to compete with West German levels. Furthermore, the monetary union manoeuvres triggered a rise in prices between 300-400% and since the two currencies did not exist anymore, there was no possibility for East Germany to adjust prices to increase competitiveness.<sup>305</sup>

Not to forget was also the influence of East German trade unions, as they aggressively presented a wage policy that pushed wages to raise continuously. In the second semester of 1990 the East German wages grew between 25 and 60%. Meanwhile productivity in the East could not raise as fast,

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<sup>300</sup> Sinn, Sinn, *Jumpstart*, cit., p. 62.

<sup>301</sup> *Ivi*, p. 63.

<sup>302</sup> OECD, Glossary of Statistical Terms: Unit Labour Cost, <http://stats.oecd.org/glossary/detail.asp?ID=2809>, last updated July 2007, consulted in February 20014.

<sup>303</sup> Sinn, Sinn, *Jumpstart*, cit., p. 63.

<sup>304</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 57.

<sup>305</sup> *Ibidem*.

therefore it triggered widespread bankruptcies and unemployment.<sup>306</sup> Trade unions were trying to contribute to the diminishing of Westward migrations, on the contrary supporting a rapid wage increase they supported a more rapid decline of the East German economy.

### **The Unification Treaty**

The Treaty between the Federal Republic of Germany and the German Democratic Republic on the Establishment of German Unity, more simply called Unification Treaty (*Einigungsvertrag* in German) was signed on the 31<sup>st</sup> August 1990 by the two parties, the FRG and the GDR. The authorities appointed to negotiate the Treaty were guided by the Federal Minister of the Interior, Wolfgang Schäuble, for the FRG, and by Günther Krause, the leader of GDR delegates. Negotiations begun in east Berlin in July 1990 and went on until the official signing date. A further meeting was organised in September due to new difficulties, which was concluded with the signing of an agreement the same month.<sup>307</sup>

The Unification Treaty was composed of 45 Articles, several annexes and memorandums for more than 260 printed pages.<sup>308</sup>

As the name indicated, the aim of the Treaty was the fusion of the two separated German states, which occurred by means of the Article 23 of the FRG Basic Law. The basic model underneath the Unification Treaty is very similar to the one used for the GEMSU, since it implied the extension of the laws and regulations of the FRG to East Germany. Moreover, the GDR regulations were to be abolished and modernised while establishing a transitional period that stretched until 1995.<sup>309</sup> The annexes to the main body of the Treaty played a crucial role, because they regulated specific East German institutions and planned their modernisation and adjustment to Western standards, for instance the privatisations of GDR cultural institutes.<sup>310</sup>

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<sup>306</sup> Sinn, Sinn, *Jumpstart*, cit., p. 64.

<sup>307</sup> Ritter, *The Price of the German Unity*, cit., p. 184.

<sup>308</sup> Collotti Enzo, *Dalle due Germanie alla Germania Unita*, Torino, Einaudi, 1992, p. 290.

<sup>309</sup> *Ibidem*.

<sup>310</sup> *Ibidem*.

The very first chapter dealt with the effects of accession, in particular it described which new Länder were becoming part of the FRG and dealt with the choice of the capital. The Article 2 stated, “The capital of Germany shall be Berlin. The seat of the Parliament and the Government shall be decided after the establishment of the German Unity.”<sup>311</sup> This article did not overcome discussions about the precise place where to settle the Federal administration offices, but it just postponed the decision after the completion of the Unification process. In addition, some of the West German CSU and part of the Bavarian government did not agree with the intention of moving the leading offices to Berlin, as Bonn had become the symbol of 40 years of “good federalism.”<sup>312</sup>

The second chapter of the Treaty involved its relationship with the German Basic Law. Therefore, Article 3 announced the extension of the Basic Law to the new Bundesländer and the next article listed specific amendments to it. In addition, one of the most important provisions of this part was the withdrawal of Article 23 of the Basic Law, the article through which the Unification process was being implemented. It was repealed since its aim was finally fulfilled and its elimination was crucial for overcoming possible future claims on public lands and German borders.<sup>313</sup> Particularly interesting was the amendment to the Article 146 of the Basic Law, which stated that the Basic Law would cease its function when a new constitution was adopted and accepted by the German people.<sup>314</sup>

Article 7 dealt with the access of the GDR to the West German financial system and its modernisation. At the fifth paragraph, it established the German Unity Fund to give special assistance to the new regions and how the Funds’ resources should be administered within the Länder. Furthermore, the next paragraph provided the basis for further aids with the objective to level the financial conditions overall.<sup>315</sup>

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<sup>311</sup> Press and Information of the Federal Government, *The Unification of Germany in 1990- A Documentation*, Press ad Information of the Federal Government, Bonn, 1991, Art. 2.

<sup>312</sup> Collotti, *Dalle due Germanie alla Germania Unita*, cit., p. 292.

<sup>313</sup> *Ivi*, p. 291.

<sup>314</sup> Press and Information of the Federal Government, *The Unification of Germany in 1990*, cit., Art. 4, par. 6.

<sup>315</sup> *Ivi*, Art. 7.

In chapter 3, the Treaty asserted the continued validity of the Law in the GDR, provided that it was compatible with the FRG Basic Law and the Law of the European Communities. Meanwhile, the following chapter took into account the future of GDR international Treaties and Agreements. These would be examined carefully in order to grant their compatibility with the Law of the FRG.<sup>316</sup>

The fifth chapter involved the organisation of the public and justice administration. This would occur, as for the other regulations just seen, with the adjustment of GDR institutions and rules to the ones of FRG, for example, each new Land had to control the administration of justice duties.<sup>317</sup> Chapter 6 took into consideration the sphere of public assets and debts and it defined how the financial, administrative, Deutsche Post or Deutsche Reichsbahn assets and various debts were to be administered and how problems arising from this situation might be solved. One of the most important regulations of this part is the Article 23, since it was establishing a Special Fund to raise loans and pay debts stemming from East Germany. The Special Fund was meant to cease its function in 1993. A further essential article for German economy was Article 25, which referred to the Privatization and Reorganisation of Publicly Owned Assets Act (Trusteeship Act) of 17 June 1990 or normally known as *Treuhandanstalt*.<sup>318</sup>

In addition, it is interesting to notice how the Treaty differentiated the expropriation periods in the scope of future restitution or compensation. It distinguished the periods 1945-1949 and from 1949 on to the dismantling of the GDR. A further law of the Bundestag was issued later, the “Law for the Settlement for the unresolved Propriety Questions” that dealt with the 1933-1945 period. Firmly supported by the United States, it took into account the ideological expropriations that had occurred during the fascist regime, specifically proprieties taken from Jews.<sup>319</sup> The privatization issues and problems will be discussed in detail in the next section.

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<sup>316</sup> *Ivi*, Art. 12.

<sup>317</sup> *Ivi*, Art. 13.

<sup>318</sup> *Ivi*, Art. 25.

<sup>319</sup> Sinn, Sinn, *Jumpstart*, cit., p. 90.

The chapter 7 of the Unification Treaty regarded the various adjustments of labour, social welfare, family, health and environment spheres. For instance, the issue of environmental protection policies applied to the GDR was widely considered fundamental, since East Germany was known not to have particular interest in environmental issues. Moreover, a very controversial discussion arose from different approaches concerning abortion policies in GDR and the FRG, but essentially concerning how to harmonize different views correctly.<sup>320</sup> Further detail will be given on the Social Welfare in a subsequent section.

In the following chapter, the Treaty dealt with the cultural, science and education spheres. Article 35 firmly underlined the importance of German cultural roots for achieving the Unification successfully, despite the 40 years separation. A special fund called Cultural Fund was established to promote arts and culture in the new Länder.<sup>321</sup> In the field of education and research, the articles emphasised the relevance of mutual recognition of examination certificates, specific competent agencies, proven research methods and programmes within the scope of the Unification process.

The concluding chapter attracts the attention to the transitional and final provisions, such as the obligations stemming from the GEMSU or the necessity for the East German Volkskammer to choose 144 delegates (plus reserves) to be part of the 11<sup>th</sup> German Bundestag.<sup>322</sup> This remained only a partial accession to the Bundestag, since the GDR delegation was doomed to be overcome on the day of the Treaty's entrance into force.<sup>323</sup>

The most important and difficult problem preparing the negotiations of the Treaty regarded the speed of the law integration in the GDR. There were, in fact, two different positions about it: the first one was supported by Schäuble and it saw the maintenance of the GDR law into force while applying the FRG law to some exceptions. On the other hand, the Federal Ministry of Justice, the Federal Minister

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<sup>320</sup> *Ivi*, Art. 30-34.

<sup>321</sup> Press and Information of the Federal Government, *The Unification of Germany in 1990*, cit., Art. 35.

<sup>322</sup> *Ivi*, Art. 42.

<sup>323</sup> Collotti, *Dalle due Germanie alla Germania Unita*, cit., p. 292.

of Labour, Norbert Blüm, and many other ministers and employers promoted the rapid extension of the FRG law applying the GDR law to some exceptions.<sup>324</sup> The advocates of the second approach were convinced that the preparation of a temporary and transitional law for the GDR area would take too much time. In addition, in the political context it might become a symbol to the people of the modernisation and organisation of new social structures.<sup>325</sup>

To mention is also the crisis occurred in the second half of August 1990 as some heads of the Social Democrats in the new Länder asked some modification to the draft treaty. They were struggling between the methods of compensation and restitution for boosting investment, asking for more financial aids and not to impose compulsory dismantlement of public service to the Länder. Moreover, the SPD was concerned about the condition of former GDR agriculture, in particular within the European Community. At the end of August some compromises were found, hence the Unification Treaty was ready to be signed.<sup>326</sup>

Now, consider in detail the regulations and economic manoeuvres that were applied to achieve the re-unification. First, privatisations and the actions Treuhandanstalt will be taken into account. Secondly, social policy and the welfare. Thirdly, the roles of the Bundesbank and the government will be analysed in the scope of their decision-making and international acceptance. Finally, a brief investigation on the public budget efforts and debts.

### **Privatizations, the Treuhand and Trade**

The first chapter had already dealt with the economic conditions of the GDR, specifically with the nationalisations, expropriations and the complete transformation of the enterprises soon after the end of WWII. The trade of East Germany was mainly directed towards the COMECON countries and especially

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<sup>324</sup> Ritter, *The Price of the German Unity*, cit., p. 185.

<sup>325</sup> *Ibidem*.

<sup>326</sup> *Ivi*, p. 200.

towards the Soviet Union, which was estimated to absorb between 36 and 39% of GDR exports. The GDR, namely, traded in high value industrial products, which were well welcomed in the East as a way to acquire Western higher technological goods. In turn, the Soviet Union sufficed the GDR with raw materials and energy, which amounted to 10-12% of the USSR total trade relations.<sup>327</sup>

As the unification process developed, the USSR became more worried about the destiny of their trade relations. Precisely, Gorbachev was preoccupied with the implementation of his reforms at home. Therefore, already in April 1990 the Soviets asked guarantees for the fulfilment of GDR economic commitments and respect to the treaties, even with the FRG assistance when needed.<sup>328</sup> These demands were included in the State Treaty (GEMSU), even if “[...] it was ultimately no more than a non-binding assurance and a gesture of good will,”<sup>329</sup> as many critics had pointed out. In addition, the economic situation in the Soviet Union was deteriorating fast, when in August 1990 data showed the increase of GDR exports to the USSR and decline in imports from USSR.<sup>330</sup> Gorbachev was expecting an increase in trade with a united Germany, but the situations was developing in another direction.

In contrast to trade trends, the Federal Republic of Germany was interested in continuing trade relations with the East, especially because of their will to expand to the new markets. This is only one of the reasons why in the first half of 1990 the FRG provided the GDR’s enterprises with 5,000 million DM of aids to exports.<sup>331</sup> Moreover, as a result of the Soviet-German relations, an agreement was found in November 1990 with the ‘Treaty to develop comprehensive cooperation in the areas of economics, industry, science and technology’. The Treaty implied a non-binding commitment to develop the already working measures towards smoother trade with the Soviet Union, even within the framework of the European Community markets,

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<sup>327</sup> Ritter, *The Price of the German Unity*, cit., p. 78.

<sup>328</sup> *Ibidem*.

<sup>329</sup> *Ibidem*.

<sup>330</sup> *Ivi*, p. 79.

<sup>331</sup> *Ibidem*.

and a commitment to continue the distribution of the subsidies to exports in a limited amount.<sup>332</sup>

At the eve of the unification, a pressing problem was the privatisation issue. In the history of Germany, privatizations had left the fear of destructions and war, as it had occurred in 17<sup>th</sup> Century during a religious war when private proprieties were to be returned to the public forces, in this case, the Church. Such consequences were not to be feared in 1990, also because it dealt with public assets to be re-distributed to private individuals or enterprises.<sup>333</sup>

Nevertheless, the privatisation issue was one of the most controversial ones in the scope of the united Germany. Without privatisation, there is no impulse to capital formation and investments. Namely, investments and, more generally speaking, commitments were not particularly attracted by the new Bundesländer' economic and legal conditions.<sup>334</sup> Economic and legal conditions were essential to the development and implementation of a market economy in the GDR.

The first version of the Treuhandanstalt was instituted in March 1990, eventually before the beginning of the various inter-German and international negotiations, but the first plans had already come to mind in February of the same year. The plan for the establishment of such an institution emerged when it became clear that the merge of the two German states would have been inevitable.<sup>335</sup>

At the beginning, discussions regarding the future of the East German public proprieties did not meet the agreement of the Western parts, since there was no equivalent of Eastern Kombinate or public proprieties of such sizes in the FRG. To solve this problem, a trust authority for the protection of people assets was proposed. The plan was to group all the public proprieties within the legal form of a company. Its aim would be to distribute properties certificates to East German citizens that provide each one with part of the GDR public property.<sup>336</sup> The beginning

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<sup>332</sup> Ivi, p. 80.

<sup>333</sup> Sinn, Sinn, *Jumpstart*, cit., p. 81.

<sup>334</sup> Siebert Horst, Burda Michael, Obstfeld Maurice, "German Unification: The Economics of Transition", *Economic Policy*, (1991), 12, p. 291.

<sup>335</sup> Giacchè, *Anschluss, l'Annessione*, cit., pp. 76-77.

<sup>336</sup> Ivi, p. 78.

of the emissions of the properties' certificates was planned to be on the same day of the GDR Volkskammer elections, 18<sup>th</sup> March 1990, in order to symbolise the transmission of public estate to private owners.<sup>337</sup> The proposal became official on the 12<sup>th</sup> February when it was explained publicly. The 1<sup>st</sup> March the Modrow government established the Trust Agency or Treuhandanstalt by law, while proclaiming the transformation of public owned enterprise into private limited companies. The Treuhand would own these limited companies and the Parliament would control the actions needed to be undertaken.<sup>338</sup>

To be underlined were the three main aims of this Treuhand. First, it was the protection of productive means of people in a durable and secure way. Second, the Treuhand might assist the GDR economic transformation and ensure the maintenance of its productive capacity. Third, another aim was to ensure that the new economic system would enable the GDR to attract capitals or investments and hence boost competitiveness and employment. Therefore, any privatisation of State owned companies or a fair management of Treuhand were completely excluded, at the beginning.<sup>339</sup>

However, contrary to the first proposals, the law did not comprehend any propriety certificate to GDR citizens, fact that excited the ongoing discussions regarding the Unification process.<sup>340</sup>

This first regulation for the Treuhand did not survive long. The day on which the GEMSU was signed, 18<sup>th</sup> May 1990, West German banks began to demand a different type of regulation for public assets. Essentially, there were two requests: first of all, the total removal of the limits affecting the privatisation of the East German industry, because the Modrow government had introduced a law that allowed to privatise East German industries only with a limit of the 49% of the enterprise. Secondly, to avoid the transformation of GDR companies into typical West German limited companies, which allowed the participation of labour union

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<sup>337</sup> *Ibidem.*

<sup>338</sup> *Ivi*, pp. 78-79.

<sup>339</sup> *Ibidem.*

<sup>340</sup> *Ibidem.*

organisations to the control of the company.<sup>341</sup> The principal reason regarded the fear of any investor towards spending in East German companies, which later had to cope with the participation of labour organisations at internal decisions.

Nonetheless, West German investors appeared not to share such fears, since Western investors were willing to expand to the East. In fact, already before the monetary union such participations had occurred. For example, Siemens had concluded 26 new contracts in the East until March 1990.<sup>342</sup>

The new law for the Treuhand arrived at the Volkskammer on 17<sup>th</sup> June 1990 and it would have come into force on the 1<sup>st</sup> July 1990, the same day of the GEMSU Treaty. The main characteristic of the second version of the Treuhand law implied the possibility of a complete privatisation of the public owned enterprises. Moreover, an other important change was the rejection of the Parliament control on the authority, while some area of manoeuvres was given to the Finance Ministry.<sup>343</sup>

The only concession granted was already part of the GEMSU Treaty, namely the possibility to use part of the revenues from the sale of the public properties to reimburse the losses of individuals during the monetary merge. Still, these reimbursements have never occurred.<sup>344</sup>

Criticism arose also from the question of the method that had to be used in order to privatise and the related problem of the ownership rights. As just said above, propriety rights had been a bastion of the German area since 17<sup>th</sup> Century. East Germany had made a break with propriety rights after the Second World War since it had to adjust to Soviet policies. With the Unification being implemented, East Germany had to transform its system and acquire the West German propriety rights system.<sup>345</sup> Propriety rights were themselves not the problem, since there was no uncertainty in the Western model.<sup>346</sup>

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<sup>341</sup> *Ivi*, p. 82.

<sup>342</sup> *Ibidem*.

<sup>343</sup> *Ivi*, p. 83.

<sup>344</sup> *Ibidem*.

<sup>345</sup> *Ibidem*.

<sup>346</sup> Lange, Pugh, *The economics of German Unification*, cit., pp- 65-66.

Here the problem was who owned what and “the propriety rights certainty did not yet guarantee ownership certainty.”<sup>347</sup> It is, in fact, fundamental to underline that:

The distinction between ill-defined proprieties rights and ownership uncertainty is crucial for the comparison of the German, Eastern European and the USSR cases. In the German case, propriety rights are clearly established but there is uncertainty with respect to ownership. In the USSR and to some extent in Eastern Europe, propriety rights themselves are uncertain.<sup>348</sup>

In Horst Siebert opinion, in East Germany two preliminary conditions impacted. First, respect for private propriety rights. Second, the need to a rapid process in order to boost investments and growth.<sup>349</sup> The first aspect tended to dominate in importance over the speed required to the process, because a market economy could not be implemented without settling the problems arising from the expropriation of State-owned assets. Moreover, there would have been huge dissents in the GDR when the previous ownership was not respected.<sup>350</sup>

Basically, there were two methods of transfer of ownership rights to previous owners that were being discussed at the time and included in the treaties: restitution and compensation.<sup>351</sup>

The Unification Treaty proposed the natural restitution that admitted the priority of former owners of proprieties in the dispute over the Communist States’ heritage. Only in exceptional cases the Treaty allowed a compensation in money to the former owners, for example when urgent investments for the public good were involved.<sup>352</sup>

Still, different cases of privatisation could be identified, according to the type of public asset. According to 1998 data, it was estimated that those East Germans who left the GDR for the West between 1945 and 1953 were confiscated around 3,000 firms. 80,000 real estates proprieties of refugees were confiscated from GDR

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<sup>347</sup> Siebert, Burda, Obstfeld, “German Unification: The Economics of Transition”, cit., p. 296.

<sup>348</sup> *Ibidem*.

<sup>349</sup> *Ibidem*.

<sup>350</sup> Siebert, Burda, Obstfeld, “German Unification: The Economics of Transition”, cit., p. 297.

<sup>351</sup> *Ibidem*.

<sup>352</sup> Sinn, Sinn, *Jumpstart*, cit., p. 87.

after 1953. In addition, there were 100,000 real estate proprieties and 2,000 ownership rights owned by West Germans, around 70,000 real estate proprieties that became propriety of West German people through inheritance after 1953 and 12,000 small industrial firms that were nationalised in 1972.<sup>353</sup> Other types of assets that were to be managed were agricultural land and communalities, for instance harbours, airports or sewage, which were to be transferred to municipal authorities.<sup>354</sup>

However, the Treuhand was not the only authority appointed or able to complete privatisation processes. Before the establishment of the Treuhand, the Modrow government had privatised around 30,000 small activities. On the other hand, during the Treuhand operations, certain specific sectors were being maintained out of the international market and competition, for instance savings banks or energy businesses, which were entrusted to West German entrepreneurs.<sup>355</sup>

Other data suggest that State-owned enterprises were responsible for 88% of total output in 1988. The Treuhand was in charge for 90% of the GDR productive capacity.<sup>356</sup> In Table 1, in the next page, some numbers are shown that date back to the year 1991.

As said, the principle that was being followed was the restitution over compensation, but a problem that cannot be underestimated was the difficulty of identifying the owner and the impossibility to make it effective. In particular the amount of the claims that began soon to arrive at the Treuhand was inconceivable to handle properly and quickly, as it was wished. By mid 1991, the restitution claims to the Treuhand from former owners had amounted to 1,5 million.<sup>357</sup>

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<sup>353</sup> *Ivi*, p. 88.

<sup>354</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 74.

<sup>355</sup> *Ivi*, p. 72.

<sup>356</sup> *Ibidem*.

<sup>357</sup> *Ivi*, p. 66.

### Privatization of enterprises

	Units to be privatized	Units privatized by			% of firms privatized
		Head office	Regional branches	Total	
Total number	32,400	440	18,030	18,470	57
Industrial firms of the productive sector	6,800	353	717	1,070	16
Firms in the service sector	25,600	97	17,303	17,400	68
Large retail stores	14	14	—	14	100
Restaurants and small stores	20,000	—	15,200	15,200	76
Hotels	390	—	212	212	54
Pharmacies	1,839	—	1,134	1,134	62

Table 2: Siebert Horst, Burda Michael, Obstfeld Maurice, "German Unification: The Economics of Transition" in *Economic Policy*, Centre for Economic Policy Research, Centre for Economic Studies and the Maison des Sciences de l'Homme, Vol. VI, No. XII, New Jersey, Wiley, 1991, p. 299.

The complications regarding the privatisations did not stop there. It is important, at this point, to clarify the actors involved in the ownership rights problems and the privatisation process. In short, these were, first of all, the Treuhand, the government, the unions, the workers of the public firms, the previous owner, the present users, the heirs of the previous owners, who might have lived also in West Germany, and the investors from West Germany or from outside of Germany.

A further case of dubious ownership rights could be identified from Sinn and Sinn point of view and in a particularly intricate one. At the beginning, before the economic collapse of the communist country, many properties were sold to the users. In such cases, the restitution principle was outlined through the establishment of a limit date, beyond which the ownership rights were to be returned to the previous owner.<sup>358</sup> This might trigger ambiguity in the ownership. In fact, there had been many cases, in which the land was returned to the previous owner, the buildings

<sup>358</sup> Sinn, Sinn, *Jumpstart*, cit., pp. 88-89.

remained to the users and the previous owners could ask for compensation due to the buildings loss.<sup>359</sup>

The structure of the industrial sector in the GDR was based on big dimension and State-owned enterprises, the so called *Kombinat*. The Treuhand objective extended also to the privatisation of such big firms. However, the Kombinate needed to be broken into different parts, since they could not be considered proper firms from the Western point of view and it would have been impossible to sell them to western entrepreneurs entirely.<sup>360</sup>

A further problem complicating the intricate question of privatisation was the fact that the ownership of a firm was usually strictly connected with the ownership of the land. Besides, the principle of restitution took into account the heirs of the previous owners, in spite of the fact that, very often, they did not have the ability to continue the previous business.<sup>361</sup>

A related issue was the subsequent step, with which the privatisation process was put into effect once the Treuhand had acquired the public assets, namely, the sale of the firms. This ranged between two extremes. On the one side, the stock market was used, which is a substantial method to understand the value of the firm but its access is subordinated to a long list of preconditions. On the other side there was the "Informal Selling,"<sup>362</sup> where few buyers are involved but prices are much lower.<sup>363</sup>

As already stated many times, it must be highlighted one more time that the sale of a firm is fundamental to occur when the ownership rights issues are cleared. There would be no investors interested in acquiring the firm if there are still doubts about its possession.

