The Euro: A German Tale

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1. Introduction

The Euro crisis has brought with it lively and to some extent agitated discussions amongst economists and others about causes and corrections of the crisis – but also about issues of squalor, waste, hegemony and power, the latter being mainly targeted at German European politics, in particular at German European economic policy and to be even more precise: German European monetary economic policy. Discussing the German position on (or within) the Euro crisis “has to start from the fact that the experience of the destruction of two currencies in one generation (1923 and 1948) had left a deep imprint on the mind of people” (Issing, 2010, p.6) – that is the German people. The aim is to identify this position in its origins and direction.

2. Some Time Ago

German monetary economic policy has its foundation in the currency reform of 1948 that introduced the Deutsche Mark in exchange for the inflation plagued Reichsmark in the geographical area that became the Federal Republic of Germany in 1949 – it also initiated the factual creation of two separate German states. The currency reform was seen as one of the fundamental framework components for the creation of a prospering economy. The coordination of individual plans and the well functioning of the economic process was viewed as dependent on the structure of the monetary system. The monetary economic policy found its institutional base in the creation of an independent central bank of the Federal Republic. The Deutsche Bundesbank has aimed at creating and maintaining price stability since its inauguration in 1957; that is in its institutional conversion of the previous Bank deutscher Laender and later as a member of the European Central Bank. The focus of the independent central bank was set on safeguarding the value of the currency. On a broader level, by the time of the Bundesbank's creation, the West German economic system had changed fundamentally from one of command and control to a market based economic system.

To the extent of the definition of what kind of a market based economy the German economy was to be, intellectual or ideological ideas were, as so often, overtaken by actual events and readjusted. A paradigm shift of German economic policy occurred towards the end of the 1960s, influenced by fears of the first anticipated recession after the World War II. Ludwig Erhard, the chancellor of the German economic recovery and the advocate of “welfare for all” stood for political and economic freedom within a concept of social cooperation. The subsequent Grand Coalition of the Social Democrats and the conservative Christian Democratic Union (with Chancellor Kiesinger) was economically led by an unlikely couple, Karl Schiller (SPD) as minister for economic affairs and Franz Josef Strauss (CSU) minister for finance. The social democratic dogma was a retreat from self-regulating markets towards a more interventionist state economy in the form of a social market economy.


In February 1967, the paradigm shift becomes apparent with the introduction of the first growth program. A total of DM 2.5bn were to be invested in rails, roads, mail and science. This was followed by the second growth program in September of the same year which injected another DM
5.3bn into the economy, a total of 10 % of the public budget. Alongside these political decisions, the fundamental legal basis was created too. In May 1967, the Bundestag (Parliament) introduced the “Law for the Promotion of Economic Stability and Growth” (further referred to as stability law), the so-called magic square identifying the aims as price stability, adequate growth, full employment and a balance of payment equilibrium, all equal in weight (Article 1). Keynesian anti-cyclical policy became the backbone of German economic policy. Within two years, the objectives were achieved: growth rates of 7–8 %, a reduction of unemployment from 2.2 % to 0.8 % as well as increasing wages and budget surpluses. The Bundesbank followed a policy of low interest rates, exports grew and the collective wage bargaining process followed a concerted action. This was to last and the Golden Goose got stuck with the unwanted: by 1982 the state/GDP ratio had increased to 48 %, the unemployment rate had risen to 7.6 % and public expenditure had increased threefold.

The stability law allowed the following four political instruments to counteract cyclical swings:

- Economic balancing reserves
- Economic levy
- Financial planning
- Concerted action

The first two instruments are also known as the golden rule of public finances: the first one targets public expenditure, the second one tax revenue. The third instrument is that of fiscal consolidation within a federal framework. The fourth instrument raised many concerns regarding the extent to which wage policy was commensurate with a social market democracy.

The concerted action of income policy was accepted as a policy instrument to achieve growth and stability. Autonomous wage bargaining groups were supposed to negotiate within quantified guidance provided by the state. The concerted action is one of joint-up decision making between economic political institutions and social groups of employees and employers. Article 3 of the Stability Law specifies that the government provides quantitative data as orientation guide to state and local authorities, trade unions and industry associations. This data shall act to adjust the social groups’ behaviour and decisions with regards to the attainment of the economic objectives defined in Article 1. The emphasis of this policy instrument was placed on the voluntary agreement with the aim to integrate the necessary social order. Nevertheless, the concerted action in its original form factually collapsed in 1976 when dominant trade unions withdrew their support in order to maintain wage autonomy.

The Stability Law envisaged a symbiosis between various forms of economic policy which was so fatally neglected in the construction of the Euro currency area.

4. No Gold Spun from Hay – What went wrong: Policy Design or the Optimum Currency Area?

The German Stability Law required that public financial policies and wage policies would not move beyond the limits that were defined by the monetary authority. German monetary and interest policy were gaged at the national inflationary risks and at the domestic potential growth rates. The working relationship between central bank and government was close. Industrial trade unions were economically well informed and could respond in their wage negotiations to the annual yardsticks given by the monetary decision-makers when considering the wage political spectrum.

In contrast, the requirements that were set by the Maastricht Treaty were created as entrance criteria for potential members of the currency union. The convergence criteria were set up to ensure practically that the Euro currency area was in fact an “optimum currency area”, i.e. following the criteria that Mundell focussed on (Mundell, 1961). However, what was missing from the convergence analysis was the realisation of Mundell’s paradigm. The paradigm of costs and benefits as a result of the currency union: the benefits are the ones of reduced transaction costs in a single currency union, the costs are those of the reduced economic political autonomy. That the loss of this autonomy would be more costly to countries of the periphery is not unexpected. Eichengreen (1997) showed that the cost of the loss of monetary policy would be the higher the greater the degree of asymmetry is. In an earlier study Eichengreen and Bajoumi (1993) identified the disparate effects, namely that economic shocks would affect countries of the periphery such as Italy, Portugal, Spain and Greece differently to those countries at the centre, such as France, Germany and the Netherlands.

Each EU member country that intended to join the Euro has had to fulfil certain criteria. These were:

- The currency of the country has to be within the currency band of the European Monetary System for at least two years.
- The long term interest rates must not be more than 2 % above the average of the three EU members with the lowest interest rates.
- The rate of inflation must be below a rate of reference (must not be more than 1.5 % within three years).
- The total debt of the country must not be more than 60 % of the GDP and the current debt must not be more than 3 % of the GDP.

Nations worked very hard to meet the Maastricht entrance criteria. However, it remains debated whether the political, economic and institutional differences between these countries render the Euro currency area an optimal currency area or not. Factually, the macroeconomic development could not be successfully guided through a unified monetary policy. As a result, the focus has been shifted to the
flawed Optimum Euro area. On the one hand, these potential set up flaws are identified, on the other hand fire fighting in the form of active economic policy is discussed at length. However, the main problem of the euro zone construction has been the fact that the functional conditions of the Euro currency area were insufficiently addressed.

Firstly, functional conditions proved insufficient to portray and guarantee structural homogeneity. Secondly, no fiscal union was envisaged, maintaining fiscal sovereignty of Euro currency members. Instead, the monetary policy oriented itself at the Deutsche Bundesbank, and the main fallacy was the belief that macroeconomic stability could be maintained without fiscal consolidation. In fact, when the monetary union started on 1st January 1999 with a group of 11 countries, including Spain, Ireland and Portugal no such provisions for fiscal consolidations were made. When Greece joined two years later in 2001 again all that mattered was the structural status quo.

How the structural status quo failed can be demonstrated by the one for all monetary policy of averages. European monetary policy focussed on the zone as a whole rather than on the economic requirements of individual member states. The interest rate convergence amongst diverse European economies has fundamentally sent the wrong signals to capital markets (Simm, 2010). The ECB could not successfully respond to national inflation or interest targets, instead European monetary policy used the average as a yardstick. There was no scope for macroeconomic guidance and concerted action between ECB, finance ministries and wage bargaining bodies. What was left was constrained and uncoordinated fiscal policy.