In order to continue its tasks, the Treuhand had to evaluate the state of the firms and, if any reorganisation was needed, it should implement it. Therefore, the

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<sup>359</sup> *Ibidem*.

<sup>360</sup> *Ivi*, p. 91.

<sup>361</sup> *Ibidem*.

<sup>362</sup> Siebert, Burda, Obstfeld, "German Unification: The Economics of Transition", cit., p. 301.

<sup>363</sup> *Ibidem*.

trust agency required the firms to write a DM balance sheets, after which it was decided whether firms were viable or not.<sup>364</sup>

In addition, a definition of viability was not an easy task. Horst Siebert defined the viability of a firm in connection to the bankruptcy law, meaning that the old debts should be abandoned, even the environmental damage should be taken into account and managed by the government.<sup>365</sup> Namely, a firm might display a “positive present value<sup>366</sup>, even with its old capital stock and without adjustments,”<sup>367</sup> or a positive present value after adjustments and it might be able to grant finance backing for the adjustments and investments. For these instances, there would be no management and sales difficulties for the Treuhand.

On the other hand, when the firm had a negative value the issue was understanding whether there would be good premises for a future positive value. When a firm could not do this, many authors pointed out that the Treuhand should not have subsidized it.<sup>368</sup>

Here a further question arised, that was whether the Treuhand should have continued to subsidize non-viable firms but granting jobs and employment security (or at least in part) or leaving them alone and closing them down because they could not commit on the internal and international markets.<sup>369</sup>

Not to forget is the question regarding the budget constraints of the trust agency. The Treuhand had, in fact, its own balance sheet that was composed of all the assets, not only its own assets but also the balance sheets of all the firms for which it was responsible. The budget must also include the liabilities<sup>370</sup> of the Treuhand itself but also of the firms, for examples old debts.<sup>371</sup>

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<sup>364</sup> Sinn, Sinn, *Jumpstart*, cit., pp. 98-99.

<sup>365</sup> Siebert, Burda, Obstfeld, “German Unification: The Economics of Transition”, cit., p. 302.

<sup>366</sup> “The difference between the present value of cash inflows and the present value of cash outflows. NPV is used in capital budgeting to analyse the profitability of an investment or project.[...] NPV compares the value of a dollar today to the value of that same dollar in the future, taking inflation and returns into account. If the NPV of a prospective project is positive, it should be accepted. However, if NPV is negative, the project should probably be rejected because cash flows will also be negative.” Investopedia Dictionary USA, Net Present Value, <http://www.investopedia.com/terms/n/npv.asp>, updated in 2013, consulted in February 2014.

<sup>367</sup> Siebert, Burda, Obstfeld, “German Unification: The Economics of Transition”, cit., p. 302.

<sup>368</sup> *Ivi*, p. 303.

<sup>369</sup> *Ibidem*.

<sup>370</sup> For a definition of liability see chapter 3.2.

<sup>371</sup> Siebert, Burda, Obstfeld, “German Unification: The Economics of Transition”, cit., p. 303.

Some data collected in 1991 show that the Treuhand was already indebted and the expected budget for the same year would have been 14 billion DM revenue from privatisation but an expenditure of 37 billion DM for adjustments and subsidies.<sup>372</sup>

Here below a table summarises the revenues and expenditures of the Treuhand in 1991.

<b>Operating budget of Treuhand, 1991 (DM bn.)</b>			
Revenue		Expenditure	
Privatization		Costs of privatization	5
Production and service sectors	10	Restoration of firms	12
Agricultural sector and land	3	Closure of firms	3
Other	1		
		Interest on debt (a)	12
Credits	<u>23</u>	Other	<u>3</u>
Total	<u>37</u>		<u>37</u>

*Source:* Information provided by Treuhand.  
*Note:* (a) Old debt DM 7 bn.; Kreditabwicklungsfunds DM 5 bn.

Table 3: Siebert, Burda, Obstfeld, "German Unification: The Economics of Transition", cit., p. 304.

In March 1991 a new regulation called "Obstacle-Removal Law" was being announced as the problems with the restitution principle were finally recognised and understood by the Economics Ministry. In the words of Sinn and Sinn "[The Obstacle-Removal Law] modified the restitution principle, giving investors interested in buying a propriety priority over the former owners in certain cases."<sup>373</sup> Although the new law did improve the situation for certain cases, additional reformation was still necessary.

To conclude this section, a further issue related to the markets might be considered. Many authors pointed out that the privatisation policy used was unrealistic in an open market situation. Politicians and some economists referred to the assumption of the existence of a strong market for firms, not only in Germany but also internationally. The point was that the Treuhand had rapidly 'flooded' the

<sup>372</sup> *Ibidem.*

<sup>373</sup> Sinn, Sinn, *Jumpstart*, cit., p. 84.

German business sale market with firms assuming that it would be able to absorb them. On the contrary, the prices of these firms had decreased very rapidly because the businesses were offered into the market all at once.<sup>374</sup> This situation triggered a huge reduction in the revenues from assets sales. The trust agency initial hypothesis of revenues from GDR public assets was around 600 billion DM.<sup>375</sup>

To conclude with the presentation of the privatisation issue, consider here below a table from Lange and Pugh summarising the four years of the work of the Treuhand in numbers. Namely, the Treuhand ceased its function in 1994 with scandalous background. As the table imply, the total debt that was forecasted in 1994 was of around 275 billion DM. Recently, a famous German television channel, *das Erste*, produced an explanatory documentary movie on the Treuhand history and its faults, denouncing the people in charge of the trust and their work very harshly.<sup>376</sup>

*Impact of the Treuhand, 1990–1994*

	June 1990	By the end of 1994
1. Number of enterprises (initial portfolio of 8,000 + enterprises newly created by THA)	8,000 (13,781 by 1992)	
2. Number of establishments	40,000	
3. Enterprises dissolved through merger or break-up; or otherwise excluded from the initial portfolio		1,418
4. Contracts completed by THA and successor institutions		c. 50,000
5. Outcome for 12,363 enterprises in THA portfolio*		
a. privatization		6,464
b. reprivatization (restitution)		1,571
c. in liquidation		3,661
d. remaining with THA (transferred to successor institutions after 31/12/94)		354 (192)
6. Number of workers employed in Treuhand/ former-Treuhand companies (and employment promises by new owners)	4.1 million	930,000 (1.5 million, including employment promises)
7. Proportion of total east German workforce (with and without employment promises by new owners)	45 per cent	Assuming a one-third decline in the size of the workforce: 15 per cent; 25 per cent (including employment promises)
8. Investment undertakings by new owners (carried out mainly 1994–99)		DM 211 bn (including DM 130 bn contractually enforceable*)
9. Privatization revenue		DM 65 bn*
10. Cumulative debt of THA, including		
a. enterprise debts (initial debts + interest payments of DM 26 bn)	Initial debts: DM 75 billion	DM 101 bn
b. enterprise restructuring		DM 154 bn
c. environmental clean-up		DM 44 bn
Total debt (allowing for privatization revenue)		DM 230 bn
11. Anticipated borrowing of successor institutions		DM 45 bn (anticipated by 2000)
12. Total debt by 2000		DM 275 bn

*Note:* \* Data as of 30 September 1994.

Table 4: Lange, Pugh, *The economics of German Unification*, cit., p. 73.

<sup>374</sup> *Ibidem*.

<sup>375</sup> *Ibidem*.

<sup>376</sup> Das Erste, Dokumentarfilm im Ersten: Goldrausch; Die Geschichte der Treuhand, <http://www.daserste.de/information/reportage-dokumentation/dokus/sendung/swr/08102013-dokumentar-film-im-ersten-goldrausch-100.html>, last updated October 2013, consulted on February 2014.

## Social Policy and the Unification

The social policy is a further controversial issue in the discussions on German unification. As already said in a previous section, the socialist planned economy of the GDR was showing several drawbacks, in particular in the public budget. The majority of the critics had identified part of the reasons in the organisation and the structure of the social policy.

In short, the East German social policy was characterised by a deep belief in the right to work and the guarantee for a secure job position, in particular in the communist State it was believed that the producers and owners of the economy were the working population.<sup>377</sup> Moreover, the social policy was defined by huge quantity of subsidies, not only for certain basic goods but also in the housing and employment fields. The GDR was a country based on the fundamental right to work, for this reason the most important part of the welfare policies was directed towards the improvement of all the issues related to employment.<sup>378</sup>

According to Schmidt and Ritter the German unification was the event that entailed several profound changes not only in the German society but in the whole European ones. The two authors were referring to the changes in demographic composition of the FRG in particular, caused by a drop in births and the consequent aging population. Furthermore, the change in the conception of families, the intensification of the competition in the framework of wider European markets, the changes in the labour market and law.<sup>379</sup>

Part of these transformations of society might seem not to involve the welfare state, but as a matter of fact they define the problems that arose during the first years of the 1990s and they were, in certain ways, exacerbated in Germany by the unification process.

Just before the beginning of the unification, the welfare state or *Sozialstaat* of the FRG was undergoing profound reforms in order to stabilise and consolidate the

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<sup>377</sup> Schmidt, Ritter, *The Rise and Fall of the Socialist Welfare State*, cit., p. 128.

<sup>378</sup> *Ibidem*.

<sup>379</sup> *Ivi*, p. 202.

policies. An example might be the pension reform that the Bundestag passed on the same day of the fall of the Berlin wall, which involved a reduction in the social expenditures in the FRG.<sup>380</sup> However, when the Unification and particularly the subsidies and money transfers began their way to the East, such consolidation reforms were stopped.<sup>381</sup>

During the State Treaty negotiations in February 1990, the social policy unification was taken into account for various reasons. For instance, the FRG Economics and Finance Ministry were not among the advocates for the accession of the GDR to West German more complicated social policy, as it would increase FRG costs and the GDR would risk a fall in competition.<sup>382</sup> The supporter of the social policy accession was the Labour Ministry, Norbert Blüm. He favoured, in fact, “as smooth and as complete a transference of the West German welfare state to the GDR as possible.”<sup>383</sup> Besides, Blüm had advocated also the 1:1 wage, salaries and pensions conversion.

In the GDR the main characteristic of the welfare policies was the social insurance system, which was cause of great debates during the unification negotiations. The first approach had been the *Social Insurance Law* of the GDR in June 1990.<sup>384</sup> Moreover, particularly open to debates was the issue of the ‘supplementary insurance systems’ and all those special insurances strictly connected to professional elites and groups of the leading party of GDR.<sup>385</sup>

As far as the employment law, health and safety regulation is concerned, East German social policy needed to adapt and change in favour of the West German one.

However, one of the most important requests of the GDR was the maintenance of the GDR *Labour Statute Book*. It seemed that the Federal Labour Ministry showed some propensity to accept the utilisation of the Statute Book in certain fields and with several amendments.<sup>386</sup> Eventually, the FRG position stiffened

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<sup>380</sup> *Ibidem.*

<sup>381</sup> *Ibidem.*

<sup>382</sup> *Ivi*, p. 204.

<sup>383</sup> *Ibidem.*

<sup>384</sup> Ritter, *The Price of the German Unity*, cit., p. 175.

<sup>385</sup> Schmidt, Ritter, *The Rise and Fall of the Socialist Welfare State*, cit., p. 208.

<sup>386</sup> Ritter, *The Price of the German Unity*, cit., p. 188.

during the negotiations, underlining the relevance of the institution of a single employment law. As a result, during the Unification process a compromise was reached. The Western employment law was to be extended to the new Bundesländer, provided that a new and unified legislation for the employment law was found as soon as possible.<sup>387</sup> In addition, some health and safety regulations stemming from the European Community still needed to be adopted in the FRG during the early 1990s, but “transitional arrangements ensured that the existing facilities at GDR enterprises could continue in operation.”<sup>388</sup>

As far as pensions were concerned, it was agreed that the Federal pension system was not going to be applied to the new Bundesländer until the entering into force of the new Federal regulations that would occur in January 1992. In the meantime the GDR pension law continued to be applied.<sup>389</sup> Particular arrangements of the Eastern pension system had to cease at the end of December 1991. Some problems and criticism arose when the supplementary provision system for parties in the GDR was delayed.<sup>390</sup>

A further issue among the welfare policies regarded the health care and health insurance. Particularly debatable were the financial advantages that were attributed to GDR citizens in the scope of health. For example, the purchase of drugs, hospital treatments, various types of medical aids or compensation for loss of earnings due to the assistance to sick children.<sup>391</sup> Consequent to these amount of financial assistance, the Federal Ministry was not willing to extend the Western subsidies to the East even if this was firmly supported by the Federal Labour Ministry.<sup>392</sup>

A partial solution that was proposed later, in 1992, comprised the creation of a non-profit insurance system for the health care based in the East. However, this idea met some restraint and it was transformed, extending the German non-profit

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<sup>387</sup> *Ibidem.*

<sup>388</sup> *Ibidem.*

<sup>389</sup> *Ivi*, p. 192.

<sup>390</sup> *Ibidem.*

<sup>391</sup> *Ivi*, pp. 194-195.

<sup>392</sup> *Ibidem.*

health insurance system to the new Bundesländer.<sup>393</sup> The health regulations were finally passed in December 1992 with the *Law on the Stabilisation and Structural Reform of the Statutory Health Insurance System*.<sup>394</sup>

Other debates arose with the discussions about the policies of families and women. At this point, the differences in families forms between the FRG and the former GDR must be considered. According to A.G. Ghaussy and W. Schäfer, in the new Bundesländer there was a lower number of singles and a lower age of marriage compared to the Federal Republic.<sup>395</sup> Moreover, the former GDR presented a higher number of working women. The policies that were being extended to the new region preoccupied the GDR negotiators, because they were considered to be not as advanced as the Eastern ones.<sup>396</sup> The solution that was found in the Article 31 of the Unification Treaty, "It shall be the task of the all-German legislator to develop further the legislation on equal rights for men and women,"<sup>397</sup> underlined the relevance for the development and improvement of regulations in the field of equal rights to men and women.<sup>398</sup>

The reforms that were being promised would be implemented not before 1994, when the first constitutional changes, started by the unification process, were entering into force.<sup>399</sup>

A deep concern regarding the social policy, pensions and subsidies related to the way they were going to be financed. According to an article of the Frankfurter Allgemeine Zeitung of 21 July 2000 (quoted by Schmidt and Ritter), the social insurance contribution climbed from the 35,5% of the former FRG to the 42,1% of the united country in 1997.<sup>400</sup> In addition, soon at the aftermath of the Unification, between 1991 and 1995 the transfers used for the unemployment subsidies and social protection amounted at 23% of the total transfers, that was around 140 billion

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<sup>393</sup> Schmidt, Ritter, *The Rise and Fall of the Socialist Welfare State*, cit., p. 217.

<sup>394</sup> *Ivi*, p. 218.

<sup>395</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., p.95.

<sup>396</sup> Ritter, *The Price of the German Unity*, cit., p. 198.

<sup>397</sup> Press and Information of the Federal Government, *The Unification of Germany in 1990*, cit., Art. 31.

<sup>398</sup> *Ibidem*,

<sup>399</sup> Ritter, *The Price of the German Unity*, cit., p. 199.

<sup>400</sup> Schmidt, Ritter, *The Rise and Fall of the Socialist Welfare State*, cit., p. 234.

DM.<sup>401</sup> Further data will be given in the next section of this chapter on public budget and transfers.

### **Fiscal Effort and Transfers**

The previous sections of this paper dealt with economic policy adjustments, problems arising from international and internal spheres, treaties, social policy difficulties, etc.. As it was introduced, the majority of the problems regarding the unification process had to deal with public budgets and transfers of money. First of all, consider the fiscal organisation of West Germany.

In short, the author Helmut Seitz divided the organisation of the taxing system into two different levels: vertical financial equalisation system and horizontal financial equalisation system. The first one dealt with the distribution of tax revenues between the Federal government and the Bundesländer.<sup>402</sup> The taxes that were distributed stemmed from *joint taxes* and they were collected by the government in each Länder. Revenues from taxes were then re-distributed also according to the population size. Namely, only a little percentage of income taxes remained to the local authorities and what was going directly were local exercises or local business taxes. Moreover, the Federal government received all revenues from, for example, tobacco duties or insurance taxes. Länder governments usually received revenues from vehicle taxes, lottery taxes or inheritance taxes.<sup>403</sup>

From Helmut Seitz's point of view, the second taxation level, or the horizontal financial equalisation system, was introduced to deal with the problem of disproportion within the different Bundesländer. In fact, some German Länder might receive more revenues from taxes than others. To overcome this inequality problem, stronger Länder transfer part of their own revenues to weaker ones. In addition, there were also other possibilities for weaker Länder to obtain more funds. These

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<sup>401</sup> *Ivi*, p. 235.

<sup>402</sup> Seitz Helmut, "Fiscal Policy, Deficits and Politics of Subnational Governments: The case of the German Länder", *Public Choice*, CIV (2000), pp. 188-189.

<sup>403</sup> *Ivi*, p. 189.

latter special transfers were generally regarded as a third level of equalisation system.<sup>404</sup>

As far as the unification of the GDR was concerned, the first regulations with regard to transfers and taxes stemmed from the GEMSU Treaty and the Unification Treaty. The first one comprised some regulations about the adaptation of GDR budgetary provisions to the FRG ones, cuts in public spending and subsidies. On the other hand, the Unification Treaty aimed at settling the difficulties arising from revenue sharing, fiscal equalisation and transfers. Moreover, a new equalisation system effective for the whole Germany would have been implemented from the 1<sup>st</sup> January 1995. Meanwhile the old system would remain at work in the FRG. In the GDR the West German system would be acquired with some exceptions.<sup>405</sup>

As just said, the new Bundesländer began to share West German revenue distribution system from the beginning of 1995. From the German Unification day, 3<sup>rd</sup> October 1990, to 31<sup>st</sup> December 1994 the new Länder were given the necessary money from special funds, instituted because of Unification, such as the *German Unity Fund*. Officially, on the 1<sup>st</sup> January 1991 the FRG tax and transfer system with exceptions was introduced in the GDR.<sup>406</sup> It is worth to mention that the single Bundesland could not decide its own tax policy. This particular issue was (and it still is today) only matter of the Bundestag. The Bundesrat (the Federal authority that group the representatives of all Bundesländer) only had the power of influencing and steering negotiations regarding taxes distribution.<sup>407</sup>

To introduce the public deficit issue in the framework of the unification process it is important to highlight that West Germany in 1989 presented a public debt of 42% of its own GDP.<sup>408</sup> Above, the table was taken from the Deutsche Bundesbank's Monthly Report of 1997 and it shows the trends of German debt.

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<sup>404</sup> *Ibidem*

<sup>405</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., pp. 74-76.

<sup>406</sup> *Ibidem*.

<sup>407</sup> Seitz, "Fiscal Policy, Deficits and Politics of Subnational Governments: The case of the German Länder", cit., p. 190.

<sup>408</sup> Seitz, "Fiscal Policy, Deficits and Politics of Subnational Governments: The case of the German Länder", cit., p. 191.

In the previous sections it was explained how financial policies had been connected to the unification process. In particular, the German Central Bank pointed out that the financial outcomes of the process were not considered as seriously as they should have been.<sup>409</sup> Moreover, the economic boom triggered by the unification did not help in providing a clear view on the issue. The Central Bank calculated approximately an inherited burden from the GDR of 340 billion DM. As said in one of the previous sections of this work, the Treuhandanstalt did collect a net of around 275 billion DM debts and also the funds that were to be found for the social policy in the new Bundesländer required transfers from the Federal government.

The German government and the Bundesbank were more and more concerned with the increase of debt ratio. According to the Bundesbank, the debt ratio could be calculated by “the level of the primary debt (i.e. the overall deficit less interest expenditure) and the difference between the interest rate and the overall economic growth rate.”<sup>410</sup> When the interest rates exceeds the economic growth rate, the primary surplus needed in order to counter the primary debt must be higher.

Long-term trend in public debt

Period/year	Level at end of period or year		Increase as an annual average or compared with previous year (%)
	DM billion	% of GDP	
1955 to 1959	50	18.4	5.1
1960 to 1964	74	17.6	8.3
1965 to 1969	118	19.8	9.8
1970 to 1974	192	19.6	10.3
1975 to 1979	414	29.8	16.6
1980 to 1984	718	41.0	11.6
1985 to 1989	929	41.8	5.3
1990 to 1994	1,662	50.1	12.3
1991 1	1,174	41.1	11.4
1992	1,345	43.7	14.6
1993	1,509	47.8	12.2
1994	1,662	50.1	10.1
1995	1,996	57.7	20.1
1996	2,135	60.3	7.0

1 From 1991 for Germany as a whole.

Deutsche Bundesbank

Table 5: Deutsche Bundesbank, “Trends in Public Sector Debt since Unification”, *Deutsche Bundesbank Monthly Report March 1997*, Frankfurt am Main, Deutsche Bundesbank, 1997.

All these factors might exacerbate the growth of the inflation rate and trigger a

<sup>409</sup> Deutsche Bundesbank, “Trends in Public Sector Debt since Unification”, *Deutsche Bundesbank Monthly Report March 1997*, Frankfurt am Main, Deutsche Bundesbank, 1997, p. 18.

<sup>410</sup> Deutsche Bundesbank, “Trends in Public Sector Debt since Unification”, cit., p. 23.

vicious circle, as exemplified in the Monthly Report of March 1997 by the Bundesbank. Therefore, the German Central Bank pointed out that the best way to avoid inflation was stabilise debt and reduce it.<sup>411</sup>

The FRG established a number of different funds in order to finance the various fields of the unification process. The most renowned ones are the *German Unity Fund*, the *European Recovery Program (ERP) Special Fund*, the *Debt Processing Fund*, the *Redemption Fund for inherited Liabilities* and other more specific subsidiary budgets accounts, such as one aimed at developing German railways.<sup>412</sup> The ERP Special Fund stemmed directly from the Second World War Marshall Plan aids. Since Germany had to pay back only one part of the money received through the Marshall Plan, these were later converted into an all-German fund that could grant long-term investment loans to support and develop German economy.<sup>413</sup>

On the other hand the German Unity Fund was established before the unification but it was meant to work only temporarily. The Fund was financed by maximum 10% from the Federal government and the other part by the states themselves. In 1990 the Fund amounted to 115 billion DM overall with rates of 22 billion DM in 1990 and of 35 billion DM in 1991.<sup>414</sup>

However, transfers to the new Bundesländer were not the only ones who were involved. As reported by Siebert in 1990, other type of transfers must be added: transfers regarding social security system of around 7 billion DM in 1990, transfers directed to the Treuhand, transfers to the Soviet Union around 2 billion in 1990 because of previous signed contracts with the GDR and new ones with the FRG.

Between 1990 and 1991, the budgetary situation planned in the Unification treaty proved to have been undervalued. Namely, the authors Ghaussy and Schäfer pointed out how the lack of information of the real situation in the GDR was the reason to blame for such an increase in funds in 1991. In January the Federal

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<sup>411</sup> *Ibidem*.

<sup>412</sup> *ivi*, p. 21.

<sup>413</sup> KfW: Bank aus Verantwortung, The Marshall Plan and the ERP, [https://www.kfw.de/KfW-Group/About-KfW/Identit%C3%A4t/Geschichte-der-fW/Themenfelder/Marsh allplan-und-ERP/](https://www.kfw.de/KfW-Group/About-KfW/Identit%C3%A4t/Geschichte-der-fW/Themenfelder/Marsh%20allplan-und-ERP/), consulted on March 2014.

<sup>414</sup> Siebert, Burda, Obstfeld, "German Unification: The Economics of Transition", cit., p. 318.

government added 5 billion DM, in May a little less than 5 billion DM and in November around 36 billion DM.<sup>415</sup>

This worsened public budget situation was the result of the global economic trend in those years. In fact, Germany was experiencing a boom in growth, in particular an increase in imports due to the Unification. However, at the same time the international economic situation was involved in a cyclical downswing and Germany did not export as much as before. Therefore, the international economic condition did influence in the increase of Germany's public deficit in the 1990s.<sup>416</sup>

However, other authors have recently pointed out the difficulty in defining with certainty the real amount of West German expenditures in the East. Vladimiro Giacchè underlined the discrepancies between what was declared by Kohl in the first years of Unification and by Schröder, former Chancellor, in 1999. Specifically, Schröder desired to attract the attention to the resources that were used for the economic development of the new Bundesländer and the *Solidarity Pact I*.<sup>417</sup> This latter came from the fact that the *German Unity Fund* resulted insufficient compared to the amount of funds needed and it implied an agreement proclaimed in March 1993 by the German leadership. It aimed at modifying the fiscal equalisation system of the Länder, for instance it reintroduced the solidarity surcharge and extended the system to the Eastern regions.<sup>418</sup>

In 1999, it was calculated that transfers amounted between 40 and 50 billion DM annually. In addition, Hans-Werner Sinn calculated that the transfers to the East in 20 years from the unification amounted at around 1,200 billion DM.<sup>419</sup>

The table below (next page) was taken from Eckhard Wurzel's Working Paper for the OECD in 2001, where he analyses the economic integration of the East. More importantly, this table highlights the commitments in the German Unification not

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<sup>415</sup> Ghaussy, Schäfer, *The Economics of German Unification*, cit., p. 76.

<sup>416</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 477.

<sup>417</sup> Giacchè, *Anschluss, l'Annessione*, cit., pp. 231-233.

<sup>418</sup> German History Documents, Protest against the Proposed Solidarity Pact (February 17, 1993), [http://www.germanhistorydocs.ghi-dc.org/sub\\_image.cfm?image\\_id=31\\_20&language=english](http://www.germanhistorydocs.ghi-dc.org/sub_image.cfm?image_id=31_20&language=english), consulted on March 2014.

<sup>419</sup> Giacchè, *Anschluss, l'Annessione*, cit., pp. 231-233.

only of the Federal government but also of other Western countries and the European Community.<sup>420</sup>

Table 3. **Public transfers to the new states**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>A. Gross and net transfers by source<sup>1</sup></b> (DM billion)									
Expenditures									
Federal government	75.1	90.0	115.7	115.9	136.7	136.7	129.6	130.8	140.0
Western states and communities	5.3	5.7	10.3	13.5	11.2	11.3	11.6	11.5	11.6
Germany Unity Funds	31.0	24.0	15.0	5.0	0.0	0.0	0.0	0.0	0.0
Social security system (net) <sup>2</sup>	18.7	34.2	23.0	29.8	33.3	30.9	34.7	31.9	36.0
EU	4.0	5.0	5.0	6.0	7.0	7.0	7.0	7.0	7.0
Treuhanderanstalt	8.8	13.7	23.0	23.8	0.0	0.0	0.0	0.0	0.0
Revenues									
Federal government	33.0	39.1	41.4	45.2	46.8	48.2	47.8	48.6	50.6
Gross transfers	142.9	172.6	192.0	194.0	188.1	186.0	183.0	181.2	194.6
Net transfers	109.9	133.5	150.6	148.8	141.3	137.7	135.1	132.6	144.0
As per cent western German GDP <sup>3</sup>	4.2	4.8	5.4	5.2	4.7	4.5	4.4	4.1	4.4
<b>B. Gross transfers by function<sup>1</sup></b> (Per cent of total)									
Business-near infrastructure	12.4	9.9	8.6	10.1	13.0	13.3	13.2	12.9	12.6
Support to enterprises	2.5	4.7	7.6	7.5	8.0	7.0	6.3	6.4	5.8
Social transfers	45.4	54.1	54.3	54.4	49.5	49.7	49.7	49.1	51.4
Non-earmarked transfers	28.0	22.3	20.0	19.5	23.5	24.6	25.0	25.8	24.5
Not attributable	11.7	9.0	9.3	8.4	6.0	5.4	5.8	5.8	5.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. Excluding special depreciation allowances, debt servicing expenditure and credits.

2. Without the contributions by the federal and state governments.

3. GDP of western Germany excluding Berlin.

Source: Institut für Wirtschaftsforschung Halle and OECD.

Table 6: *Public Transfers to the new states*, Wurzel Eckhard, *The Economic Integration of Germany's new Länder: Economics Department Working Paper No. 307, OECD, September 2001, p. 19.*

## The role of the government and the Bundesbank

In the previous sections of this chapter, the treaties and problems arising from the unification process were considered. Now it is essential to focus on the two main actors, the government and the Bundesbank. This section will deal with a brief history of the Bundesbank and the role of the central bank in the unification process, in particular the specific objective of understanding the stakes of its policy relations with the other European countries and in the framework of the European community.

First of all, consider a brief overview of the history of the Bundesbank. The beginning of the central bank in West Germany can be traced back to the institution of the *Bank Deutscher Länder* soon after the end of the Second World War, namely

<sup>420</sup> Wurzel Eckhard, *The Economic Integration of Germany's new Länder: Economics Department Working Paper No. 307, OECD, September 2001, p. 18.*

in March 1948. As for the majority of post-war reconstruction, the Allied powers established their own regional banks in each area of influence, called *Landeszentralbanken*.<sup>421</sup> It was thanks to the British government, which advocated the establishment of a bank that could coordinate all other regional banks that the BDL was finally established.<sup>422</sup> Moreover, the banks were controlled by the *Allied Banking Commission*, which had the veto power over the Bank Deutscher Länder. The first President of the BDL was Wilhelm Vocke.<sup>423</sup>

After the establishment of the regional banks and a central bank the Allied powers implemented the currency reform, as already explained in the first chapter of this work. However, it is important to highlight a previous historical experience, in which many critics saw (and continue seeing today) the source of German preoccupation with inflation. It referred to the Hyper-Inflation or Hyper-devaluation of the Reichsmark in 1923 and 1924. The Hyper-Inflation is “a ruinously high increase (50 percent or more per month) in prices due to the near total collapse of a country's monetary system, rendering its currency almost worthless as a medium of exchange.”<sup>424</sup> Namely, in November 1923 the Reichsmark reached a value of 4,200,000,000,000 per dollar. The consequences of such an experience remained clear in the mind of German economists and politicians.<sup>425</sup>

The Bundestag established the Deutsche Bundesbank, as it is known today, through the adoption of the *Bundesbank Act* in July 1957. The establishment of a federal central bank was required by the Federal Basic Law, which entered into force when the FRG was officially proclaimed.<sup>426</sup>

The German Central Bank was based in Frankfurt, where it had the central offices. In addition, before the unification, there were eleven offices, called *Länder*

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<sup>421</sup> Kennedy Ellen, *The Bundesbank: Germany's Central Bank in the International Monetary System*, London, Pinter Publishers, 1991, p. 12.

<sup>422</sup> *Ibidem*.

<sup>423</sup> *Ibidem*.

<sup>424</sup> Business Dictionary, USA, Hyperinflation: Definition, <http://www.businessdictionary.com/definition/hyperinflation.html>, updated 2014, consulted on February 2014.

<sup>425</sup> Der Spiegel Online International, Millions, Billions, Trillions: Germany in the Era of Hyperinflation by Alexander Jung, <http://www.spiegel.de/international/germany/millions-billions-trillions-germany-in-the-era-of-hyperinflation-a-641758.html>, last update August 2009, consulted on February 2014.

<sup>426</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 159.

*Central Banks*, in each Western Land and in West Berlin, Bremen and Hamburg. With the accession of the new five Bundesländer, fifteen new offices were established, which were all directed from the East Berlin headquarters. However, this was just a provisional organisation, since the Länder Central Banks organisation would have been regularised by 1<sup>st</sup> July 1991.<sup>427</sup>

One of the main characteristics of the Bundesbank was its independence from the Federal government's power as specified in the Section 12 of the Bundesbank Act "independent of instructions from the Federal Government in the exercise of all the powers to which it is entitled [...]."<sup>428</sup>

A further essential trait of the Bundesbank referred to the necessity and the obligation, which was stemming from the Bundesbank Act, of advocating the economic policy of the Federal government.<sup>429</sup> This feature might appear in contrast with the previous quality, which is its independence. This was and still is usually regarded as an interpretation matter, since, according to the Deutsche Bundesbank itself, "the Bundesbank is obliged to provide support only to the extent that this does not run counter to its own role of safeguarding the currency."<sup>430</sup> Therefore, both the central bank and the government are required to work together in the pursuit of the German economic aims, for instance price stability.<sup>431</sup>

In order to understand the role of the institution in the framework not only of the German Unification but also in the international policies, it is essential to consider the structure of this body. The Bundesbank consisted (and consists still today) of the Bundesbank Council, which was the head of the whole bank structure, the Directorate, the President and Vice-President, the Land Central Banks and the Presidents of the Land Central Banks.<sup>432</sup>

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<sup>427</sup> De Haan Jakob (ed.), *The History of the Bundesbank: Lessons for the European Central Bank*, London, Routledge, 2002, p. 8.

<sup>428</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 159.

<sup>429</sup> *Ivi*, p. 151.

<sup>430</sup> *Ivi*, p. 152.

<sup>431</sup> *Ibidem*.

<sup>432</sup> De Haan, *The History of the Bundesbank*, cit., p. 9.

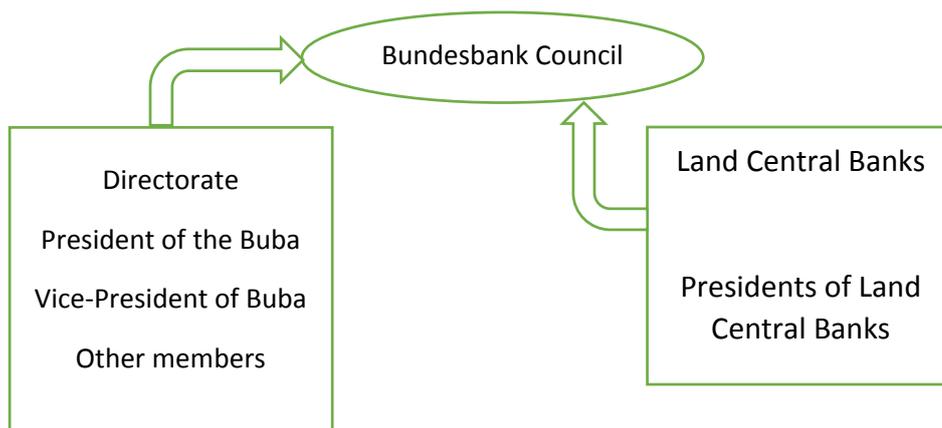


Figure 3: The structure of the Bundesbank.

As it could be implied by the names, the Bundesbank Council is the highest policy-making body. According to the critics, the structure and the operating principle of the Council is very similar to the German Federal state, since it was formed by the Presidents of each Land Central Bank, the eight members of the Directorate, the President and the Vice-President of the Council.<sup>433</sup> Furthermore, the Council followed the federal principle “each Land, one vote,”<sup>434</sup> without taking into consideration the amount of inhabitants or the economic power. The objective of the Bundesbank Council is to discuss current and future policies and to decide credit and monetary policy of the Bundesbank.<sup>435</sup>

The Directorate, now known as Bundesbank Board,<sup>436</sup> was based in Frankfurt and it is still based there at the moment. It consisted of the President and the Vice-President of the Bundesbank and six other members. The Federal government had (and still has) the power of deciding the components of the Directorate, the President and the Vice-President. In a later moment, the Federal Republic President officially designates the nominated people.<sup>437</sup> In particular, the Frankfurt Directorate was composed of a huge number of specialised offices, such as Treasury, Statistics and National Economy, Organisation and Bookkeeping, Credit or Press, Public Relations

<sup>433</sup> Kennedy, *The Bundesbank*, cit., p. 14.

<sup>434</sup> *Ibidem*.

<sup>435</sup> *Ibidem*.

<sup>436</sup> Clarida Richard H., Gertler Mark, “How the Bundesbank conducts Monetary Policy” in C.D. Romer, D.H. Romer (eds.), *Reducing Inflation: Motivation and Strategy*, Chicago, University of Chicago Press, 1997, p. 366.

<sup>437</sup> De Haan, *The History of the Bundesbank*, cit., p. 9.

and Administration. Its tasks were various, from the consultative documents for internal purposes to the issue of the DM currency.<sup>438</sup>

The *Länder Central Banks* are the administrative branches of the Bundesbank. They were considered very important bodies, because of their proximity to the provinces and to people's interests in various fields, for example agriculture and local businesses. They were in charge of credit divisions, statistic division, which collected on field data, foreign currency division, which controlled the investments of locals in foreign currencies or of strangers in DM in their local area, etc..<sup>439</sup>

Finally, the President of the Bundesbank worked within the framework of the Bundesbank Council. He/she had only one vote in the Council, that meant that the President might have high international recognition, without the consequent power that derived. Namely, it was in the duties of the President to try and use his/her international recognition and power and convince the Bundesbank leadership of the rightfulness of certain commitments.<sup>440</sup> There had been disputes arising from this very discrepancy in opinions, for instance the disagreement in the scope of the position taken by the Bundesbank during the Plaza and Louvre agreements (dealing with exchange rates) between 1985 and 1987.<sup>441</sup>

Particularly interesting were the objectives pursued by the German central bank. Historically speaking, the main task was the price stability, which is generally associated with control of inflation. Moreover, a complete list of the Bundesbank tasks is found in the Bundesbank Act, Article 3:

The Deutsche Bundesbank, being the central bank of the Federal Republic of Germany, is an integral part of the European System of Central Banks (ESCB). It shall participate in the performance of the ESCB's tasks with the primary objective of maintaining price stability, shall hold and manage the foreign reserves of the Federal Republic of Germany, shall arrange for the execution of domestic and cross-border payments and shall contribute to the stability of payment and clearing systems. In addition, it shall fulfil the tasks assigned to it under this Act or other legislation.<sup>442</sup>

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<sup>438</sup> Kennedy, *The Bundesbank*, cit., p. 17.

<sup>439</sup> *Ivi*, p. 18.

<sup>440</sup> *Ivi*, p. 15.

<sup>441</sup> *Ibidem*.

<sup>442</sup> Deutsche Bundesbank, The Bundesbank Act, [http://www.bundesbank.de/Redaktion/EN/Downloads/Bundesbank/Tasks\\_and\\_organisation/bundesbank\\_act.pdf](http://www.bundesbank.de/Redaktion/EN/Downloads/Bundesbank/Tasks_and_organisation/bundesbank_act.pdf), consulted on February 2014.

In order to succeed with the stability of the currency, the Bundesbank used the method of the *monetary targeting*. According to Clarida and Gertler, this term depicted (and it still does today) the setting of specific targets in the scope of monetary policy, for which Germany is also famous internationally. The authors underlined how this policy choice had not been warmly welcomed by central banks and academic circles in the past, but now this habit and the discussions about it are increasingly spreading among them.<sup>443</sup> However, in the words of Otmar Issing, quoted by Clarida and Gertler, “Even in Germany, where a high degree of stability of financial relationships was observed, the central bank has never seen fit to transfer monetary targeting to an ‘autopilot,’ as it were.”<sup>444</sup> But, what is a monetary target? And how did the Bundesbank decide, which one should be followed?

The monetary targeting methodology was introduced in 1975 after the collapse of the Bretton Woods agreements.<sup>445</sup> Clarida and Gertler explained the procedure with these words:

Each year the Bundesbank first establishes a goal for inflation. A target growth rate for a designated monetary aggregate<sup>446</sup> is then established that is meant to be consistent with the inflation goal. In particular, the money-growth target is backed out of a conventional quantity-theory equation that links money, velocity, prices, and output. As inputs into the equation, the Bundesbank uses the target rate of inflation and estimates of the trend growth of velocity and the trend growth of capacity output.<sup>447</sup>

The objective of using such monetary targets was to make manifest the inflation rate required to the German economy, as calculated by the central bank, and in particular to workers and management. These last actors are, in the Bundesbank opinion, those to whom the targeting is directed, since their stakes into the employment conditions are high and might suffer from rises in inflation.<sup>448</sup>

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<sup>443</sup> Clarida, Gertler, “How the Bundesbank conducts Monetary Policy,” cit., p. 367.

<sup>444</sup> *Ibidem*.

<sup>445</sup> *Ibidem*.

<sup>446</sup> “Broad categories measuring the total value of the money supply within an economy. In the United States, the standardized monetary aggregates and their measured contents are known as:

M0 – Physical cash and coin

M1 – All of M0 plus demand deposits, traveler's checks

M2 – All of M1 plus savings deposits, money market shares.” Investopedia Dictionary, USA, Monetary Aggregate Definition, <http://www.investopedia.com/terms/m/monetary-aggregates.asp>, updated in 2013, consulted in February 2014.

<sup>447</sup> Clarida, Gertler, “How the Bundesbank conducts Monetary Policy,” cit., pp. 367-368.

<sup>448</sup> *Ibidem*.

Originally, in 1975, the German central bank used fixed money targets but it soon became clear that it was an ambitious choice. From 1979, the *target-zones* were used instead.<sup>449</sup>

The Bundesbank did not only want to keep the inflation rate under control, but it was also careful about determination of targets. The very first year of monetary targeting, 1975, the Bundesbank had set the inflation target at 4,5%, which was very high and uncommon. This was done because Germany was undergoing a stagflation<sup>450</sup> period triggered by the international economic conditions, in particular the oil shock of 1973.<sup>451</sup> However, the usual inflation goal that was set annually from 1986 on was at 2%.<sup>452</sup>

In addition, fundamental in setting the inflation target is the determination of the *monetary aggregate*<sup>453</sup>. First, the German central bank used the *Central Bank Money* or *Zentralbankgeldmenge*, a weighted type of aggregate, of its own construction, but in 1988 it was replaced for a broader one, the M3.<sup>454</sup>

Once the monetary target is set, the Bundesbank could benefit from a series of monetary instruments. Monetary instruments referred to all those tools managed by the central bank in order to control and steer the country's monetary market and to follow monetary objectives.<sup>455</sup> According to Jakob de Haan, the Bundesbank was provided with a list of instruments: minimum reserve requirements, discount window, Lombard window and open market operations.<sup>456</sup> Moreover, monetary instruments used by the German central bank could be also securities repurchase transactions policies, foreign exchange market policies and deposit policies.<sup>457</sup>

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<sup>449</sup> De Haan, *The History of the Bundesbank*, cit., p. 15.

<sup>450</sup> "A condition of slow economic growth and relatively high unemployment - a time of stagnation - accompanied by a rise in prices, or inflation." Investopedia, Stagflation, <http://www.investopedia.com/terms/s/stagflation.asp>, last update 2013, consulted on February 2014.

<sup>451</sup> Clarida, Gertler, "How the Bundesbank conducts Monetary Policy," cit., pp. 368.

<sup>452</sup> *Ibidem*.

<sup>453</sup> See explanation in previous quote.

<sup>454</sup> Clarida, Gertler, "How the Bundesbank conducts Monetary Policy," cit., p. 370.

<sup>455</sup> OECD, Glossary of Statistical Terms: Monetary Instruments Policy, <https://stats.oecd.org/glossary/detail.asp?ID=4471>, last updated July 2002, consulted on March 2014.

<sup>456</sup> De Haan, *The History of the Bundesbank*, cit., p. 18.

<sup>457</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 233.

The *minimum reserve requirement* was introduced in 1948 and it referred to “the minimum reserves required for depositary institutions. [...] A change in a minimum reserve ratio affects the amount of its deposit base a financial institution can lend out.”<sup>458</sup> The *discount rate* was generally associated with the base for short term interest rates in the monetary markets.<sup>459</sup> The *Lombard rate* was (and is) one of the main instruments utilised by the Bundesbank. It referred to the upper limit for the interest rates in the monetary policy. With reference to the *open market operations*, these were usually associated with the purchase and sale of governments bonds in the open market. As reported by de Haan, in 1979 “the Bundesbank developed the instrument of repurchase agreements in fixed interest rates securities”<sup>460</sup> and it soon turned into one of the most used monetary instrument.

In addition to these, the information policy had an essential role in the monetary policies, since a skilful use of information was able to modify the expectations of participants and so controlling prices and capital markets.<sup>461</sup> It must be underlined, however, that a central bank must be careful in using such monetary instruments, because there is always the risk of misunderstanding the Bundesbank’s actions for deliberate finance of public deficits.<sup>462</sup>

One last pillar of the Bundesbank worth to mention briefly is the regulations on which the central bank was based. According to Ellen Kennedy, there were three fundamental statutes: the Bundesbank Act (or Law) of 1957, the Credit Law of 1961 and the Stability and Growth Law of 1967.<sup>463</sup>

Before considering in detail the concept of Bundesbank’s independence and related issues, it is useful to understand the difficulties in goals reconciliation. In the opinion of Manfred J. M. Neumann, there are several difficulties in maintaining a positive relationship between the stability of domestic monetary policy and the stability of the nominal external value of the currency. In fact, in the Bundesbank Act,

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<sup>458</sup> OECD, Glossary of Statistical Terms: Reserve Requirements, <https://stats.oecd.org/glossary/detail.asp?ID=2320>, last update November 2001, consulted on March 2014.

<sup>459</sup> De Haan, *The History of the Bundesbank*, cit., p. 18.

<sup>460</sup> *Ivi*, p. 19.

<sup>461</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 233.

<sup>462</sup> *Ibidem*.

<sup>463</sup> Kennedy, *The Bundesbank*, cit., p. 31.

in its proclamation year, it was avoided a complete predominance of one goal. The President of the Bank Deutscher Länder, Vocke, at the Banking Conference in March 1957 stated that “we don’t want to revalue the currency and we don’t want to adopt the inflationary course taken by some countries.”<sup>464</sup> These words distinctly explained the behaviour of the Central Bank leadership, which implied a classification of the revaluation of the currency tool as a taboo. It was Ludwig Erhard, Minister of Economics, that started to see the revaluation of the DM (which occurred in particular against the dollar) as a tool to contrast the external economic disequilibrium and avoid inflation. Not only the first President but also his successor, Karl Blessing, did share the same opinion with regard to revaluation procedures. Finally, 1961 the first revaluation of the DM occurred but in the framework of the opposition of the Bundesbank.<sup>465</sup>

The same type of conflict arose during the final period of the Bretton Woods system between 1968 and 1971, when the Council refused to let the currency float, thus finishing to support the dollar. The Bundesbank was actively supporting the flow of dollars coming from speculative attacks against the American currency. However, in doing so, the Bundesbank favoured the damage of the internal stability of West German economy. In May 1971, the Federal Minister of Economics, Karl Schiller, decided to cease the German support to the dollar and the DM temporarily went floating. However, this suspension was corroborated by the famous Nixon’s announcement the 15<sup>th</sup> August, which marked the end Bretton Woods exchange-rate system.<sup>466</sup> According to Neumann, the Bundesbank did understand the lesson from Bretton Woods: not to maintain exchange-rate parities at any price provoking suffering on the internal stability, which was soon transformed into the main objective of German central bank economic policy.<sup>467</sup>

Closely connected is also the debate about the form of the central bank’ independence. Above, it was already said how fundamental the central bank

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<sup>464</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 294.

<sup>465</sup> *Ivi*, p. 296.

<sup>466</sup> *Ibidem*.

<sup>467</sup> *Ivi*, pp. 296-297.

independence was (and still is today) and how the objectives of the federal government and the central bank might appear similar and imprecise. In addition to them, another issue might result debateable: concurrent function in the field of foreign monetary policy.<sup>468</sup>

Generally, in the field of international agreements on monetary policies it was the Federal government that was in charge of the international negotiations. However, in a later moment, the responsibilities and rights derived from the agreements were transferred internally to the Bundesbank.<sup>469</sup> Moreover, in a system with fixed exchange rates, as the European Monetary System (EMS), “the changes in parity in respect of the currencies of other states [...] are ordered by the Federal Government.”<sup>470</sup> The President of the Bundesbank could, nevertheless, be of fundamental importance in the Federal government decisions regarding parities.

Due to these possible concurrent functions between the government and the central bank, conflicts might arise. In the case of legal conflicts, general regulations are applied, since there is no specific solution to such a problem. According to Klaus Stern, the courts, to which it might be appealed, are two: the general administrative courts and the Federal Constitutional Court. Nonetheless, the latter could intervene provided that the issue regards the constitutional law or other issues in its competences list.<sup>471</sup>

In short, the solution could be found in the Bundesbank Act: “the Bundesbank is neither a constitutional body nor otherwise party to a dispute between highest Federal bodies relating to rights and duties.”<sup>472</sup> Hence, the recourse might be done to the general administrative courts and they would act following their Law.

As far as conflicts in the matter of monetary policies were concerned, it was considered desirable (and it is considered so today) to settle all questions internally, between the Bundesbank and the government themselves.<sup>473</sup>

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<sup>468</sup> *Ivi*, p. 152.

<sup>469</sup> *Ivi*, pp. 152-153.

<sup>470</sup> *Ibidem*.

<sup>471</sup> *Ivi*, p. 154.

<sup>472</sup> *Ibidem*.

<sup>473</sup> *Ivi*, p. 156.

The very first debate between the central bank and the government occurred in November 1955 when Chancellor Adenauer tried to stop the actions of the President of the Bundesbank, Vocke, because he was implementing monetary policies (concerning interest rates) without the consent of the government.<sup>474</sup> In the following years, the German economy was experiencing a huge boom, the so-called economic miracle. Also, foreign capital was flooding the economy because of the DM full convertibility from 1958, thus triggering pressure on rising inflation.<sup>475</sup> Soon the Bundesbank had to determine whether it should let the currency revalue or control inflation internally. A consequence of the possible revaluation of the DM would have caused damage to its exports. In 1961, the Federal Economics Ministry, Erhard, favoured revaluation in contrast with the Bundesbank, Deutsche Bank and industrial interests. In March 1961 the DM was revalued 5%.<sup>476</sup>

A second debate arose during the Helmut Schmidt government, in particular in 1981 and 1982. Internationally speaking, the 1970s had been a critical decade, since the 1973 first oil shock triggered a major rise in oil prices while attempts were made to depress the economies in order to reduce expenses.<sup>477</sup>

Chancellor Helmut Schmidt was preoccupied with the German situation: the government deficit reached 1,82% of the GDP and the trade deficit amounted at 25 billion DM, the inflation rate had reached 5,5% and they were trying to compete with very high American interest rates.<sup>478</sup>

Socially speaking, West Germany was undergoing a period of harsh demonstrations organised by citizens initiatives groups and university students. Businesses found themselves under pressure from the economic conditions. Even politically, inside the SPD-FDP coalition government there was huge pressure regarding the direction to take. The Bundesbank opted for a sharp rise in interest rates (specifically the Lombard rate) and several measures to reduce the liquidity

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<sup>474</sup> Kennedy, *The Bundesbank*, cit., p. 38.

<sup>475</sup> *Ivi*, p. 39.

<sup>476</sup> *Ibidem*.

<sup>477</sup> *Ivi*, p. 40.

<sup>478</sup> *Ibidem*.

accessible to the banks.<sup>479</sup> The policy choice provoked harsh criticism from all the fields of society, as exemplified in the various German newspapers at the time, but it is also cited at international level, as in the Italian newspaper *il Giornale*.<sup>480</sup> The government began to encourage investments in new energy sources in particular, as one of the main reasons of the public deficits was the too high prices for raw materials. The solution to the problem was found in the reduction of energy costs.<sup>481</sup> However, the solution found by the government was not welcomed by the Bundesbank President, Karl Otto Pöhl, as it comprised an agreement with Saudi Arabia and the French President, Giscard d'Estaing (the origins of the European Monetary System will be treated in more detail in the next chapter).

In Ellen Kennedy opinion, this clash between the government and the central bank demonstrated the difficult interrelation of the politics into the field of the monetary policy: “the conflict between Schmidt’s government and the Bundesbank demonstrated the importance of Germany’s legal culture in an economic crisis.”<sup>482</sup> The President Pöhl continued sustaining the importance of reducing the current-account deficit to enhance employment.

During the mid-1980s, the economic situation of West Germany was not improving and some authors blamed high interest rates and a depressing policy. The United States, on the other hand, had a similar, if higher real interest rates level, but did apply an expansionist fiscal policy. In 1984, the United States began to manoeuvre in order to reduce the value of the dollar. The year after the value of DM began to raise against the dollar, that meant an appreciation of the German currency. This was accompanied by a still weak real economy, as it was exemplified by the deterioration of output growth during 1986 and 1987. However, the appreciation of the DM against the dollar brought a lowering of the inflation rate below the target of 2%.<sup>483</sup> As a consequence, the Bundesbank was brought to ease the short-term interest rates and

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<sup>479</sup> *Ivi*, p. 45.

<sup>480</sup> Allegri Angelo, “Quando la Germania si salvo con i soldi della Bundesbank”, *Il Giornale*, 14<sup>th</sup> August 2012, <http://www.ilgiornale.it/news/esteri/quando-germania-si-salv-i-soldi-bundesbank-829669.html>, consulted on March 2014.

<sup>481</sup> Kennedy, *The Bundesbank*, cit., p. 48.

<sup>482</sup> *Ivi*, p. 51.

<sup>483</sup> Clarida, Gertler, “How the Bundesbank conducts Monetary Policy,” cit., p. 376.

also real short-term interest rates were reduced, triggering a slow output recovery, which would have sped up in 1989.<sup>484</sup>

Now consider the role of the German Central Bank in the Unification process.

The first vital challenge of the Bundesbank was the monetary unification or, better said, the accession of the five new East German Bundesländer to West Germany. As already explained in the previous sections, the West German government, Chancellor Kohl in particular, soon after the fall of the Berlin Wall began to convince the Eastern electorate of the good intentions with regard not only of the monetary union but also of the unification process overall. The Bundesbank Council did not agree with the government about the rapid monetary and economic unification, as it was exemplified by several interviews granted by the Bundesbank President, Karl Otto Pöhl, in January 1990.<sup>485</sup>

In the Council view, the reasons supporting this implied the structural weakness of GDR economy, for instance the lack of free competition and private ownership. Therefore, the West German central bank was advocating a more slow and gradual type of accession. However, since February 1990 Kohl had begun the talks with the Eastern parts to implement the economic unification. This behaviour led the Bundesbank Council to criticise harshly the government.<sup>486</sup>

A further issue of conflict was found in deciding the most appropriate conversion rate, because of the diverging points of view of the two parts. As usual, the main concern of the Bundesbank regarded the internal stability of the DM, in particular avoiding rises of prices. The problem was the uncertain data stemming from the GDR with regard to productivity, money stock, velocity of circulation of money and the political imposed price levels. In June 2000, Karl Otto Pöhl was interviewed by the German newspaper *Süddeutsche Zeitung* and he stated that the

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<sup>484</sup> *Ivi*, p. 367.

<sup>485</sup> Blohm Bernard, Hupe Reiner, "Das muß doch die DDR entscheiden: Ein ZEIT- Gespräch mit Karl Otto Pöhl über eine deutsch-deutsche und die europäische Währungsunion", *Die Zeit*, 26<sup>th</sup> January 1990, <http://www.zeit.de/1990/05/das-muss-doch-die-ddr-entscheiden>, consulted on March 2014.

<sup>486</sup> Morys Matthias, *Was the Bundesbank's credibility undermined during the process of German reunification?*, Working paper No. 74/03, Department of Economic History, London School of Economics, London, May 2003, p. 8.

agreed conversion rates, that were later used, were the result of a compromise between the Federal government and the central bank itself.<sup>487</sup>

Moreover, already in early 1990, the Council had warned the German population of the risk of a raise in taxes in the near future due to the enormous expenditures that might have been triggered by the unification process. This latter declaration provoked the criticism and disdain of the Federal government. It was obvious that once again the government and the central bank were at conflict: the Bundesbank criticised the fact that the Federal government was trying to minimize the costs that the unification might have brought to Germany's balance of payments. In addition, the Bundesbank was raising questions about the independence issue in the framework of the birth of a European Central Bank and the possible behaviour that Federal government would choose in economic terms.<sup>488</sup>

Specific of the unification issue, according to Clarida and Gertler, the Bundesbank had two concerns. The first one implied the increase in inflation level over the targets in 1991, also triggered by the economic growth begun in 1989. Secondly, the currency conversion at 1:1 in the new Bundesländer entailed a sudden increase of 13% of the M3 aggregate in only four weeks. Therefore, it was understandable why the German central bank was so preoccupied with exceeding its monetary targeting.<sup>489</sup> The difficulty was found in the calculations of the provisions of liquidity needed in Eastern Germany.

During 1990 and 1991, various trends could be registered internationally, but two among them were, on the one hand, a weak economic growth (cyclical downswing) in the global context, which led to different responses from the various central banks, and on the other hand the fact that the European Community was trying to implement economic convergence.<sup>490</sup>

The Bundesbank decided to continue its usual policy of monetary targeting even in the framework of the problematic period of unification. Initially, in 1990, the

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<sup>487</sup> Piper Nikolaus, "Wir sind im Jahr überrumpelt worden", *Süddeutsche Zeitung*, 29<sup>th</sup> June 2000, p. 31.

<sup>488</sup> Morys, *Was the Bundesbank's credibility undermined during the process of German reunification?*, cit., p. 19.

<sup>489</sup> Clarida, Gertler, "How the Bundesbank conducts Monetary Policy," cit., p. 377.

<sup>490</sup> *Ibidem*.

actual monetary growth of West Germany respected the target's corridor (4-6%) but the extended M3 growth did exceed the target, and it accounted for 8%. In 1991, the monetary target did not change, in spite of the fact that it was imposed on the united Germany now. The fear of a raise of inflation because of the monetary overhang stemming from the conversion remained very high among the Bundesbank Council.<sup>491</sup>

The growth of the money stock in the Western part brought the need to raise the interest rates in February 1991, which was followed by other two increases in August and December. This move was done in order to control the future increase of inflation and even of inflation expectations.<sup>492</sup> According to Ernst Baltensperger, the Eastern part of Germany was experiencing a decline in the monetary stock, derived from the adjustments after conversion, which resulted into the Bundesbank decision to lower the monetary target in the first half of 1991.<sup>493</sup> However, in the second half of 1991 the M3 aggregate growth began to speed up again, exceeding the target.

Here below the table from the OECD Statistics of consumer price changes in West Germany exemplifying the level of inflation during the unification years.

In Eastern Germany it was thought that inflation reached 13,5% in 1990.

Subject	Consumer prices - all items								
Measure	Percentage change on the same period of the previous year								
Frequency	Annual								
Time	1988	1989	1990	1991	1992	1993	1994	1995	
Country									
Germany	i 1,3	2,8	2,7	4	5,1	4,5	2,7	1,7	

data extracted on 12 Mar 2014 14:49 UTC (GMT) from OECD.Stat

Table 7: OECD.StatsExtras, Consumer Prices: annual inflation in Germany, [http://stats.oecd.org/Index.aspx?Data setCode=MEI\\_PRICES#](http://stats.oecd.org/Index.aspx?Data setCode=MEI_PRICES#), last updated 11<sup>th</sup> March 2014, consulted on 12<sup>th</sup> March 2014.

As far as the monetary policy was concerned, in the first half of 1992 the Bundesbank interest rates were kept high, also because of fear of a continued raise of inflation as also the M3 money stock was continuing to grow rapidly. In Ernst

<sup>491</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 478.

<sup>492</sup> *Ibidem*.

<sup>493</sup> *Ivi*, p. 482.

Baltensperger opinion, the Bundesbank maintained such monetary expansion “not to impose unnecessary restriction on the- still favourable- development of the real economy and, more importantly, the great attention paid to exchange rate developments and international contexts.”<sup>494</sup>

Particularly during 1992, the German central bank was receiving the critics of the majority of European Community members, when the European Monetary System was at risk due to German high interest rates. The EMS system and its crisis will be treated in the next chapter in more detail, but in summary, in 1992, the Bundesbank was forced to divert funds to acquire transactions and sale treasury bills in order to counter the flood of foreign currency used to maintain EMS parities.<sup>495</sup>

In the same period the DM appreciated, a fact that helped to discourage inflation. In 1993, monetary expansion became normal.<sup>496</sup>

The cyclical downturn that had occurred globally reached Germany in the last months of 1992 and continued in 1993 with a reduction of GDP with an increase of Eastern wages. This situation saw also a slight rise in unemployment in West Germany.<sup>497</sup> However, in 1994 the German GDP began to grow rapidly again. Restrictive measures might have been needed, from the autumn 1992 on the Bundesbank decided to begin to cut interest rate very gradually over time. This policy was maintained throughout 1993 and until the spring of 1994.<sup>498</sup>

Internationally speaking, the Bundesbank raised a huge amount of criticism with its monetary policy. The New York Times journalist Gerard Vila explained the problem in his article “Waiting for the Bundesbank Means Too Much Pain for Europe” of the 12<sup>th</sup> August 1992. He pointed out that transfers to East Germany were financed by monetary growth, since the German population would not have accepted a raise in taxes. As the money stock grows, the risk of a raise in inflation increase. To counter this trend, to try and suppress demands in West Germany and to allow the adaptation of East German economy the Bundesbank set high interest rates. The problem would

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<sup>494</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 487.

<sup>495</sup> *Ivi*, pp. 485-490.

<sup>496</sup> *Ivi*, p. 490.

<sup>497</sup> Clarida, Gertler, “How the Bundesbank conducts Monetary Policy,” cit., p. 377.

<sup>498</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., pp. 485-486.

not have emerged if the European Community member countries had not been financially and monetarily integrated. The result was an export of the high levels of interest rates to all other members of the EC participating to the integration.<sup>499</sup>

In the next chapter, this issue will be treated with more details.

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<sup>499</sup> Vila Gerard, "Waiting for the Bundesbank Means Too Much Pain for Europe", *The New York Times*, 12<sup>th</sup> August 1992, <http://www.nytimes.com/1992/08/12/opinion/12iht-edvi.html>, consulted on March 2014.

## Chapter 4

### The Crisis of the European Monetary System

In the previous chapter it was implied that the German Unification was not only an all-German experience but it had international repercussions. The period soon after the Second World War was characterised by deep economic instability worldwide. However, the European countries have tried to cooperate and ameliorate their relations with the aim of improving their economic conditions and maintaining peaceful coexistence.

This chapter will deal with the historical background and a brief overview of the economic events preceding the institution of the EMS, the EMS itself and how it worked. Specifically, it will focus on German Unification, the crisis of the EMS and the European repercussions that arose from the German behaviour. The aim of this part is to analyse and understand the birth of the European Economic Integration by means of a failed system and the reasons why this system did not succeed.

#### **Europe: Historical background**

In order to understand the events occurred during the 1980s and the early 1990s it is essential to go back and see the historical and economic background of the European and international economy.

One of the main events in the international economic history was the suspension of the dollar-gold convertibility on the 15<sup>th</sup> August 1971. As already said in the previous section on the Bundesbank's role in the unification issue, the Bretton Woods System became unsustainable in the early 1971, when the dollar flow and speculative attacks to the DM triggered the suspension of the DM participation to the mechanism in May 1971. Moreover, the American economy was undergoing a period of high pressure stemming from bank and the industrial sector at home. The United States President Nixon's announcement was regarded as the end of the Bretton Woods System, which had been useful to stabilise the international economic order soon after the end of the Second World War. Immediately, chaos was generated at

international level as currencies went floating and the gold began to be handled as a raw material rather than a monetary means.<sup>500</sup>

In the next few months, the main economic and industrial powers tried to cooperate and agree on a form of international monetary system, in particular because of the serious instability triggered by the collapse of Bretton Woods. In December 1971, the representatives of the G-10 (Group of Ten) met in Washington DC at the *Smithsonian Conference* and agreed for a devaluation of the dollar and the establishment of fluctuations margins with the other currencies. The fluctuations bands amounted to 2,25%. Moreover, in this occasion the Americans firmly refused to re-establish dollar-gold convertibility.<sup>501</sup>

Since the Second World War the European countries had always tried to cooperate first to restore a normal economic development and later to stabilise in order to boost trade and cooperative policies in their region. Namely, one of the first approaches at cooperative policies was made with the European Payments Union (EPU) in 1950.<sup>502</sup> The main aim of this institution was to restore inter-European convertibility, specifically directed to trade relations. At the beginning, the European trade relations were conducted through the means of bilateral agreements, for the WWII had destroyed not only physical infrastructure but also economic interrelations. The EPU provided a means to overcome bilateral agreements and it involved the assignment of an import and export quota deposited at the EPU. When a country exhausted its quota there were temporary impediments to the export and import opportunities for that country.<sup>503</sup>

The first major crisis in the EPU occurred to the Federal Republic of Germany in 1950 caused by the public budget difficulties after the War. The solution was found within the EPU with the temporary suspension of imports, which contributed to

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<sup>500</sup> Eichengreen Barry, *Globalizing Capital: A History of the International Monetary System*, Princeton, Princeton University Press, 1996, p. 133.

<sup>501</sup> *Ibidem*.

<sup>502</sup> *Ibidem*.

<sup>503</sup> Gros Daniel, Thygesen Niels, *European Monetary Integration: From the European Monetary System to European Monetary Union*, Avon, Longman, 1992, p. 6.

reduce the public deficit and to a tightening of the public spending.<sup>504</sup> Already in 1951, the FRG public deficit was reduced and the trade limitations applied by the EPU were removed. However, such trade problems did not diminish with time, even for the FRG. Finally, this system ceased to function since the position of the participants' quota improved in 1957 and 1958, which meant that the EPU was not needed. Formally speaking, the EPU ceased in late 1958.<sup>505</sup>

Most importantly, it was in the framework of the Bretton Woods Agreements that the European recovery and integration was taking place. Moreover, in 1967 the European Economic Community was coming into force with the *Treaty of Rome*, which involved the launch of the European open markets and the *Common Agricultural Policy*. The *Treaty of Rome* introduced also the idea of common policy in the exchange-rate field, but the commitments in this direction did not involve other specific provisions.<sup>506</sup> In the 1960s some European currencies like the French Franc devaluated and other currencies revaluated, like the German DM. However, at this point the problem in Europe were not the exchange-rates or the customs union per se, but the prices of basic goods. Specifically, under the *Common Agricultural Policy* the prices were established on a common unit, called *European Unit of Account*, which "was defined as the gold content of one US dollar."<sup>507</sup> More details about the EUA will be given in the next section.

The national prices for agricultural products were equivalent to the common prices in EUA. Therefore, the prices of agricultural goods were strictly connected to the variations in EC exchange rates. For this reason a change in the exchange rates of one European currency (in the Bretton Woods System it involved the dollar parity) gave several internal problems to that country.<sup>508</sup>

As a consequence, these imbalances in exchange rates risked to endanger the core of the European Community, the *Common Agricultural Policy*. New methods were found in the 1960s, in order to overcome this problem, but at the end of the

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<sup>504</sup> Gros, Thygesen, *European Monetary Integration*, cit., pp. 7-8.

<sup>505</sup> *Ibidem*.

<sup>506</sup> *Ibidem*.

<sup>507</sup> *Ivi*, p. 11.

<sup>508</sup> *Ibidem*.

decade and as the customs union were completed, the need to go beyond the CAP arose.<sup>509</sup>

Also thanks to the initiative of the German Chancellor Willy Brandt, the idea of a European economic and monetary union began to be taken more seriously into account. At the beginning of 1970, Pierre Werner was selected to assemble a group of experts, the Werner Group, in order to discuss and prepare a report on the future steps and framework for the EC aimed at achieving a monetary union. The Werner Group met several times between March and May 1970.<sup>510</sup>

In short, the Werner Report highlighted the need to set few steps dealing with basic objective towards the common aim, not only simple coordination and policy harmonisation, but also shared risks and solidarity between members. In addition, it considered the institution of a common capital market, tax harmonisation, agreement on international monetary relations as a single unit, fixed internal exchange rates and the eventual implementation of a certain degree of independence in the monetary policies of the EC.<sup>511</sup>

In addition, the Werner Plan applied a target period, the year 1980, in which the European Monetary Union should come into force. The experts pointed out also that there might be a need for public financial transfers to overcome huge disequilibrium between European regions in the long run. Interestingly, the Report did not pay much attention to the inflation and convergence, since preoccupations of such kinds arose only during the early 1990s.<sup>512</sup> In the words of the Werner Group the EMU involved the “total and irreversible convertibility of currencies, the elimination of fluctuations in the exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital.”<sup>513</sup>

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<sup>509</sup> *Ivi*, p. 12.

<sup>510</sup> Danescu Elena Rodica, “The Werner Report” in *A rereading of the Werner Report of 8 October 1970 in the light of the Pierre Werner family archives*, Sanem, CVCE, November 2012, p. 2.

<sup>511</sup> *Ivi*, p. 3.

<sup>512</sup> Gros, Thygesen, *European Monetary Integration*, cit., p. 13.

<sup>513</sup> Werner Pierre, Ansiaux Baron Hubert, Brouwers Georg, Clappier Bernard, Mosca Ugo, Schöllorn Jean-Baptiste, Stammati Giorgio, *Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the Community*, Werner Report in Bulletin of the European Communities, Brussels, 1970, p. 10.

The Werner Report was not implemented, but its influence remained important in the *Economic and Financial Affairs Council* (ECOFIN) until it was surpassed by the Delors Report nearly ten years later. The ECOFIN was one of the first arrangements of the Council and it constituted of the Finance and Economic Ministers of the European Community member states. Sometimes it involved also the Budget Ministers, but only when the topics discussed required their intervention. The main aim of the ECOFIN was to discuss the economic policy coordination, monitoring of the member's monetary policy, financial markets and capital movements and also the relations with other countries outside the EC.<sup>514</sup>

The ECOFIN did not see the necessity to institute new bodies and intervene with a monetary integration, because the *Bretton Woods System* and the *International Monetary Fund* (IMF) still permitted the EC to maintain fixed exchange rates. Therefore, in the opinion of Gros and Thygesen, the Werner Plan failed to be implemented because of the existence of a still functioning *Bretton Woods* and of the *Smithsonian Agreement* until 1973.<sup>515</sup>

However, as already said above, in August 1971 US President Nixon discontinued the dollar-gold convertibility triggering great concern in Europe. The *Smithsonian Agreement* did last until 1973, when the dollar further devaluated of 10% and left the Smithsonian bands.

The very first step towards the creation of EMU was taken in 1971 and was going to be implemented the same year. However, in May Germany and the Netherlands allowed their currency to float, especially because of the huge amount of dollars and consequent rising inflation in Germany. The move of the German and Dutch authorities stopped the monetary integration process abruptly.<sup>516</sup> At the establishment of the *Smithsonian Agreement*, the European members became worried. In fact, with the new bands the dollar could oscillate between +2,25% and -

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<sup>514</sup> Council of the European Union, ECOFIN Council, <http://www.consilium.europa.eu/policies/council-configurations/economic-and-financial-affairs.aspx?lang=en>, updated 2014, consulted on March 2014.

<sup>515</sup> Gros, Thygesen, *European Monetary Integration*, cit., p. 14.

<sup>516</sup> *Ibidem*.

2,25% with respect to another currency, which meant that two European currency would have floated up to 4,5% with each other.<sup>517</sup>

The preoccupation of the EC regarding the new monetary agreement, was understandable because it implied a huge difference in competitiveness between a strong currency country and a weak currency country and it endangered the *Common Agricultural Policy*.

For this reason, the six EC members, Belgium, France, Germany, Italy, Luxembourg, the Netherlands, signed the *Basel Agreement*, which entered into force on the 24<sup>th</sup> April 1972, just four months after the *Smithsonian Agreement*. The EC members decided to narrow the fluctuation bands against one another, namely at 4.5% or between +2,25% and -2,25%.<sup>518</sup>

This system was called *the snake* and more completely, *the snake in the tunnel of the dollar* because, virtually, the dollar created a tunnel with its wider fluctuations margins and inside this, the European snake was free to float within the dollar's margins, like a proper snake formed by the European currencies pegged with each other.

In few weeks, other states joined the *snake in the tunnel*: the United Kingdom, Ireland, Denmark and Norway. However, the stability of the snake did not last for long time. Already in June 1972, the UK and Ireland were forced to withdraw because of a foreign exchange rate crisis of the Sterling that brought it to the lower margin of the bands.<sup>519</sup> Denmark was undergoing to the same problem and it withdrew few days after the UK. In February 1973, it was the time for the Italian Lira to withdraw from the system.<sup>520</sup>

While the European *snake* was involved in some exchange rate crisis, the dollar was experiencing two important devaluations. The second one in particular triggered the failure of the *Smithsonian Agreement* since the dollar broke its fluctuations belts in March 1973 and continued for some months its devaluation.<sup>521</sup>

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<sup>517</sup> *Ivi*, p. 16.

<sup>518</sup> *Ibidem*.

<sup>519</sup> *Ibidem*.

<sup>520</sup> *Ibidem*.

<sup>521</sup> *Ivi*, p. 18.

From this moment on this system was only known as *the snake in the lake* because there was no dollar tunnel anymore.

The dollar crisis created pressure on the European currency equilibrium causing the revaluation of the DM of 3% immediately in March 1973 and of another 5,5% some months later. The German trend was followed after some hesitation from the Netherlands and Norway. Moreover, from the point of view of Gros and Thygesen, it was at this point that the differences between strong and weak currencies began to be increasingly felt in Europe, on the one hand working out the DM as a strong currency and on the other hand the French Franc as a weak currency.<sup>522</sup>

The monetary problems were exacerbated also by the oil shock of 1973. In January 1974, the French Franc was allowed to float and left the *snake*, for it did not resist to such pressures, but it re-entered the system in July 1975 at the antecedent rate. The 1973 oil shock triggered an increase of inflation inside the snake and outside the snake, for instance in Italy, where the inflation rate reached 20% in 1975 in comparison with the average inside countries with a maximum of 15%. The rising of prices and the change in exchange rates were risking to create a vicious cycle for some countries. Even France was experiencing a recessive period in the Autumn of 1975 and left the snake again in March 1976.<sup>523</sup>

In October 1976, the countries still participating in the snake agreed on a common realignment, the *Frankfurt Agreement*, which represented the first common agreed realignment of more than one currency at the same time. Moreover, it opened a period, until 1978, of various realignments, for instance the devaluations of the Swedish, Danish and Norwegian currencies and the revaluation of the DM. *The snake* was completely resumed when the European Monetary System became operational in March 1979.<sup>524</sup>

Soon after the exit of the dollar from the *Smithsonian Agreement*, the American currency encountered further months of devaluations but afterward it

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<sup>522</sup> *Ibidem.*

<sup>523</sup> *Ibidem.*

<sup>524</sup> *Ivi*, p. 17.

settled, having eradicated the previous overvaluation and becoming more and more demanded following the oil shock. It is important to mention the strong difference between the dollar and the DM during 1975, 11% gap that required the support of the German Central Bank to the dollar.<sup>525</sup> The Bundesbank continued intervening in support of the dollar in 1977 and 1978, while the Carter administration was continuing to stimulate the American economy with expansionary policies. In July 1978 at Bonn, Carter proclaimed the beginning of anti-inflationary policies and the FRG government conceded to raise the public expenditures in order to improve internal demand in the next year.<sup>526</sup> The European initiative to expand was taken into consideration also by the Japanese government with the main aim of countering the dollar's decline and the foreign deficits stemming from it.<sup>527</sup>

At the eve of the 1980s, Germany and Japan ceased to pursue the stability of exchange rates and the dollar began to appreciate between 1980 and 1981. Meanwhile the American budget deficit situation did not improve with the Reagan administration. Because of the widening of the American public deficit, the interest rates began to raise attracting investments and revaluating more and more the dollar between 1983 and 1985.<sup>528</sup> In February 1985, the dollar continued to appreciate while the interest rates premium<sup>529</sup> ceased to follow the previous trend. Immediately, the investors were realising that there might have been a bubble<sup>530</sup> on the dollar and this could have caused a huge capital flight. Consequently, the G-5 decided to meet in New York City at the Plaza Hotel in September 1985 in order to cooperate and try to guide the value of the dollar downward and jointly. At the

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<sup>525</sup> Eichengreen, *Globalizing Capital*, cit., p. 144.

<sup>526</sup> *Ibidem*.

<sup>527</sup> *Ibidem*.

<sup>528</sup> *Ibidem*.

<sup>529</sup> "An asset's risk premium is a form of compensation for investors who tolerate the extra risk - compared to that of a risk-free asset - in a given investment. [...]For example, high-quality corporate bonds issued by established corporations earning large profits have very little risk of default. Therefore, such bonds will pay a lower interest rate (or yield) than bonds issued by less-established companies with uncertain profitability and relatively higher default risk." Investopedia Dictionary, Risk Premium, <http://www.investopedia.com/terms/r/riskpremium.asp>, updated in 2013, consulted from December 2013 until March 2014.

<sup>530</sup> "An economic cycle characterized by rapid expansion followed by a contraction. [...]Bubbles form in economies, securities, stock markets and business sectors because of a change in the way players conduct business." Investopedia Dictionary, Bubble, <http://www.investopedia.com/terms/b/bubble.asp> updated, in 2013, consulted from December 2013 until March 2014.

proclamation of the cooperation between the finance ministers and the central banks governors, the dollar devalued 4% against the yen and the DM, but it progressively endured its fall.<sup>531</sup>

The *Plaza Agreement* did improve the situation of the dollar, when at the end of 1986 it had devalued of around 40%. However, the partners of the United States, in particular Japan, were preoccupied by the consequences of such a dollar devaluation, since it put pressures on Japanese competitiveness. A bilateral agreement between the United States and Japan tried to find a solution to this problem.<sup>532</sup>

A further important event to be considered is the *Louvre meeting* in February 1987. The G-7 finance ministers consented to stabilise the dollar value at the 1987 levels, even if not specific decisions were taken at that point. As a matter of fact, already the following year the dollar tended to appreciate up to mid 1989. However, at the end of 1989 and through the early 1990s the dollar's value tended to decline. This last pattern was good for American producers and trade, but it was not for other nations, for instance Japan, where the undervalued dollar equalled a tightening of competitiveness.<sup>533</sup>

### **The institution of the European Monetary System and how it worked**

In the previous section, it was considered a brief historical background of the institution of the EMS. From the information reported above, it is clear that the period between the 1970s and the 1990s had been characterised by continued economic imbalances. This could be applied not only at global level but in particular at European level, where attempts at monetary and economic integration at various levels were being implemented. Hence, first the establishment of the European Monetary System will be considered in detail and second it will be dealt with the mechanics of the system and how it influenced the member countries.

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<sup>531</sup> Eichengreen, *Globalizing Capital*, cit., pp. 147-149.

<sup>532</sup> *Ivi*, p. 150.

<sup>533</sup> *Ivi*, pp. 151-152.

At the end of the 1970s, there was a shared feeling about the failure of European integration and the Werner Plan. However, a new initiative was being presented by the French President Valéry Giscard d'Estaing and the FRG Chancellor Helmut Schmidt during the year 1978. According to Gros and Thygesen, there were three main political factors in Europe that influenced the realization of the new project. First, the normalisation of the political situation in France, where in March 1978 the parliamentary elections were held and, in particular, stability-oriented policies for the near future were confirmed. Germany continued to be politically committed to stability not only internally but specifically towards the EC. The second factor, in the authors' opinion, regarded the political tensions in Italy, where the Communist party was made part of the government majority because of the rising importance throughout the Italian population. The third factor involved the United States expansive policies and the decline of the value of the dollar from the point of view of the FRG government. Consequently, the German currency was undergoing a period of appreciation, which created alarm because of the deriving pressures and difficulty in finding a common international policy aiming at the stabilisation of the dollar.<sup>534</sup>

The German Chancellorship initiative was trying to convince other EC members of the importance of a stability-oriented common policy for the near future. Germany sought to stabilise the trade conditions in order to improve its trade relations, defend itself from the accusation of implementing detrimental policies in Europe and to boost the importance of European policies at international levels.<sup>535</sup> Germany's ideas were welcomed by some economic partners, first of all France, which was trying to underline the importance of a common response at EC level to external policies, and also the UK supported Germany as the main European surplus country to be acknowledged. The main difficulty arising from the various economic policies interpretation in the European framework was the divergence in the path that had to be followed.<sup>536</sup>

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<sup>534</sup> Gros, Thygesen, *European Monetary Integration*, cit., pp. 35-36.

<sup>535</sup> *Ibidem*.

<sup>536</sup> *Ivi*, p. 37.

Before the Schmidt-Guiscard proposal in April 1978, other three approaches were discussed during the 1970s. The first one was named after the French Finance Minister Jean-Pierre Fourcade, namely the *Fourcade Plan* of 1974. The main features involved the utilization of intra-marginal interventions, large credit, the establishment of the *European Unit of Account* as a sort of anchor for exchange rates and a common policy for the relationship with the dollar. These characteristics would have been the main points for the establishment of the EMS in 1978 and its reform ten years later.<sup>537</sup>

Particularly interesting is the concept of the *European Unit of Account*. In the words of the *European Monetary Committee from the Report of the Monetary Committee on the Problem of the European Unit of Account of 1974*:

The Unit of Account to be utilised in the European Committee serves the following functions:

- a) The denominator and measure of claims and obligations arising from intra community monetary transactions;
- b) The instrument to account for and, in certain cases, to determine the value of financial transactions and to maintain over time the relative value of the rights and obligations, for example in the European Development Fund, the Social Fund and the European Coal and Steel Community;
- c) The instrument to make it possible to preserve a given and unified price structure in certain sectors of the Community such as Agriculture.<sup>538</sup>

The Report continued assessing the difficulties of its utilisation inside the EC, the basic approaches that might be allowed and some final suggestions with regard to the future steps to implement such a system. Moreover, the EUA was the antecedent for the European Currency Unit of 1978 and, to a certain extent, of today's Euro.<sup>539</sup>

The *Fourcade Plan* was said to be very disapproving of the asymmetrical system of fixed exchange rates, which was a basic feature of the future preparation of the EMS. In fact, it was contrary to the symmetrical system in the snake, where both strong and weak currencies were forced to intervene to defend the margins. However, this approach was not welcomed particularly warmly by the UK and Italy,

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<sup>537</sup> *Ivi*, p. 38.

<sup>538</sup> European Monetary Committee, *Report of the Monetary Committee on the Problem of the European Unit of Account*, Brussels, European Communities, 4<sup>th</sup> December 1974, p. 1.

<sup>539</sup> *Ivi*, pp. 2-3.

because they were not willing to commit to any other modification in their exchange-rate policy. Also for these reasons the *Fourcade Plan* was abandoned during 1975.<sup>540</sup>

A second proposal came from the Netherlands, specifically from the Financial Minister Duisenberg in the Summer of 1976. The main characteristics of the *Duisenberg Plan* was the presentation of a target zone, in which the exchange rate should have been limited.<sup>541</sup> However, this proposal met the critics of Germany and some doubts about its application only for the three floating countries or for the most powerful, the DM. In 1977, the Dutch Plan was delayed but the main feature that was saved for the future EMS debates was the need for an instrument, which could eventually require an automatic adjustment of exchange rates.<sup>542</sup>

The third project was called the *Commission Plan* and it came from the initiative of the new President of the EC Commission, Roy Jenkins, at the beginning of 1977. This approach was widely considered as the most radical one. The main features of the Plan comprised the idea of transfers to the EC of a part of the public finance functions and a revision of the *Duisenberg Plan*, which regarded the target zones and in particular their opening towards the DM participation. However, the global imbalances occurring in late 1977 deriving from the fall of the dollar did not convince the European countries in committing to new obligations.<sup>543</sup>

The Schmidt-Giscard plan was proposed the 7<sup>th</sup> and 8<sup>th</sup> April 1978 at the Copenhagen European Council. Although the difficulties arising the previous years with the other plans, the French-German one revealed to be more ambitious and it did also consider some of the preceding discussions. In 1978, the dollar became unstable once again, triggering a raise of the DM and creating problems inside the snake, since the remaining currencies were unable to control the DM appreciation, consequently increasing the probability of more devaluations or withdraws.<sup>544</sup> On the other hand, the European member currencies that were floating outside the snake were undergoing a calm period in their exchange rates. The proposal for a common

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<sup>540</sup> Gros, Thygesen, *European Monetary Integration*, cit., pp. 38-39.

<sup>541</sup> *Ibidem*.

<sup>542</sup> *Ivi*, p. 40.

<sup>543</sup> *Ivi*, pp. 41-42.

<sup>544</sup> *Ibidem*.

and essentially intra-European (regional) monetary policy was becoming very attractive to the majority of EC member states. The termination of a full commitment to dollar stability was not well welcomed by the UK authorities, who advocated a globalist approach.<sup>545</sup>

The two initiators did not follow the usual path for the presentation of their idea. In fact, they chose their own personal representatives to discuss the matter within their own committee. The usual path involved the committee to prepare and wait the ECOFIN decisions on the matter. The unusual behaviour was severely criticised by the Bundesbank President, Otmar Emminger.<sup>546</sup>

The committee's work would have been presented few months later at the Bremen Meeting of the European Head of states or government, in July 1978. At the Summit the European Council pointed out the relevance of a united commitment and cooperation towards monetary stability in Europe. From the *Conclusions of the Presidency of the European Council in Bremen*:

The European Council regards such a zone as a highly desirable objective. The European Council envisages a durable and effective scheme. It agreed to instruct the Finance Ministers at their meeting on 24 July 1978 to formulate the necessary guidelines for the competent Community bodies to elaborate by 31 October 1978 the provisions necessary for the functioning of such a scheme – if necessary by amendment.<sup>547</sup>

Strictly connected, in the same document, the target date to prepare for commitment was settled, namely on the next European Council Meeting in December 1978. Moreover, the annexes to the Conclusions provide some provisions regarding the EMS. Here below the main points from the Annex to the Conclusions containing some basic elements of the future EMS:

- 1 In terms of exchange rate management the European Monetary System (EMS) will be at least as strict as the "Snake". In the initial stages of its operation and for a limited period of time member countries currently not participating in the snake may opt for somewhat wider margins around central rates. In principle, interventions will be in the currencies of participating countries. Changes in central rates will be subject to mutual consent. Non-member countries with particularly strong economic and financial ties with the Community may become associate members of the system. The European

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<sup>545</sup> *Ivi*, pp. 42-43.

<sup>546</sup> *Ibidem*.

<sup>547</sup> European Council, *Conclusions of the Presidency of the European Council of the 6<sup>th</sup> and 7<sup>th</sup> July 1978*, Brussels, 18<sup>th</sup> July 1978, p. 3.

- Currency Unit (ECU) ('1) will be at the centre of the system; in particular, it will be used as a means of settlement between EEC monetary authorities.
- 2 An initial supply of ECU's (for use among Community central banks) will be created against deposit of US dollars and gold on the one hand (e.g. 20 per cent of the stock currently held by member central banks) and member currencies on the other hand in an amount of a comparable order of magnitude.  
[...]
  - 5 A system of closer monetary co-operation will only be successful if participating countries pursue policies conducive to greater stability at home and abroad; this applies to deficit and surplus countries alike.<sup>548</sup>

Soon after the Bremen meeting some criticism arose, one among all concerning the anchor currency to be used in the intervention system. Some were advocating the main role of the *European Currency Unit* while others, such as the Benelux and German governments, still believed in the firmness of the snake system. Realistically, the debate implicated the choice between reform and compromise with already existing issues.<sup>549</sup>

The debates continued on the mechanism to be used to trigger or at least warn a possible realignment until the Brussels meeting in December 1978. Essentially, these involved, on the one hand, the French authorities advocating for the settlement of the intervention limits and central rates through the ECU and on the other hand Germany, the Netherlands and Denmark, advocating the snake's bilateral grid system of intervention.<sup>550</sup>

However, the bilateral meeting between the German Chancellor and the French President in September 1978 was able to find a compromise. The French representatives accepted of obligatory interventions when two currencies reached their bilateral margins.<sup>551</sup> They also agreed to use an *indicator of divergence*, an index whose calculation was based on the ECU to enhance cooperation. Moreover, according to Gros and Thygesen, the indicator of divergence did not acquire a very important role in the EMS but it was useful to overcome debates about the asymmetry of the EMS.<sup>552</sup>

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<sup>548</sup> *Ivi*, pp. 16-17.

<sup>549</sup> Gros, Thygesen, *European Monetary Integration*, cit., p. 45.

<sup>550</sup> *Ibidem*.

<sup>551</sup> *Ibidem*.

<sup>552</sup> *Ivi*, pp. 47-48.

It is interesting to mention that during the negotiations the concerns of the Bundesbank regarding the EMS arose. The German central bank, namely, desired the assurance from the government of their commitment to internal stability when a conflict between exchange rates and price stability occurred. Besides, the Bundesbank worried also about pegging the DM to other inflationary economies and to a bigger European one.<sup>553</sup>

A further issue regarded the possible necessity to transfer funds to weaker economies, such as Italy and Ireland. The suggestion came from the European Parliament, but it was firmly rejected by the ECOFIN, some member state governments and the Brussels European Council. Instead, they opted for interest rates subsidies and delayed repayments of long-term loans.<sup>554</sup>

The EMS Foundation Act was finally signed on the 5<sup>th</sup> December 1978 at the Brussels Council by means of the *Resolution of the European Council of the 5<sup>th</sup> December 1978 on the establishment of the European Monetary System and related matters*. Officially, the EMS began to function in March 1979. The document instituted the use of the *European Currency Unit* and it described the functions related to the EMS. The third part explained the working of the EMS<sup>555</sup> and here below are the main points:

- Each currency will have an ECU-related central rate. These central rates will be used to establish a grid of bilateral exchange rates. Around these exchange rates fluctuation margins of + 2.25% will be established. EC countries with presently floating currencies may opt for wider margins up to ± 6% at the outset of EMS; these margins should of gradually reduced as soon as economic conditions permit to do so. [...]
- Adjustments of central rates will be subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission. [...]
- Intervention in participating currencies is compulsory when the intervention points defined by the fluctuation margins are reached.
- An ECU basket formula will be used as an indicator to detect divergences between Community currencies. A "threshold of divergence" will be fixed at 75% of the maximum spread of divergence for each currency. It will be calculated in such a way

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<sup>553</sup> *Ibidem*.

<sup>554</sup> *Ivi*, pp. 50-52.

<sup>555</sup> European Council, *Resolution of the European Council of the 5<sup>th</sup> December 1978 on the establishment of the European Monetary System (EMS) and related matters* in Annex I to the Conclusions of the Presidency of the European Council, Brussels, 31<sup>st</sup> January 1979, pp. 1-3.

as to eliminate the influence of weight on the probability of reaching the threshold.  
[...]<sup>556</sup>

The Resolution continued listing the procedures to correct the above mentioned situation and it also implied the use of domestic monetary policy and changes in central rates.<sup>557</sup> Moreover, the document dealt also with credit mechanisms, the relations with third countries and international relations, and further requirements, for instance specific provisions directed to the EC central banks to be implemented in few weeks time. In addition, the section B to the Resolution involved the measures to help member states finding problems in implementing the EMS provisions and having a less flourishing economy.<sup>558</sup>

Before taking into account the activities of the EMS, it is significant to mention the *European Monetary Cooperation Fund*. It was established on the 3<sup>rd</sup> April 1973 and its main function involved the coordination and control over the Community business exchange system and the administration of short-term financing and short-term monetary support. It was managed by the Board of Governors, which comprised the governors of the member states central banks. Moreover, the EMCF worked to assist in the correct functioning of the EC exchange rate system and while doing this granting coordination with central banks and in the field of monetary interventions.<sup>559</sup> The Fund was replaced by the *European Monetary Fund* during the establishing of the EMS in order to supervise the foreign exchange rate reserves of the participants and to generate ECU reserves used in the EMS.<sup>560</sup>

Now, consider the period of activity of the European Monetary System.

As already highlighted above, the aim of the EMS was to stabilise monetary fluctuations, boost economic growth while creating an environment for cooperation among EC member states. The main instrument of the EMS was known as the

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<sup>556</sup> *Ivi*, pp. 3-4.

<sup>557</sup> *Ibidem*.

<sup>558</sup> *Ivi*, pp. 9-10.

<sup>559</sup> European Communities, "Regulation (EEC) No 907/73 of the Council of 3 April 1973 establishing a European Monetary Cooperation Fund" in *Official Journal of the European Communities* (OJEC) n° L 89. [s.l.], 5<sup>th</sup> May 1973, pp. 2-5.

<sup>560</sup> Eichengreen, *Globalizing Capital*, cit., p. 161.

*Exchange Rate Mechanism.* This was characterised by four main mechanisms, which were highly debated during the negotiations, and they were the ECU, the parity grid, the divergence indicator and credit facilities.<sup>561</sup>

The ECU consisted on a basket with all EC currencies. Each currency had a fixed amount of units in ECU, but the weights of a currency were variable over time. For example in 1990 data the DM retained the 30,53%, the British Sterling the 12,06%, the French Franc 19,43% and the Italian Lira 9,82% of the ECU basket. The ECU was also a reserve instrument, as explained above.<sup>562</sup>

The first countries to apply to the ERM were the Federal Republic of Germany, France, the Netherlands, Belgium, Luxembourg, Italy, Denmark and Ireland. The United Kingdom joined the system in October 1990, Spain in June 1989 and Portugal in April 1992. Greece did not enter the EMS.<sup>563</sup>

The parity grid construction comprehended the central rate, the bicentral rate and the marginal intervention, in the form of a matrix table.<sup>564</sup> The central rate of a currency was fixed and it referred to the amount of that currency in ECU. The main function of the central rates was to control the various fluctuations of the currencies with one another. The bicentral rates were the result of one currency's central rate divided by an other currency's central rate. This latter value fluctuated within given bands, which were between +2,25% and -2,25% for all EMS participating states except for Italy, who was allowed a wider band of fluctuations of +6% and -6%. Sometimes the bicentral rate might reach the margin of the fluctuation bands and if this occurred a marginal intervention was soon needed. The intervention was performed by means of the problematic currency's central bank, who intervened selling its reserve of the strong currency while the strong currency's central bank was buying the weak currency.<sup>565</sup> The changes in the exchange rates could not be done at

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<sup>561</sup> Kondonassis A. J., Malliaris A. G., "Toward Monetary Union of the European Community: History and Experiences of the European Monetary System", *American Journal of Economics and Sociology*, LIII (1994), 3, p. 296.

<sup>562</sup> *Ivi*, p. 300.

<sup>563</sup> Kennan B. Peter, *Economic and Monetary Union in Europe: Moving beyond Maastricht*, New York, Cambridge University Press, 1995, p. 7.

<sup>564</sup> Baldwin Richard, Wyplosz Charles, *L'economia dell'Unione Europea: Storia, Istituzioni, Mercati e Politiche*, Trento, Hoepli Editore, 2005, p.352.

<sup>565</sup> Kondonassis, Malliaris, "Toward Monetary Union of the European Community", cit., p. 296.

the desire of a single country but it must be agreed with the other EMS participants. These changes were named *realignments* and they occurred when speculative pressure on one country's currency was so high that the central bank was not able to counter the trend and had to make a change of its exchange rates.<sup>566</sup>

Moreover, another essential feature of the EMS was the credit financing. These were the *Very Short Term Financing Facility*, unlimited credit that a central bank gave to one another in the ERM but with the very short duration of 45 days. The *Short Term Monetary Support*, which consisted of mutual credit assistance within the EC central banks and it could last between three and nine months. Lastly, the *Medium Term Financial Assistance*, which implied the mutual credit assistance within States and it could last five years.<sup>567</sup>

As it was hinted above, the *EMS Act of Foundation* granted an unlimited support among central banks when such situation might present. However, it is essential to underline that the German Finance Minister granted the possibility for the President of the Bundesbank not to fulfil his obligations regarding the support to a weak currency by means of credit financing or at least to discontinue it.<sup>568</sup> More details about this issue will be given in the next section. The problem with credit financing might arise when a central bank finished its capital reserves in order to intervene to support its own currency and change its pattern. Therefore, the central bank that bought the reserves of the first one was recommended to give loans to the first central bank. Doing this the first central bank would have been able to continue its intervention in the currency.<sup>569</sup>

In addition, capital controls were still a power retained by each national authority in order to allow each country with space for realignments and monetary policies.<sup>570</sup>

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<sup>566</sup> Baldwin, Wyplosz, *L'economia dell' Unione Europea*, it., p. 353.

<sup>567</sup> Kondonassis, Malliaris, "Toward Monetary Union of the European Community", cit., pp. 296-297.

<sup>568</sup> Eichengreen, *Globalizing Capital*, cit., p. 162.

<sup>569</sup> Baldwin, Wyplosz, *L'economia dell' Unione Europea*, it., p. 353.

<sup>570</sup> Eichengreen, *Globalizing Capital*, cit., p. 163.

Some critics usually divide the EMS period of activity into three parts, the first one between 1979 and 1983, the second one from March 1983 to January 1987 and lastly the third after January 1989 until its crisis and end.

Internationally speaking, the establishment of the EMS coincided with a stormy period. In the USA, the monetary policy changed and it was tightened, creating more and more difficulties for Europe as the American interest rates increased and its variations were more volatile than before. Moreover, due to the second Oil Shock, occurred during 1979, prices started to raise sharply. As a consequence, European current accounts worsened, output did not grow and unemployment rates increased. Internally, some European countries were undergoing some political difficulties, in particular in France after the elections of President Mitterrand in 1981. In Germany as well, political divergences were felt, regarding responses to the oil shock crisis. Namely, Chancellor Schmidt was substituted by Chancellor Helmut Kohl. These political imbalances were endangering the consensus that was reached for the EMS throughout EC member states.<sup>571</sup>

Between September 1979 and March 1983, seven realignments were necessary. The first one occurred in September 1979 when the Bundesbank was trying to support the dollar and other two European currencies, namely the Belgian and the Denmark's krone, few weeks before the American change of attitude towards monetary policy. This first decision was not reached easily. Specifically, the problem was about changing the fixed exchange rate with the Benelux countries, while at the same time they wanted to maintain their currency strong in order to serve as a substitute to the DM. The realignment was the result of a compromise, namely the DM revalued of 2% and the Danish krone devalued around 3%.<sup>572</sup>

The second realignment occurred when the Dutch authorities announced the intention of a 5% devaluation in order to maintain competitiveness even if this manoeuvre was not urgent. This realignment was very different from the first one as

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<sup>571</sup> Gros, Thygesen, *European Monetary Integration*, cit., p. 72.

<sup>572</sup> *Ivi*, p. 73.

it was unilateral and was not followed by a meeting of the Council of Ministers in November 1979.<sup>573</sup>

After these two first changes, sixteen months passed before the third one had occurred. In fact, the third realignment occurred in March 1981. The Italian authorities asked for a lira devaluation of 6% since there were various defensive manoeuvres against the rising inflation differential within the EC and, moreover, the Italian current account was continuing to weaken also because of expansive public spending. As the second realignment, the third one was granted informally as well.<sup>574</sup>

In September 1981, a few months after the presidential and parliamentary elections in France, the French authorities asked for a compromise fourth realignment with Germany. Therefore, the German DM was revalued 5.5% and the French Franc was devalued 3%. This time the EC member states did not accept the changes warmly and some were very critical about it, such as the Italian authorities who found unacceptable to be forced to follow the French devaluation.<sup>575</sup>

The fifth realignment occurred in February 1982, when Belgium asked for a 12% devaluation. The intervention was objected by the majority of the EC. Denmark also asked for a 7% devaluation, since it continued to have competitive difficulties. A decision was finally reached: Belgium was allowed to devalue 8.5% and Denmark 3%.<sup>576</sup>

The sixth realignment was decided four months later. The French Franc was reaching the bottom of its band and the change was programmed for June 1982. This realignment involved both the revaluation of the DM and the Dutch guilder of 4,25% and the devaluation of the French Franc of 5,75%. In addition, the Italian lira was devalued of an other 2,75%. This was considered the larger realignment since the establishment of the EMS, because it implied a total bilateral change of 10%.<sup>577</sup>

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<sup>573</sup> *Ibidem.*

<sup>574</sup> *Ivi*, p. 74.

<sup>575</sup> *Ivi*, p. 75.

<sup>576</sup> *Ibidem.*

<sup>577</sup> *Ivi*, p. 76.

In March 1983, the seventh realignment of the first phase was occurring. This last one embraced all EC participating currencies: the DM was revalued of 5.55% and French Franc was devalued of 2.5%.

While the first period was characterised by many realignments and changes at international level, according to Gros and Thygesen, the second one from March 1983 until January 1987 was considered to be more relaxed. The first realignment of this second period, or the eighth one, occurred in July 1985. The Italian currency devalued 8% against all other EMS participating currencies. The lira was reaching the lower band of the margin and the Italian authorities were persisting in implementing their expansionary policies.<sup>578</sup>

In April 1986 the ninth realignment occurred. The manoeuvre was agreed within the ECOFIN and it resulted in the French franc devaluation of 6% against the DM and the Dutch guilder: the two stronger currencies revalued of 3% and the French Franc devalued of around 3%.<sup>579</sup>

The tenth realignment was executed in August 1986 and it was requested by Ireland, which was experiencing a very sharp appreciation of its bilateral exchange rate. Moreover, Ireland's pressure was intensified by the declining value of the Sterling from 1981. The realignment was informally granted to the Irish authorities and it amounted at 8%.<sup>580</sup>

The eleventh realignment and the last one occurred in January 1987. The value of the dollar began to fall in 1986 and this triggered pressure on the DM. In addition, the French Franc was reaching its lower intervention margin again. Although the French central bank had tried for some time to counter this trend, it could not continue.<sup>581</sup> France and Germany decided for a compromise agreement, which involved the revaluation of the DM and the Belgian currency of 3% and the Belgium-Luxemburg economic union currency by 2% against the remaining currencies. According to Gros and Thygesen, this last realignment belonged to a

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<sup>578</sup> *Ivi*, p. 83.

<sup>579</sup> *Ibidem*.

<sup>580</sup> *Ivi*, p. 84.

<sup>581</sup> *Ibidem*.

different type, because it was provoked by international pressures, in particular stemming from the dollar and not specifically inside the EMS.<sup>582</sup>

The eleventh realignment was the last one for a very long time. In fact, three years passed before a new realignment was necessary, in January 1990. This was widely regarded as peculiar, since divergence in various fields had been a problem since the establishment of the EMS. However, in the first three years of the third period a convergence pattern seemed to be working in the seven countries participating.<sup>583</sup> The only country that did not display the same improvements was Italy, which was later joined by Spain and the United Kingdom. When convergence was considered, it meant that inflation rate and interest rates in the various member countries did not differentiate much if compared against each other. For the initial EMS group the inflation rate did narrow to 1% point but the pattern improved after the begin of the German Unification.<sup>584</sup> The nominal interest rates convergence was slower but it did reach 2% point differential within the group except for Ireland. The public budget deficit of some countries, including Italy, still caused difficulties concerning convergence as it created imbalances signals inside the system.<sup>585</sup>

According to other authors, Baldwin and Wyplosz, there had been no realignments from January 1987 until September 1992. The twelfth realignment above, was not considered a proper one, because the Italian authorities narrowed the fluctuation band to +2,25% and -2,25% and brought their central rate towards the weaker margin.<sup>586</sup>

A very important step that must be mentioned was the *Basel-Nyborg Agreement* in September 1987. The aim of the agreement was to change some operational characteristics of the EMS. The main changes were, first of all, the credit facilities to the national authorities, for instance the *Very Short Term Financing Facility*, were extended in time, and namely rather than 45 days it was extended to 75, in order to give more space for national manoeuvres. Second, before the

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<sup>582</sup> *Ibidem*.

<sup>583</sup> *Ivi*, p. 91.

<sup>584</sup> *Ibidem*.

<sup>585</sup> *Ibidem*.

<sup>586</sup> Baldwin, Wyplosz, *L'economia dell'Unione Europea*, it., p. 358.

utilisation of intra-marginal interventions of a currency needed the consent of the issuing central bank.<sup>587</sup> Thanks to the *Basel-Nyborg Agreement*, it was possible to use the Very Short Term Financing Facility for intra-marginal intervention as a cumulative amount. Both new provisions were supported by the French authorities. Moreover, an important recommendation was made towards the improvement of the coordination between the balance manoeuvres that could be implemented in the EMS. Namely, interventions, use of exchange rate differential and exchange rates movements. A recommendation that was pursued by the German authorities, who considered it a vital improvement of policy cooperation.<sup>588</sup>

According to Gros and Thygesen, two further factors might have contributed to the stability of the third EMS period, namely the newly achieved stability of the dollar by means of the *Louvre Agreement* and the maintenance of capital controls for some countries.<sup>589</sup>

It is essential to mention also the signature of the *Single European Act* in 1986, since it integrated and completed the main object of implementing the EMU.<sup>590</sup> In particular, Single European Act introduced a great change in Europe, namely the removal of the all remaining barriers, from the goods, services and resources to the capital movements.<sup>591</sup>

The main period of activity of the ERM was explained by means of a division into three periods supported by some critics. However, others divided its life only in two periods, as for Baldwin and Wyplosz. They pointed out that it could be traced back only to the initial period, until 1986, characterised by several realignments due to the policy followed, which meant a preference for exchange rates adjustments rather than aiming at a parity in conversion rates and also similar inflation rates.<sup>592</sup> However, other authors usually divided the EMS working period into two parts, which were

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<sup>587</sup> Gros, Thygesen, *European Monetary Integration*, cit., p. 94.

<sup>588</sup> *Ibidem*.

<sup>589</sup> *Ivi*, p. 95.

<sup>590</sup> Kennan, *Economic and Monetary Union in Europe*, cit., p. 9.

<sup>591</sup> Arestis Phillip, McCauley Kevin, Sawyer Malcom, *From Common Market to the EMU: A Historical Perspective of the European Economic and Monetary Union*, The Jerome Levy Economics Institute Working Paper No. 263, February 1999, p. 22.

<sup>592</sup> Baldwin, Wyplosz, *L'economia dell'Unione Europea*, cit., p. 355.

called ‘the ERM’ and the ‘New ERM’ after 1987<sup>593</sup>, unifying to a certain extent the first and the second period of the Gros and Thygesen explanation.

Kennan also pointed out the distinction between pre- and post-*Basel-Nyborg Agreement*, when “the EMS was transformed into a virtually fixed rate regime [...]”<sup>594</sup>

In addition, the theory of the *Impossible Trinity* by Robert Mundell<sup>595</sup>, supported by the authors Gros and Thygesen, was particularly compelling. The theory says that some characteristics of a system cannot occur all together: fixed exchange rate, monetary policy independence and free capital movements. As an example they added that some countries retained capital movements controls for some time, even if they were part of the ERM and others, such as the Netherlands, resolved to peg its currency to the DM, but doing this the Dutch gave up their monetary policy and central bank independence.<sup>596</sup>

This latter feature must be remembered, since it will become an essential factor of the EMS crisis, which is described in the next section. Here below two tables representing the realignments of the EMS.

TABLE : Revaluations/devaluations in the EMS (in % compared with all other participating currencies)											
Date <sup>a</sup>	DM	BFR/ LFR	DKR	FF	IR£	HFL	LIT	£	DR	PTA	ESC
1979											
24 September	+2.0		-2.86					(+3.07)	— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
30 November			-4.76						— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
1981											
23 March							-6.00	(+22.73)	— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
5 October	+5.50			-3.00		+5.50	-3.00	(-9.89)	— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
1982											
22 February		-8.50	-3.00					(+8.27)	— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
14 June	+4.25			-5.75		+4.25	-2.75		— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
1983											
21 March	+5.50	+1.50	+2.50	-2.50	-3.50	+3.50	-2.50	(-10.90)	— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
18 May								(+8.58)	— <sup>b</sup>	— <sup>b</sup>	— <sup>b</sup>
1985											
22 July	+2.00	+2.00	+2.00	+2.00	+2.00	+2.00	-6.00	(+7.47)	(-11.54)	— <sup>b</sup>	— <sup>b</sup>
1986											
7 April	+3.00	+1.00	+1.00	-3.00		+3.00		(-13.31)	(-26.95)	— <sup>b</sup>	— <sup>b</sup>
4 August					-8.00			(-8.40)	(-2.29)	— <sup>b</sup>	— <sup>b</sup>

Table 8: Deutsche Bundesbank (ed.), *Fifty years of Deutsche Mark: Central Bank and the Currency in Germany since 1948*, New York, Oxford University Press, 1999, pp. 763-764.

<sup>593</sup> Higgins Byron, “Was the ERM Crisis Inevitable?”, *Economic Review-Federal Reserve Bank of Kansas City, IV* (1993), 4, p. 32.

<sup>594</sup> Kennan, *Economic and Monetary Union in Europe*, cit., p. 8.

<sup>595</sup> Mundell Robert, “Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates”, *Canadian Journal of Economics*, XXIX (1963), 29, pp. 475-485.

<sup>596</sup> Baldwin, Wyplosz, *L'economia dell' Unione Europea*, cit., p. 354.

Date <sup>a</sup>	DM	BFR/ LFR	DKR	FF	IR£	HFL	LIT	£	DR	PTA	ESC
1987											
12 January	+3.00	+2.00				+3.00		(-7.75)	(-8.71)	— <sup>b</sup>	— <sup>b</sup>
1990											
8 January							-3.68	(-0.68)	(-20.31)		
8 October								+5.13 <sup>c</sup>	(-7.95)		
1992											
14 September	+3.50	+3.50	+3.50	+3.50	+3.50	+3.50	-3.50	+3.50	(-16.08)	+3.50	+3.50
17 September							— <sup>d</sup>	— <sup>d</sup>		-5.00	
23 November							(-6.50)	(-17.12)	(-4.57)	-6.00	-6.00
1993											
1 February					-10.00		(-6.68)	(-1.19)	(-2.79)		
14 May								(+2.58)	(-2.13)	-8.00	-6.50

<sup>a</sup> Date on which devaluation/revaluation took effect.  
<sup>b</sup> Currency was not a component of the ECU basket at this date.  
<sup>c</sup> Participation in the ERM: pound sterling from 8 October 1990, Escudo from 6 April 1992.  
<sup>d</sup> Membership in the ERM suspended from 17 September 1992.  
Key: BFR/LFR = Belgian/Luxembourg Franc, DKR = Danish Krone, FF = French Franc, IR£ = Irish Punt, HFL = Netherlands Guilder, LIT = Italian Lira, £ = pound sterling, DR = Greek Drachma, PTA = Spanish Peseta, ESC = Portuguese Escudo.  
Note: Values in brackets = notional values as the currency was not a member of the ERM.  
Source: Deutsche Bundesbank.

Table 9: Deutsche Bundesbank (ed.), *Fifty years of Deutsche Mark: Central Bank and the Currency in Germany since 1948*, New York, Oxford University Press, 1999, pp. 763-764.

## The Crisis of the EMS and the German Unification

In the previous section, the working and a brief overview of the history of the EMS was considered. As already seen the EMS underwent several difficulties at the beginning but seemed to stabilise at the end of the 1980s. In 1989, many changes were taking place globally, but the most important one for Europe was the change occurring in the German area. By means of the peaceful revolution, the German and Russian leaders who tried to leave grief aside and the communist German Democratic Republic began an interim transformation period, which would have brought eventually to the accession to the Federal Republic of Germany.

Moreover, it was already explained how the German Chancellor Schmidt cooperated with the French President in the birth of the European Monetary System. In addition, the relationship between the government choices and the German central bank's opinion had not always been straightforward. In fact, at the beginning the Bundesbank was opposing the establishment of the EMS. What the Bundesbank feared was the compulsory intervention when a currency reached the problematic border bands, and the financing of the problematic currency interventions. The

central bank feared the occurrence of the same problems back at the time of the Bretton Woods system, namely inflation. Moreover, to these fears the Bundesbank also added concerns regarding the independence of future policies.<sup>597</sup>

As a consequence, the Bundesbank leading Council insisted with the government on a clause not informing to intervene automatically when a currency was under market pressure. According to Ellen Kennedy, the German Chancellor even threatened the Bundesbank Council to revise the Bundesbank Law, since the central bank was not willing to confirm the EMS participation. A compromise was reached and the Bundesbank was consented to retain some autonomous space of manoeuvres.<sup>598</sup>

According to Kennan, the very first conflict between the Bundesbank's basic mandate towards the maintenance of stable prices and the fulfilment of commitments towards exchange rate stability made by the FRG government occurred during the Bretton Woods period, in particular at its very end, when the German government withdrew from it and allowed the DM to float.<sup>599</sup>

Later on, in November 1978, the Bundesbank Council gave its consent to the EMS provisions asking the government to grant the maintenance of some of the central bank's own independence. According to Manfred Neumann, the government never confirmed this principle, but the German Chancellor, Schmidt, was present at the next Central Bank Council meeting.<sup>600</sup> With regard to the negotiations before the establishment of the EMS and during a discussion at the Bundesbank Council with the presence of the Federal Chancellor, the central bank chairman Otto Emminger pointed out:

I can imagine that there are still questions on it, for example, about what you have especially emphasised, the at least temporary release from the duty to intervene, as it is called in our letter. It is clear that one cannot say it openly in this form. This possibility, however, is mentioned in a report of the monetary committee.<sup>601</sup>

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<sup>597</sup> Kennedy, *The Bundesbank*, cit., p. 80.

<sup>598</sup> *Ivi*, p. 81.

<sup>599</sup> Kennan B. Peter, "Capital Controls, the EMS and the EMU", *The Economic Journal*, CV (1995), 628, p.183.

<sup>600</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 298.

<sup>601</sup> Deutsche Bundesbank Council, "EMS: Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS)" in Transcript of the Bundesbank Council on the 30<sup>th</sup> November 1978, Frankfurt, Bundesbank Archives N2/267, available at <http://www.margaretthatcher.org/document/111554>, declassified in 2008.

During the above mentioned debate the Federal Chancellor had tried to persuade the Bundesbank Board to agree to the EMS and to confirm that it was a West German responsibility to participate in the field of European cooperation improvement. It is very interesting to notice that Emminger was also mentioning an exchange of letters between himself and the Federal Chancellery about assurances of the amount of support the Bundesbank might provide for weak currencies interventions. In Gros and Thygesen opinions, the latter exchange and decisions could not be part of public affairs, since doubts about future interventions would have endangered the system.<sup>602</sup> Moreover, also Kennan stated that the unlimited intervention of central banks to support weak currencies was regarded as one of the main characteristics of the EMS for several years, at least before the 1992 EMS crisis.<sup>603</sup>

At the establishment of the EMS, the Central Bank Council was debating whether to continue its policy of monetary targets or not. A part of the Council supported the ceasing of monetary targeting since, they argued, this mechanism was not taken as a serious reference point either internally or externally of Germany. However, the other part of the Council contested that deciding a monetary target would allow a better management of raises in inflation rate. Moreover, it could be understood as a symbol of weakness externally, triggering critics regarding ceasing to follow stability oriented policies and the broken commitments.<sup>604</sup> Other critics also underlined that targeting was essential to maintain such policies because of the commitment to the ERM, which meant that West Germany was continuing to respect the stability principle on Europe.<sup>605</sup>

It is widely known that surplus countries might pursue expansionary monetary and fiscal policies in order to avoid recessionary periods in the global economy. In the first half of the 1980s Germany could count on a weaker currency in comparison with the dollar, since the dollar was revaluating and therefore pressures were eased in the

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<sup>602</sup> Gros, Thygesen, *European Monetary Integration*, cit., pp. 47-52.

<sup>603</sup> Kennan, "Capital Controls, the EMS and the EMU", cit., p. 184

<sup>604</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 432.

<sup>605</sup> *Ivi*, p. 433.

EMS.<sup>606</sup> However, when the dollar began to depreciate against the DM, tensions began soon to grow in Europe. In fact, the other EMS participants had to adopt restrictive policies in order to safeguard their exchange rate parities. The German government was undergoing a consolidation of its public budget and applying restrictive policies. For these reasons, other weak currencies were concerned with regard to the restrictive policies applied by the Bundesbank, since they had to conform to the EMS strongest and anchor currency, the DM.<sup>607</sup> Moreover, several critics were about the asymmetry of the Exchange Rate Mechanism, because weak currency's countries found that on their own part, the need for adjustment through stability-policies exceeded their possibilities.<sup>608</sup>

According to Wolfgang Kitterer, the implementation of expansionary policies of the German government would have influenced seriously the credibility for stability and growth not only in Europe and within the EMS but also internationally. A more expansionary policy would have also triggered an increase in inflation and as a consequence it would have had repercussions to the whole European Community's stability.<sup>609</sup>

In this and the previous section, the German currency was always considered as the anchor or the strongest currency of the EMS. This fact is generally agreed because the Bundesbank could institute and maintain a stability oriented monetary targeting even from the initial years. It must be remembered again that the main aim of the European mechanism was the cooperation and stability among participating countries. Therefore, also the Bundesbank became the most important central bank in the system, since the same must be said for its own policies. In addition, Ernst Baltensperger argued it was thanks to this peculiar institutional environment that the Bundesbank could defend itself not only from the political attacks stemming from the Federal government but also from foreign authorities.<sup>610</sup>

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<sup>606</sup> *Ibidem*.

<sup>607</sup> *Ibidem*.

<sup>608</sup> *Ivi*, pp. 198-199.

<sup>609</sup> *Ivi*, p. 200.

<sup>610</sup> *Ivi*, p. 440.

To the majority of critics there were several factors that influenced the events between 1992 and 1993. Some of these were the German Unification process, the speeding of the European Integration from 1992, the failure of the EC to be credible from the point of view of the population and even the changes that were occurring in the USSR and East Europe. Others simply implied that the ERM ceased to be able to maintain its aim.<sup>611</sup>

It is interesting to notice that before 1992 the EMS was generally regarded as a good system that achieved a good level of cooperation among its members and security, internationally speaking. In spite of these opinions, others remarked the fact that the reason why the system was so successful was the absence of any international agitation in the markets.<sup>612</sup>

According to Eichengreen, the first country that began to feel the problems connected to the EMS was Finland. Practically speaking, Finland was not a member of the EMS but its currency was connected to the ECU basket. They were experiencing serious problems with regard to competitiveness towards the Eastern Europe, because of the collapse of the Soviet economy that was essential to Finland's exports and the rise of German interest rates. The Finnish currency had to devalue of around 12% without rapid and substantial ameliorations in its economic conditions. Similar issues were occurring internally, for instance in Italy and the UK.<sup>613</sup> As far as interest rates were concerned, investors used to borrow money from low interest rates regions and they invested it in high interest rates regions in order to have more gains from such speculations. They were playing on the idea that convergence of interest rates inside the EMS was slow. As a consequence there were huge investments in Italy that triggered the increase in loans and monetary expansion, which increased the exposure of Italy in Europe.<sup>614</sup> As far as the UK was concerned, the British authorities soon realised that they had entered the EMS system in October 1990 with

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<sup>611</sup> Higgins, "Was the ERM Crisis Inevitable?", cit., p. 34.

<sup>612</sup> Salvatore Dominik, *The European Monetary System: Crisis and Future*, the Netherlands, Kluwer Academic Publishers, 1996, p. 5.

<sup>613</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., pp. 6-8.

<sup>614</sup> *Ibidem*.

an overvalued currency, which implied the deterioration of economic conditions and employment as well.<sup>615</sup>

It was already hinted that the European integration process was an important factor in the EMS crisis. Already in April 1989, the publication of the *Delors Report on the Economic and Monetary Union of the EC* was a first manifestation of European's intentions. More specifically, it advocated vital prerequisites in order to achieve economic union. Those were:

- the assurance of total and irreversible convertibility of currencies;
- the complete liberalization of capital transactions and full integration of banking and other financial markets;
- the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.<sup>616</sup>

Furthermore:

The adoption of a single currency, while not strictly necessary for the creation of a monetary union, might be seen for economic as well as psychological and political reasons as a natural and desirable further development of the monetary union. A single currency would clearly demonstrate the irreversibility of the move to monetary union, considerably facilitate the monetary management of the Community and avoid the transactions costs of converting currencies. [..]

The replacement of national currencies by a single currency should therefore take place as soon as possible after the locking of parities.<sup>617</sup>

Already in the *Delors Report* it was clear the direction that the EC would have preferred for the near future, the economic union, although the Report underlined that there was not a necessity for a single economic policy. On the other hand, in order to achieve the monetary unification an agreed and common monetary policy was required. Such intentions signified the request for an institution, which could control monetary policies aiming at price stability and at the same time being independent. The Report identified an institution called European System of Central Banks, entrusted with the management of monetary policies.<sup>618</sup>

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<sup>615</sup> *Ibidem*.

<sup>616</sup> Committee for the Study of Economic and Monetary Union, "Report on Economic and Monetary Union in the European Community" (Delors Report), *Report and Collections of Papers*, EC, presented on 17<sup>th</sup> April 1989, pp. 14-15.

<sup>617</sup> *Ivi*, p. 15.

<sup>618</sup> Arestis, McCauley, Sawyer, *From Common Market to the EMU*, cit., pp. 28-29.

In addition, the Report suggested three steps to be implemented gradually in order to achieve such objectives. The first one implied the suspension and removal of all controls to capital movement inside the EC and the commitment to keep to strict convergence, narrowing the fluctuations bands. This first approach was agreed in June 1989 and it was scheduled to begin in July 1990, just the same period of the entering into force of the Single European Act and its removal of capital controls.<sup>619</sup>

The second stage was regarded as an intermediate phase in which countries still retained their policies independence but had to persevere with their commitments of the first stage. With the *Maastricht Treaty*, the second part of the economic union was scheduled to begin in January 1994. The last step involved the stabilisation of exchange rates into fixed ones, the transfer of each country's central bank autonomy to EC authorities and ultimately the possibility of the introduction of a single European currency. This last stage was programmed to start from January 1999, provided that the countries that wished to participate could achieve the convergence requirements in May 1998.<sup>620</sup>

All the intentions stated in the Report became real with some amendments when the *Maastricht Treaty* was negotiated during 1991. The Treaty established the European Union and added several provisions with regard to the functioning of the EU institutions. However, according to Arestis, McCauley and Sawyer the *Maastricht Treaty* was a compromise among EC members in order to profit from a common objective. The authors, namely, listed some specific requirement that countries imposed on one another. For instance, the German authorities supported the increase in power of the European Parliament, yet the idea of one currency for all the EC stemmed from France, whilst Britain secured its non-involvement in the single currency. Moreover, one of the most important changes from the *Delors Report* regarded the strictness of the requirement to enter the new phase of the European Integration.<sup>621</sup> They amounted to five criteria, very famous especially today. In short:

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<sup>619</sup> *Ivi*, p. 30.

<sup>620</sup> *Ivi*, p. 29-30.

<sup>621</sup> *Ivi*, p. 31.

- For two years before the beginning of the integration process the average exchange rate must not vary more than +2,25% and -2,25% of its central rate;
- One country's inflation rate must not be superior than 1,5% of the average inflation rate of the three countries with lower inflation;
- Long term interest rates must not be superior than 2% of the average long term interest rates of the three countries with lower inflation rate;
- One country's budget deficit must not be superior to 3% of its GDP annually;
- One country's national government debt must not be superior to the 60% of its GDP.<sup>622</sup>

When one country's budget deficit is taken into account, it usually refers to the annual net flow of spending of the country's government, when it results to be superior to the general revenues of the government.<sup>623</sup> On the other hand, the national government debt usually refers to the overall stock of endebtmnt the state accumulated in the past.

*The Treaty on the European Union* was signed in Maastricht in February 1992. However, as far as the ratification phase was concerned, there appeared to be several difficulties. In June 1992, Denmark population was asked to vote for the ratification of the Treaty. The result was surprisingly negative, since Danish voters rejected the treaty. This was generally considered one of the main factors that exacerbated the situation in Europe during the first 1990s.<sup>624</sup> In addition, there was ambiguity towards the position of the French population in connection to the Treaty's acceptance, since opinion polls suggested that French voters were not inclined to accept it in September 1992 as for Danish people.<sup>625</sup>

The problem with the popular rejection of the Maastricht Treaty had huge impact on the behaviour of the investors and more generally of the markets. It worked as a signal of a probable imminent failure of the European Economic

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<sup>622</sup> *Ivi*, p. 32.

<sup>623</sup> Investopedia Dictionary, Budget Deficit, <http://www.investopedia.com/terms/b/budget-deficit.asp>, updated in 2013, consulted in April 2014.

<sup>624</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., p. 9.

<sup>625</sup> Higgins, "Was the ERM Crisis Inevitable?", cit., p, 35.

integration. Therefore, investors imagined that there might not be the necessity of austerity and strict economic commitments among European countries.<sup>626</sup>

The first ones to feel the change in the markets attitude were the economically weak countries, like Italy, which continued to struggle with rising inflation, a consequential decline in competitiveness and hike in interest rates. Hence, high inflation influenced the real exchange rates with downwards pressures in the narrower bands of the EMS, which in turn threatened the Italian debt position. An increase of the Italian inflation and its debt exposure suggested the investors that there might be a future devaluation.<sup>627</sup>

The same type of pressure was felt by the UK in August 1992 and it might have been exacerbated also by the approaching French referendum in September. On the 26<sup>th</sup> of August, the Sterling reached the bottom of its band. In the following weeks, the British central bank tried to manage the situation but its intervention failed. In the first days of September, the British and German governments in Bath at the ECOFIN meeting tried to find a compromise in order to stabilise the situation for weak currencies and save part of the EMS. However, the meeting failed to give a substantial response to rising speculative pressures on weak currencies in Europe, since the majority of national representatives were afraid of new realignments of the ERM. However, the Bath meeting proposed a general realignment while the German interest rates were going to be cut.<sup>628</sup>

The 8<sup>th</sup> of September the Finnish currency devalued of 15%. Speculators were expecting revenues from a similar event that might occur in Norway. The Norse central bank intervened substantially. Meanwhile, Italian authorities were continuing with their support to the lira. Thanks to a bilateral agreement, on the 13<sup>th</sup> of September the lira was allowed to devalue of 7% against the other EC currencies and the Bundesbank agreed to cut the Lombard rate by 25 basis points. The Lombard rate

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<sup>626</sup> *Ibidem.*

<sup>627</sup> *Ibidem.*

<sup>628</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., p. 10.

was one of the main indicators of international monetary transactions in Germany, therefore particularly remarkable at international level.<sup>629</sup>

The 15<sup>th</sup> September 1992 a rumour was spread about an interview made by the German newspaper Handelsblatt with Bundesbank's President Schlesinger. It was said that the next day the German newspaper would have published critical statements about the future intentions of the Bundesbank, namely it was underlined that there might be other devaluations within the EMS members countries. After the crisis, the rumour was later confirmed by an article written by Christopher Hunhe that appeared in the British newspaper *The Independent*. "[...] The news shot across the wires that the Bundesbank president had given an interview to the German financial paper Handelsblatt and the Wall Street Journal in which he cast doubt on the ability of the ERM to hold together."<sup>630</sup> The author was explaining the exit and the crises of the EMS and there was a debate on the authorisations for the publication of such declarations in a critical period. In fact, the aftermath of such announcement was disastrous for the EMS.

As a consequence, the pressures on the Sterling became unbearable for the British authorities. The British authorities did not raise interest rates as immediately and rapidly as they should have done, because they were fearing the rising tensions stemming from the population. Meanwhile, on Wednesday 16<sup>th</sup> of September 1992, a speculative attack was being directed to the Sterling. However, the rise in British interest rates of that day did not ameliorate the situation. During that evening the British government was forced to ask to EC Monetary Committee the permission to withdraw the Sterling from the EMS.<sup>631</sup> The 16<sup>th</sup> September 1992 was called *the Black Wednesday* in the UK, since the withdrawal and the recession that was underway in the country created immediate political pressures from below, endangering the credibility of the government and its political future.<sup>632</sup>

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<sup>629</sup> *Ibidem*.

<sup>630</sup> Hunhe Christopher, "Schlesinger: a banker's guilt: The president of the Bundesbank has been woefully indiscreet. But the Chancellor, too, is a diminished figure, says Christopher Huhne", *The Independent*, 2<sup>nd</sup> October 1992.

<sup>631</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., p. 12.

<sup>632</sup> *Ibidem*.

Similar pressures were occurring in Italy and, in fact, the Italian authorities decided to withdraw from the ERM a few hours after UK decision. The Spanish currency was also experiencing a devaluation, which was allowed by the EC Monetary Committee at the moment of UK withdrawal.<sup>633</sup>

However, the European turmoil that first hit the UK was felt also by other countries. Namely, the French central bank had to raise interest rates with consequently huge expenditures for the French government. Sweden was forced to revoke its currency's ECU peg in November 1992. The next month Sweden was followed by Norway, which revoked its ECU peg as well. In November 1992 Denmark, Spain and Portugal had to raise their interest rates while the Spanish and Portuguese currencies devalued. Ireland, which was still participating in the ERM, was forced to devalue by 10% in January 1993.<sup>634</sup>

However, the crisis of 1992 was not the only one with which the EMS had to deal. In fact, also during 1993 tensions and pressures inside the ERM did not cease to exist and they developed into a second phase of crisis. Specifically, the recession was still undergoing in several EC member countries, the unemployment rate continued to grow and central banks were more and more willing to lower their interest rates. In 1993, speculative attacks were directed first towards Denmark and Belgium and then turned to Spain and Portugal, which were experiencing an enormous increase in the unemployment rate. In May 1993, the Spanish currency needed to devalue by a further 6%. At the same time, France was preoccupied with its own unemployment rate and soon it became the next target of speculators. In June, French authorities asked the German ones to lower their interest rates, but Germany refused.<sup>635</sup>

The situation was aggravated in July 1993 when the French franc reached its allowed divergence level against the DM, triggering the combined intervention of the French central bank and the Bundesbank. The French central bank was purchasing a huge quantity of francs because of the large amount of currency sold by the markets.

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<sup>633</sup> Higgins, "Was the ERM Crisis Inevitable?", cit., p. 36.

<sup>634</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., pp. 12-13.

<sup>635</sup> *Ivi*, p. 13.

Meanwhile the Bundesbank did agree to lower its interest rates but it was done only at an imperceptible level at the end of July 1993. The French authorities were risking to exhaust their reserves in order to stabilise the franc exchange rate. At the same time, Germany was encountering a large rise in monetary supply, which posed much risk to its central bank's anti-inflationary policies.<sup>636</sup>

The European Finance Ministers and central banks governors participating in the ERM met in an emergency circumstance in the last days of July 1993 and they agreed to widen the fluctuations bands. Currencies now fluctuated between +15% and -15%. Meanwhile, German interest rates were being cut, even if it was done with a very slow pace. Such a wider fluctuation margin provided the speculators with less incentive to play with EC exchange rate stability. Some critics commented also that such wide bands did resemble more a floating exchange rate system than the EMS.<sup>637</sup>

From the above explanation, it can be understood that the ERM crisis was not triggered only by the German restrictive behaviours but there were also other essential concurrent factors. The failure of the European Monetary Union referendum in Denmark as well as the fear of the French rejection of EMU were both partly responsible for the development of the events.

As far as the German Unification process was concerned, several countries opposed the German behaviour in the last months of the EMS crisis. Above it was hinted that the hikes in German interest rates, which were necessary to counter inflationary trends inside Germany, caused the most critics. Inflation, in turn, was triggered by the huge expenditures that were undergoing in the German area. In Chapter 3 it was already explained how the Unification process of the FRG and the GDR was handled.

One very important feature not only regarding the Unification process but also connected to all EC participants in the EMS was the German Central Bank independence. Namely, the *Bundesbank Act* was able to provide a huge space for manoeuvres to the Central Bank.<sup>638</sup> According to Jakob A. Frenkel and Morris

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<sup>636</sup> *Ivi*, p. 14.

<sup>637</sup> Higgins, "Was the ERM Crisis Inevitable?", cit., p. 36.

<sup>638</sup> Deutsche Bundesbank, *Fifty years of Deutsche Mark*, cit., p. 733.

Goldstein, the wide autonomy of the Bundesbank had led to wide criticism internally and externally. The internal conflict was characterised by the disagreement between the Bundesbank Council and the government, in particular with the Minister of Economics, which until 1972 was in charge of the monetary policy, and from 1972 on with the Minister of Finance. However, externally speaking this large freedom could not be completely understood by other European countries, since the Bundesbank still retained the highest degree of independence in the whole world during the 1990s. Therefore, the EMS participants' government did not comprehend and accept the inaction and silence of the German government towards the policies implemented by its own central bank.<sup>639</sup>

The two authors continue highlighting the differences between a central bank granted with a relatively large amount of freedom and a central bank with a small amount of autonomy. They were critical about dependent central banks and argued that when a central bank is dependent on the instructions stemming from the Minister of Finance or any other political agency the central bank's own commitments might be greatly in danger.<sup>640</sup> In addition, the central bank itself might influence the economic activities in its own countries for political reasons.

Frenkel and Goldstein pointed out, namely, that a central bank would be able to boost the economy by means of expansionary policies when was period for new elections, counting on the fact that voters would be attracted by such economic developments. However, because of such expansionary policies, the inflation rate might become a problem in the longer period and stricter policies might be necessary to counter the trend. Politicians and bankers would rely on the voter's short-timed memory to authorise such hardships.<sup>641</sup> This view was particularly critical towards the usual expansionary policies of the so called dependent central banks, but in the author's opinion it was seen as the main effects of a central bank with no enough independence. Therefore it was from this issue that the Bundesbank and many other

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<sup>639</sup> *Ivi*, p. 734.

<sup>640</sup> *Ivi*, p. 735.

<sup>641</sup> *Ibidem*.

critics extracted the reason why the German central bank was so efficient.<sup>642</sup> Its commitment came from the *Bundesbank Act*, which had implied a full responsibility for the maintenance of price stability inside the country.<sup>643</sup>

There were many examples that supported the point of view of the European countries being at conflict with the Bundesbank's policies. The first one could be traced back at the very beginning of the EMS, when the FRG government and the Bundesbank Council were discussing about finding an agreement on this new European project. At that occasion, the German central bank had asked for grants from the government against an automatic and compulsory intervention of the Bundesbank in saving another currency.<sup>644</sup> The main fear of the Bundesbank was to lose its own independence, since such system would create difficulties in maintaining its vital objective, the internal stability of prices.<sup>645</sup>

Furthermore, during the discussions about the *Basel-Nyborg Agreement* of 1987, the Bundesbank maintained its usual position against changes of the EMS system towards the implementation of automatic financing facilities. The Bundesbank's opinions were made public in the Summer of 1987. Specifically, the monetary targeting between 1986 and 1987 had been overshoot and the Bundesbank Council was worried about the possible consequences of its monetary supply rates in the current year. The critical issue this time was the rejection of the probability to lose its monetary policy capacity. Contrary to the views of many European countries, the German central bank advocated the developments of its own economic target as a fully functioning answer to European's economic problems.<sup>646</sup> However, the European countries agreed for a compromise, the accepted final version of the *Basel-Nyborg Agreement*, which was already explained in the previous chapter.

A further and essential example might be the misunderstandings and the impossibility to reach a substantial compromise with regard to the 1992 and 1993

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<sup>642</sup> *Ibidem*.

<sup>643</sup> *Ivi*, pp. 740.

<sup>644</sup> *Ivi*, p. 736.

<sup>645</sup> Kennedy, *The Bundesbank*, cit., pp. 80-83.

<sup>646</sup> *Ivi*, p. 93.

ERM crisis. In Ellen Kennedy's words "dependence on the German currency has produced unwanted political effects for some EMS members [...]"<sup>647</sup> In particular, the author's statement referred to the issue of asymmetry of the European Exchange Mechanism, because weaker currencies were finding it difficult to cope with German leading policies in Europe and for these reasons they demanded more attention from Germany.<sup>648</sup>

Many detailed analysis have been done in the last twenty years about what were the main reasons and the dynamics of the crisis of the EMS and its relations with the German Unification. According to most of the literature, the starting point in order to understand the evolution of the EMS crisis was the fiscal expansion in Germany. Specifically, the authors Thomas Lange and Geoffrey Pugh offered an interesting overview of the events. In fact, according to them there were two ways with which the German Unification process affected the EMS: trade and interest rates.<sup>649</sup>

As it was explained in the previous chapter, the fiscal effort that was done in West Germany between 1989 and 1994 was very large. The FRG was experiencing a period of growth of output and of internal demand. Not long before of the economic unification of the two Germanies the productive capacity in the FRG was reaching the upper limit. When the demand of the eastern regions was added to the western, there was not enough output to satisfy the aggregate demand.<sup>650</sup> This shortage of supply was overcome with a huge increase in imports from other European countries. However, too much demand meant an increase in prices and therefore an increase in inflation.<sup>651</sup> According to this reconstruction and as suggested above, Lange and Pugh identified the two ways, through which the German Unification influenced the European economics, the boost of exports to Germany and the increase of interest rates to counter rising inflation trends.<sup>652</sup>

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<sup>647</sup> *Ivi*, p. 99.

<sup>648</sup> *Ivi*, pp. 99-100.

<sup>649</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 152.

<sup>650</sup> *Ivi*, p. 153.

<sup>651</sup> *Ibidem*.

<sup>652</sup> *Ibidem*.

The first channel, the trade, allowed German business partners to increase their exports towards Germany, creating a visible deficit in the German current account in 1991. Moreover, the two authors suggest that this increase in imports was triggered by the scarcity of supply potential in the eastern German regions, which could not provide enough for its own demand.<sup>653</sup> The second way of transmission of German Unification imbalances came from inflation. In the previous chapter it was seen that it cannot be said that inflation did not exist before the begin of the Unification process. Namely, inflation remained at a very low level but it exploded both because of German economic growth in that period and because of the beginning of the Eastern accession to the FRG. In Lange and Pugh opinion, an inflation rate of more than 2% was considered unacceptable by the German Central Bank.<sup>654</sup>

The Bundesbank had several instruments to try to counter inflationary trends: one these were interest rates, in particular the Lombard Rate. The latter was particularly vital to general borrowing operations in Germany, since a rise in the Lombard rate meant that the borrowing of the commercial banks required more money and in turn also commercial banks lending to privates and businesses required more money from them. As said previously, the Bundesbank had raised the Lombard rate to counter inflation, especially from 1991. Rising interest rates were said to stop the increase of inflation in several ways in Germany.<sup>655</sup> But how was it possible?

First, it could be said that the higher cost of money meant that the internal demand for money decreased and as a consequence the money growth inside Germany slowed considerably. Reducing the monetary growth it reduced the inflation.<sup>656</sup> Second, also real interest rates<sup>657</sup> increased during the first 1990s and this triggered the compression of demands for investments. Moreover, if short term interest rates increased, investors would prefer the long term interest rates, which

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<sup>653</sup> *Ivi*, p. 154.

<sup>654</sup> *Ivi*, p. 156.

<sup>655</sup> *Ibidem*.

<sup>656</sup> *Ivi*, p. 158.

<sup>657</sup> "An interest rate that has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower, and the real yield to the lender. The real interest rate of an investment is calculated as the amount by which the nominal interest rate is higher than the inflation rate." Investopedia Dictionary, Real Interest Rates, <http://www.investopedia.com/terms/r/realinterestrates.asp>, updated in 2013, consulted in April 2014.

were lower. In this way, demand reduced and inflation might lower. An other way in which interest rates affect inflation regarded the Bundesbank. As it was said many times, the main aim of the Bundesbank was price stability inside the German country. The maintenance of a stricter monetary policy was meant also to warn workers and entrepreneurs that inflation will be countered with all means and that there should not be expectations for more increases. It was already made clear how inflation was particularly damaging for businesses.<sup>658</sup>

The German monetary policies were followed by several countries inside the EMS since they were directed towards stability. As a consequence, high interest rates in Germany were, in a way, automatically transmitted to the other European currencies. The continued increase of the value of the DM, or its appreciation, was triggered also by the growth in demand for short term DM from the foreign markets, since speculators and investors were profiting from the situation to win higher returns.<sup>659</sup> While the DM tended to appreciate, the other EMS currencies tended to devaluate against the DM. The problem with the EMS was that the system forced the other currencies to raise interest rates in turn, in order to attract back foreign investments and maintain exchange rate stability with the DM.<sup>660</sup>

This explanation was applied to Europe but what was happening at international level? The EMS forced European currencies to follow the DM, even during its appreciation. At the same time, the main international currencies, the American dollar and the Japanese yen, depreciated against the DM, as they were free to do it at their will. The result was the general appreciation of the European currencies against non-European partners and declining competitiveness of the EC as a whole.<sup>661</sup>

The crisis in 1992 occurred when German high inflation rate tended to converge to the one of the usual high inflation currencies, for instance Italy and UK. This could be seen as a reduction of the difference between the German inflation and

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<sup>658</sup> Lange, Pugh, *The economics of German Unification*, cit., pp. 158-159.

<sup>659</sup> *Ivi*, p. 161.

<sup>660</sup> *Ivi*, p. 159.

<sup>661</sup> *Ivi*, p. 160.

interest rates with the UK inflation and interest rate. However, this was not achieved thanks to a reduction of the UK inflation and interest rates levels yet because of the higher German ones due to the Unification process.<sup>662</sup> Ultimately, according to Lange and Pugh, the German unification was responsible for spreading depressionary trends in EU. This was illustrated suggesting that high interest rates meant higher costs of money inside a country, as it was seen above. This eventually meant that businesses were forced to depress their demands and therefore consumer spending. In addition, it must be remembered that the appreciation of one currency meant troubles for its business competitiveness, specifically for exports. Such consequences of the Unification process were said to have spread to the whole Europe.<sup>663</sup>

In the EMS crisis of 1992 and 1993, the only solution available to save the system was the realignment.<sup>664</sup> In the first days of September 1992, the German authorities had expected a request from Italy for a realignment, but the Italian authorities did not ask for it, as they did not want to devalue the lira. The same situation happened in the summer of 1993, when the French Franc was having trouble with stability in the ERM, but the French authorities did not want to devalue since they were trying to maintain the policy for a 'strong franc' in the ERM.<sup>665</sup> Moreover, a realignment would have meant to introduce additional difficulties in the European Monetary Union, which was being implemented following the steps of the *Delors Report* and the *Maastricht Treaty*. In the words of Lange and Pugh, "the logic of realignment contradicted the attempt of EU governments to set in place a 'hard EMS' (that is an EMS without realignments) as part of the transition to monetary union."<sup>666</sup>

The situation in which the EMS crisis took place could not be understood easily. As it was said, there were several factors that played against a rapid relaxing of the tensions and one of these was certainly the German Unification. However, it is vital to be aware that it was not the only one.

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<sup>662</sup> *Ibidem*.

<sup>663</sup> *Ivi*, p. 163-165.

<sup>664</sup> *Ibidem*.

<sup>665</sup> Eichengreen, *Exorbitant Privilege*, cit., p. 92.

<sup>666</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 166.

In the next section, it will be considered a very brief overview of the debates and critics with regard to the EMS and its crisis.

### **Debates over the EMS**

From the previous section, it was hinted that the German Unification was not the only factor that influenced the 1992-1993 events in Europe. In fact, there might also be other external factors influencing the crisis, such as the dollar, which devalued 20% against the DM between April and August 1992.<sup>667</sup> Thus caused a lot of problems of competitiveness for Germany and the whole Europe. The United States were undergoing a recession in the first years of the 1990s and, in order to counter this trend the Federal Reserve began to cut interest rates in 1991. It was pointed out by Eichengreen that it was the fall in the American interest rates that contributed to deteriorate the European situation.<sup>668</sup>

Furthermore, Eichengreen gave two different interpretations of the reasons for the crisis. The first one implied that the massive use of intervention, the depletion of central banks reserves and the expansionary policies applied by some countries were to be blamed for the failure of EMS convergence in that period and consequential speculative attacks. On the other hand, the second one implied the involvement of speculative attacks that triggered the near depletion of central banks reserves and consequential policies. This latter point attribute the main role to the markets: it was investors and speculators that forced country authorities to raise interest rates and to apply such policies in order to maintain stability inside the ERM.<sup>669</sup> On the contrary, from the first point of view the national authorities were not willing to maintain stable the system of exchange rates. Eichengreen added that the first interpretation did not explain the timing of the events and it could not be

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<sup>667</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., pp. 17.

<sup>668</sup> *Ibidem*.

<sup>669</sup> *Ibidem*.

referred to as the right point of view. The second one allowed a better overview, which, however, was still regarded as partial.<sup>670</sup>

Debates continued to be made over the Danish rejection of the Maastricht Treaty. Such a choice, some authors argued, gave way to the possibility of some kind of risky interpretations by the speculators. Political commitment for a boost in the economic and monetary unification of Europe exposed these countries to international vulnerability. Speculators might have played with national authorities about how far their hardening policies would arrive and how much would it take for them to crumble. The Danish referendum worked as a trigger: the economic integration might not have occurred and countries would have swapped for more expansionary policies, an higher interest rates could not be quietly submitted anymore.<sup>671</sup> However, some critics underline that such explanation might have worked only for the attack to UK and Italy in particular, but after the critical period there was not the implementation of the expansionary policies that the model have suggested.<sup>672</sup>

Particularly critical towards the Bundesbank and the German government behaviour was Carsten Hefker, professor in Siegen, in his article *German Monetary Union, the Bundesbank and EMS collapse*. The author argues that, at the eve of the European monetary integration by means of the Maastricht Treaty's provisions, the Bundesbank, being afraid of giving up its independence, was considering the hindrance of the process.<sup>673</sup> In the author's words "[..], not only was monetary tightness seen as a way to rebuild lost reputation and heal the public humiliation in Germany, it also constituted a possibility to hinder the Maastricht process by using the inflationary effects of fiscal expansion for this policy."<sup>674</sup>

To a certain extent, it could be added that the problem of the European Integration resulted to be the credibility of the European intentions. Credibility, to

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<sup>670</sup> *Ivi*, pp. 15-16.

<sup>671</sup> *Ibidem*.

<sup>672</sup> *Ivi*, p. 26.

<sup>673</sup> Hefeker Carsten, "German Monetary Union, the Bundesbank and the EMS Collapse", *BNL Quarterly Review*, 191 (1994), p. 384.

<sup>674</sup> *Ibidem*.

the extent that the system was viable, allowed the fulfilment of its aims even in presence of international and internal imbalances. The Danish rejection of the Maastricht Treaty was the first shocking evidence that there might not be the popular underpinning it was thought to exist. Moreover, the second ERM crisis in the Summer of 1993, a few weeks before the French referendum, and the correlated tensions in the waiting could be considered further evidence of such hypothesis.

On the other hand, Lange and Pugh argued that it was thanks to the hardening of the Bundesbank policies in 1992 and 1993 that its own credibility towards a stabilisation of prices was maintained.<sup>675</sup> According to the authors, “tightening rather than relaxing its monetary stance in unified Germany confirmed the reputation of the Bundesbank and the credibility of the DM as a low inflation currency and hence, reliable store of value.”<sup>676</sup>

A further interesting debate that must be taken into account regarded the realisation of three or four impossible principles. As it was already said, in monetary policy there are three objectives that could not be allowed at the same time: fixed exchange rates, free capital movements and a country’s independence of monetary policy.<sup>677</sup> According to Paoda-Schioppa, the conflict actually emerged between four objectives, namely freedom of exchanges between nations, free capital movements, fixed exchange rates and a national independent monetary policy. In the Italian author’s opinion, it was in this impossible characteristics that the malfunctioning of a system was to be found. More importantly, he pointed out that the main danger for the EMS was stemming from the suspension and elimination of barriers to capital movements between nations in Europe.<sup>678</sup>

A further and to a certain extent different interpretation of the crisis of the EMS was given by Buiter, Corsetti and Pesenti. They advocated the point of view of a systemic crisis, not a crisis that must be explained as a country specific contribution. In fact, they argued that the EMS could be compared to a centre-periphery model, in

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<sup>675</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 168.

<sup>676</sup> *Ibidem*

<sup>677</sup> Baldwin Richard, Wyplosz Charles, *L’economia dell’ Unione Europea: Storia, Istituzioni, Mercati e Politiche*, Trento, Hoepli Editore, 2005, p. 354.

<sup>678</sup> Padoa-Schioppa Tommaso, *La lunga via per l’Euro*, Bologna, Il Mulino, 2004, pp. 114-115.

which the core of system was the anchor currency, the German DM and other stronger currencies, and the periphery were all the weak currencies, such as the Italian or the Irish currency.<sup>679</sup>

From the point of view of the authors, the EMS crisis might be triggered by confrontations between centre and periphery countries. On the one hand the core country, Germany, did not want to bear the costs of the Unification process, and on the other hand the periphery countries did not want to realign and at the same time they did not want to support the weight of disinflation.<sup>680</sup> Moreover, at the question whether the ERM could have been saved by joint realignments in 1992 and 1993, the authors argued that with the political constraints that countries were undergoing in that period, there “existed no common realignment scheme that would have compensated for the common loss of anti-inflationary credibility.”<sup>681</sup>

To conclude and as far as the post crisis manoeuvres were concerned, the various European countries applied different strategies. Spain and Portugal remained in the ERM but at much lower parities. Italy remained outside the system until November 1996 and the same was done by Finland. Both they committed to the monetary unification process that was still being built. The UK did not re-enter the EMS and preferred to maintain a floating exchange rate.<sup>682</sup>

Eichengreen has extracted two lessons from the EMS crisis. First of all, when working in an environment with freedom of capital movement, crisis might be less predictable but more difficult to bear the costs. Lastly, in order to successfully overcome such monetary crisis a country’s economy should commit to stable monetary, fiscal and economic policies and to develop and pay attention to the manoeuvres of their own financial institutions.<sup>683</sup>

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<sup>679</sup> Buiter William, Corsetti Giancarlo, Pesenti Paolo, *Interpreting the ERM Crisis: Country-Specific and Systemic Issues*, Princeton Studies in International Economics No. 84, May 1996, p. 5.

<sup>680</sup> *Ivi*, p. 7.

<sup>681</sup> *Ivi*, p. 9.

<sup>682</sup> Eichengreen, *The EMS Crisis in Retrospect*, cit., p. 39.

<sup>683</sup> *Ivi*, p. 46.

## Conclusions

The aim of this work was to analyse and determine the interrelations between the German Unification and the European economic integration process. More specifically, the German Unification has been explained taking into account its economics and history in several fields, from the international treaties to the social and healthcare area of interest. Furthermore, the EMS crisis has been considered focusing on the dynamics of the European system and the consequences of such crisis. In fact, it has been claimed that the German Unification and its consequences have, somehow, influenced the European economic integration process to a great extent. This analysis helps to understand whether this claim could be considered appropriate or not.

As it was said, the economic and political changes implemented from October 1989 on in Germany, when the Unification process started and was publicly acclaimed, were massive indeed. This work has tried to give an overall idea of the main fields in which not only the Unification took place but also the European Integration process. Therefore, in order to conclude this work, some considerations might be made on the main thematic areas that have been covered.

First of all, this work dealt with the monetary and economic unification of Germany. As hinted above and explained in chapter three, the monetary unification was a controversial and ambiguous process. In turn, these policies were part of the so called State Treaty or the German Economic, Monetary and Social Union (GEMSU), which comprised all the economic areas of the Unification. In particular, the majority of political FRG powers, led by Chancellor Kohl, supported the monetary integration of the GDR with the FRG by means of the elimination of the Ostmark, the East German currency, and the adoption of the Western one, the Deutschemark. However, the process was not straightforward. Some political tensions were observed before the implementation of the monetary integration regarding the choice of the exchange rate. The Bundesbank and other economists did not agree with Chancellor Kohl on the 1:1 exchange rate with the Ostmark. Namely, the German Central Bank was worried about the possibility of rising inflation due to a possible peak in the

circulation speed of money in the Eastern regions, and consequently it advocated a general conversion rate of 2:1. Moreover, Kohl was supporting the 1:1 conversion rate also by means of his electoral campaign.

Other problems were found in identifying the proper conversion rate because of the dilemmas regarding the registered exchange rate in the black market (it was supposed to be 7:1) and the demanding calculation of the Purchasing Power Parities between East and West Germany. Specifically, some authors pointed out that the expectation for an economic boom in the East was triggered by the mistaken calculation of the currencies in terms of relative purchasing powers.<sup>684</sup> This could be addressed to the fact that many Eastern products were subsidised by the State, a fact that could lead to mistaken interpretations of the real value of products. Strictly connected to this was the public reception of the Deutschmark, since it was much more valued than the Ostmark by GDR citizens (paradox of value). Namely, this latter fact could be exemplified by thinking about the opening of the West border in Berlin and the flow of people invading Western shops in order to acquire the craved Western goods. Moreover, one of the main aims for a currency union and, therefore, a complete integration with the West, which also was highly supported by the Western political powers, was to prevent the continuous massive flow of migrants from the GDR into the FRG. The migrations had started as soon as the GDR was established, after the Second World War, and it had been one crucial point in the negotiations among the politicians inside the German countries throughout their existence but also at international level.

However, the German politicians and economists did not deal only with the monetary unification. The whole system of the Eastern Economics had to be dismantled and integrated with the Western one. Here, the economic system called *Social Market Economy*, first adopted by former FRG Chancellor Adenauer, implied an essential attention to the social responsibility side of a free market system.

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<sup>684</sup> Sinn, Sinn, *Jumpstart*, cit., p. 52.

A second set of considerations that must be highlighted at this point is linked to the economic difficulties seen above and they regard how the privatisations had been managed during the Unification process. Namely, privatisations were considered a crucial issue since there was the fear of not giving enough impulse to investments and, in turn, industrial production in the East. The economic situation in the East did not allow the idea of private ownership of firms or more generally of the means of production. The GDR had a communist economy and it implied that the State, especially the party or SED, had the absolute power to manage, not only the politics and security issues, but also the whole economy. Taking into account that both small firms and big enterprises, *Kombinate*, were owned and managed by the State, it is understandable how essential the privatisation step was after the fall of the Berlin wall. In order to achieve this aim, a trust called *Treuhandanstalt* was instituted by the Modrow government in the GDR in March 1990. The Trust Agency took care of all the types of privatisations from the industrial sector to the houses and public domains.

The main issue that has been highlighted in this work referred to the ownership rights and the Eastern integration with the West German model. However, the problem were not propriety rights per se, since in the FRG, which law was being applied to the GDR, there were no uncertainties of this type. Nevertheless, the problem arose with reference to the unclear ownership of the Eastern entities. There were a huge amount of actors involved in this process: the Treuhand, the government, the unions, the workers of the public firms, the previous owner, the present users, the heirs of the previous owners and possible new investors.

Moreover, a related issue that was highlighted regarded the method to be used in order to restore certainty and allow the attraction of more capitals and investments. Namely, the Unification Treaty and its regulations for the Treuhand, which were in charge of settling this uncertainty, identified the choice of the method between natural restitution and compensation. A massive amount of uncertainty and several delays were the consequences, not only of the Treuhand management of the privatisation issue, but also of the political choice of the privatisation method. Only

later, in March 1991, a new law, the Obstacle Removal Law, was being implemented in order to speed the process of compensations, restitutions and investments. Not to forget is also the amount of revenue that was expected after the sale of state owned entities, the real quantity of assets sold, the activities that were effectively reorganised and future viability of the entities. Data presented in this work hinted that the Treuhand was in charge of the 90% of GDR productive capacity.<sup>685</sup> At the beginning, in March 1990, the German trust agency was not born with the objective to reorganise and privatise State-owned enterprises and other types of entities. Its function had been changed after its foundation, in June 1990, in an attempt to bring competitiveness and viability to the Eastern productive capacity. The Treuhand ceased its activity in 1994 and data produced in this work showed that a debt of around 275 billion DM was forecasted.<sup>686</sup>

A further set of considerations that can be identified, more importantly connected to this issue, is the choice of the legal framework, with which the Re-Unification had to be implemented and, more generally speaking, the various treaties that marked the unfolding of the events. First of all, there were several debates whether to support the unity via article 23 of the FRG Basic Law, which implied the accession of the new Länder or the GDR to the Basic Law of the FRG. Otherwise, the Unification could be made via article 146 of the Basic Law, which implied the declaration of a new German Constitution. After several harsh political debates, the unity via Article 23 was preferred since it did not imply the processing of a new Constitution for the united Germany but the accession to the Basic Law of West Germany. Moreover, this decision is contained in the *Treaty between the Federal Republic of Germany and the German Democratic Republic on the Establishment of German Unity*, more simply called *Unification Treaty*. The latter was signed in August 1990 and it implied all the regulations and rights of the contracting partners in order to achieve a full unification in every matter. Specifically, the purpose of the Unification Treaty was to extend the West German laws and regulations to the new

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<sup>685</sup> Lange, Pugh, *The economics of German Unification*, cit., p. 74.

<sup>686</sup> Sinn, Sinn, *Jumpstart*, cit., p. 84.

Eastern Länder from the issue of the German capital, the public and justice administration to the labour, social welfare and the environment. It was already explained how the GEMSU was in charge of settling the economic and monetary Unification.

Furthermore, a massive event as the Unification of such different states and histories required more than two treaties. The above quoted treaties regarded the internal affairs. However, the Unification of Germany was not only a German issue but an international one. An agreement was needed with the USSR and its leadership, guided by Gorbachev. In those years, it has been shown how the Soviet attitude was quite ambiguous at the beginning, also because of the position of Gorbachev and his attempt to introduce some reforms at home. However, the Soviet worries were not only connected to the political issue, but also to the future of the trade relations with the former GDR. The USSR had, namely, a specific and vital business relation with GDR, since the East Germans provided the Soviet Union with a large amount of technology and high value industrial goods. The USSR had asked the FRG leadership for the continuation of the GDR trade commitment and financial support if needed.

In addition, another relevant series of international talks were the so called *Two-plus-Four Talks*, which took place between the FRG, the GDR and the four Allied powers (USSR, USA, UK and France). The result of the Talks was a Treaty that introduced the abandonment of the Allied rights and responsibilities towards Germany from March 1991, at the completion of the Unification. In the meanwhile a suspension was agreed until the official treaty came into force. Nonetheless, not every West Allied power was seeing the Unification process in a good light. The UK leadership, Margaret Thatcher in particular, was afraid of the consequences in the balance of power in Europe and she regarded the wishes of the German Chancellor as dangerous internationally. The French leaders did not completely agree with the UK point of view. However, they were hoping for a stronger commitment of the united Germany in the European integration process. The only Allied power that supported the German Unification from its very beginning were the USA.

A further and interesting set of conclusions regards the European monetary integration, and more specifically the European Monetary System. This work described very generally how the EMS was anticipated by other systems, for instance *the snake in the tunnel of the dollar*, based on the Bretton Woods and the Smithsonian Agreements, which later, because of international instability was transformed into *the snake in the lake*. However, the monetary situation in the 1970s was still strictly correlated to the American currency: in fact, to a certain extent the instability of the dollar was transported to Europe causing tensions within the European countries participating in the system.

In the fourth chapter, a relevant document and its results were mentioned, the *Werner Report*. The Werner Report was commissioned by the initiative of Willi Brandt, German Chancellor, in 1970, because he supported the project of a European Monetary Union. The aim of the report was to examine and identify the steps towards the achievement of EMU. Pierre Werner and his group of experts pointed out that, in order to achieve such aim and overcome disequilibrium, there might be the need for financial transfers from the richer European areas to the weaker ones. Specifically, the document contained a first idea of the steps that the European countries needed to follow in order to achieve a fuller economic integration and stability, such as the institution of a capital market, fixed exchange rates and independence of the monetary policies at European level. Nonetheless, the report did not mention problems arising from inflation and convergence, which would become a vital measure of the instability between European members in few years time.

In 1978, the international monetary imbalances coming from the American currency were beginning to be dangerous from the point of view of German, the Bundesbank above all, and the French authorities. Therefore, Germany was seeking an improvement of stability by means of stability oriented policies and especially by means of coordinated policies among European countries. The country that was most interested from the beginning and that had the same objectives was France. The stability-oriented friendship between Germany and France gave birth to the *Schmidt-Giscard plan*, which was presented at the meeting of the European Head of states or

government in Bremen in July 1978. Finally, the *European Monetary System Foundation Act* was signed on the 5<sup>th</sup> December 1978 at the Brussels Council and it officially began in March 1979.

The most crucial instrument of the EMS was the *Exchange Rate Mechanism* (ERM) and its functions and working mechanisms were all highly debated from the beginnings. Specifically, it was the Bundesbank that found it difficult to confirm a full commitment to the German government concerning the EMS. There were several proofs of the letters and the interviews that the Bundesbank President, Karl Otto Pöhl, directed towards the German government enquiring about the automatic adjustments and financial support to weak currencies. Nonetheless, the *realignment* was the most controversial and debated instrument in the EMS activity, but it was not the only instrument used. The ERM comprehended several other mechanisms, such as the essential basket of European Unit of Account, the central rate, the bi-central rate, the marginal intervention border and the various mutual credit financing facilities. The main aim of the ERM was considered vital since it would imply an improved level of cooperation and stability in Europe.

As it was seen in the fourth chapter, where it was also explained in detail how the system worked, the period of activity of the EMS had not been straightforward. First, its institution coincided with a very stormy period triggered by the dollar revaluation since 1981, the second oil shock of 1979 and political difficulties in some European countries. Between 1979 and 1987 eleven realignments occurred. In spite of this stormy period of activity, between September 1987 and September 1992 there were no realignments, in particular because of the changes and new provisions introduced by the *Basel-Nyborg Agreement* of September 1987 and the temporary stability of the American currency. However, during the summer of 1992 pressure on the EMS began to be felt by the economically weaker countries. For instance, Italy had long struggled with high inflation rates and as a consequence with monetary instability and degradation of its public debt. Also, the Sterling was under pressure in the same period, even if the situation was exasperated by a period of recession and rising unemployment. Between the 15<sup>th</sup> and 16<sup>th</sup> of September, the pressure on the

Sterling became unbearable for the UK authorities. For this reason, the UK withdrew from the EMS the same day, followed few hours later by Italy. The EMS crisis did spread to other member countries as well. For instance, Sweden and Norway revoked their currency peg with the ECU shortly after. Even France struggled to maintain the exchange rate stability, also with the help of the German central bank. A second crisis occurred one year later during the summer of 1993, when speculative attacks were directed towards Denmark, Belgium, Spain and Portugal. Also in this occasion, France suffered several times with speculative attacks and its central bank was exhausting its own reserves, contributing to make the situation even more critical. In fact, the situation grew so critical that in the last days of July 1993 the European Financial Ministers and central bank governors met in an emergency meeting and decided to widen the fluctuations bands of the ERM to +15% and -15%. Thus, eliminating the constraints of the EMS completely.

Overall, this work highlights the fact that it was not only the actions of the German authorities and its Central Bank that were to blame for the crisis of the EMS. In order to understand the role of the Bundesbank in the crisis it is essential to mention that the German Central Bank was always committed to internal stability. In particular, the power to pursue such policies was given from its institution law, the *Bundesbank Act*, which gave the highest grade of importance to the control of inflation and consequently to internal stability. Moreover, it was seen how much the Unification process demanded from the German budget and stability-oriented control power. For this reason, it is easy to understand the purpose of the Bundesbank, when rising its interest rates at unbearable level for its other business and European partners.

As a consequence to the latter, a final set of conclusions could be identified, specifically concerning the role of the Bundesbank in the EMS crisis. As previously said, Germany was undergoing a demanding process in terms of monetary and economic stability. The funds necessary to be transferred to the East continued to increase meanwhile the Eastern businesses and economy did not improve as expected but wages were increasing at a high path. The result was the increase of

inflation, a fact that the German central bank(s) had been afraid of since the hyperinflation period after first world war. Specifically, the nature of Bundesbank's independence was not understood by the majority of its business partners and this resulted in a large amount of debates, internally and externally, before and after the EMS crisis.

Taking the latter fact into consideration, between 1990 and 1993 the Bundesbank had raised interest rates to counter the rising inflation trends inside, keeping a restrictive and non expansionary monetary policy. However, the ERM members were dependent on the strongest currency of the system, the Deutschmark. The German currency was acting like an anchor to the EMS, and consequently, the other countries were forced to follow not only the changes in the exchange rates but also German economic policies. Therefore, a change in the German monetary policy was felt also by the other EMS member countries. The hike in interest rates of 1992 and 1993 became unbearable for several countries and it was also highly criticised. After the crisis many authors have tried to explain and identify other possible outcomes but they encountered several obstacles.

Though the German Unification had an essential part in the EMS crisis it cannot be pointed out as the only cause. Namely, a peculiar activity was going on in Europe during the first years of the 1990s, the coming into force of the *Maastricht Treaty*, which had been negotiated in 1991 and signed in February 1992. Several authors showed that the lack of confidence that was emerging in the European Integration process was another major cause for the failure of the EMS. Specifically, the lack of popular confidence was demonstrated publicly when the Danish voters, when asked for their opinion on the Maastricht treaty, gave a negative answer. Moreover, the same result was feared for France, when French citizens were asked to give their opinions in September 1992, the same period of the first turbulence and crisis in the EMS.

To conclude, it cannot be said that the German Unification was the sole and only cause of the EMS crisis. Truth is that it was a big concurrent in the crisis.

Nevertheless, the EMS collapse was triggered by a large amount of factors that played all together against it. The Bundesbank had a role in the events and what still needs to be underlined is its independence and its power to manage monetary policy without or with a slight influence from the political field. Several proofs have been shown throughout this work concerning the conflicts that originated between the German central bank and the government. The conflict between the internal stability of the process and the external stability of the exchange rates is one among them. However, they are not the sole contributors to the crisis. Before the Unification, Germany was experiencing a good period for its economy and it was reaching a full employment level. The accession of the East with its increasing demand and declining output meant an increase in the overall aggregate demand. When demand do not meet enough supply at home, inflation increases and restrictive manoeuvres are requested by the German central bank to restore equilibrium. Thus, the economic cycle in Germany contributed to the rising pressures in the country. Moreover, public budgets and the new funds created to support the accession were not enough. This triggered an increase in the borrowings of the German government (Kohl promised not to raise taxes) and it developed in an increase in the monetary circulation and depletion of the German public budget.

The economic policy and the actions of countries outside of Europe must be taken also into account. During the EMS period of activity, the DM was seen to appreciate against all the other European currencies. Nevertheless, the DM was also appreciating against the dollar. This situation exacerbated the European economy, since not only the DM became less competitive at global level, but also all the EC pegged currencies were suffering from this problem.

A further concluding fact that was not mentioned before is the liberalisation of the capital movements in Europe. Thanks to the *Single European Act* and the will to achieve a full integration in Europe, eventually the capitals were set free to move inside the EU. However, from the point of view of several critics, Padoa Schioppa and Mundell among them, there are three characteristics that cannot be fulfilled simultaneously in an economic system: fixed exchange rates, freedom of capital

movements and independent monetary policies of each central bank. Practically speaking, the EMS and other various attempts to implement the economic integration aimed at achieving a fixed exchange rate among participating countries and freedom of capital movement (which scheduled to occur by 1990) while retaining the control of one's own economic and monetary policy. Taking into consideration the 'three impossible principles', is a such system viable or will it be subject to speculators and systemic vulnerability?

Some critics also regarded the early 1990s economic difficulties in general, as the stubbornness to maintain the direction taken with the Maastricht Treaty at any cost. In particular, in 1993, when the French Franc was experiencing strong pressures towards a devaluation, a realignment needed to be avoided because its occurrence meant a contradiction to the 'hard EMS', one of steps for a monetary integration to be developed from the Maastricht Treaty. In this way, the result was feared to be a demonstration of the speculators rightness about the credibility and the vulnerability of the European commitments.

Lastly, from this work it might be inferred also that there are some relationships of today's European crisis with the German behaviour and the Bundesbank support for non-expansionary policies in the European Central Bank. Controversial is also the idea of continued financial support from the European Union, specifically the ECB and economically stronger countries, towards economically problematic countries, for instance Greece, Spain, Italy or Portugal. Namely, the issue of financial transfers is still in the mind of the German authorities as a consequence of the accession of the East Länder to the FRG and its economical disadvantage in comparison to the West. Even if it is done at European level, the German authorities do not agree completely with the latter EU intention. This work also demonstrated how these policy directions were originated and solutions were supported or implemented.

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