The European macroeconomic policy failed on three accounts. Firstly, the European monetary policy has not guided fiscal policy due to its lack of remit and thus guidance for fiscal policy. Secondly, the law of averages has implied that the fiscal room was too lax for some nations and too restrictive for others. The policy of averages has failed and given wrong signals and incentives which either contributed to excess growth or recession. Thirdly, European economic policy did not respond to financial signals. Financial markets lost the fear of devaluation; as a result interest on state debt fell across the union to a low German level. This turned out to be beneficial in the very short-term to nations that previously had to pay a risk premium; now they could obtain funds for less money! This rise in national debt could have been accompanied by rises in GDP in which case the nation would stay within the criteria. There were no control mechanisms in place that would act as danger signals. All that was required was that member states remained within the structural criteria of the Maastricht Treaty. A structural criterion is a static measure, the designers failed to incorporate dynamic control mechanisms. The static criteria were misleading as public finance appeared to be in order.

5. Germany in Luck: The Hare or the Tortoise?

Germany has regularly been seen as the nation benefitting from the Euro. However, Germany was not always the growth engine in Europe, rather did Germany lag behind for quite some relevant time. During the first part of the 1990s it became apparent that wage increases (of 25 %) were not matched by productivity increase (less than 10 %). Furthermore, the nominal effective exchange rate rose by around 18 % which further lowered German comparative competitiveness. Since 1995, the pattern has changed, the real effective exchange rate dropped and nominal labour costs fell. Wage moderation and deregulations were exercised, but by 2002 West Germany still had the highest labour costs in Europe, in fact German labour costs were two and a half times those of Greece (Jansen, 2005). During the first half of the last decade Germany was Europe’s ill man and it was part of the Euro currency area.

Without the European monetary union, the Deutsche Bundesbank could have counteracted the slack through monetary relaxation. Instead Germany’s hands were tied as the recession meant lower government revenue and increased expenditure. Economic growth in other European countries impacted on labour demand and thus increased wages, in particular in European countries of the periphery. These economies became increasingly less competitive whereby Germany improved its trade balances. The common adjustment process to such imbalances was prevented from functioning due to the lack of proper price or value signals that usually induce such adjustment. In fact the wrong signals, here the interest rate set by the European Central Bank allowed a misallocation. Current account disequilibria could not be corrected through exchange rate adjustments; instead German and core European countries’ capital exports financed the increasing demand for funds in the periphery.

The disparate European monetary policy of the averages implied that the nominal interest rate was too high for the German economy which joined the Euro with the lowest inflation rate. At the same time, the real interest rate was too low for the peripheral countries and their significantly higher inflation rates. Ireland, Spain and Greece saw economic expansion and reduction in unemployment due to the relatively cheap access to funds: debt financed economic growth for some and balance of payment surplus recycling for others. The financial crisis broke this circle of surplus recycling.

6. Europe: Sleeping Beauty or Wicked Witch?

Europe as an institution has been labelled many things depending on the onlooker’s view. For some, Europe brings peace and stability for others a loss of sovereignty.

The mirror on the wall shows the discrepancy amongst Euro currency nations becomes particularly apparent in light
of the misaligned effective exchange rates. The rebalancing requires a real appreciation in Germany, the opposite is required for countries like Greece. As part of the recent agreement between the Greek government and the Troika, Greece commits itself to improving competitiveness through unit labour cost reductions, and a reform of the collective bargaining framework, i.e. curb the power of the trade unions. With an official unemployment rate of 20% in Greece, such measures will most likely be disastrous for economy and society. The requests by the IMF, ECB and European Commission for austerity and privatisation in countries like Greece ignore the fundamental imbalances and the necessary institutionalisation of proper functional adjustment policies. It is necessary to focus on fiscal consolidation.

The single monetary policy within a structurally diverse eurozone caused the macroeconomic disequilibria. Jürgen Stark stated before his resignation from the ECB board that the ECB will not divert from the aim to maintain price stability in the eurozone. Again, the dilemma of the averages!

As early as 2011, 189 German economists warned about future calamities of the European Fiscal Stability Mechanism (de Gauwe, 2011). Furthermore, in July 2012, 172 German Professors of Economics protested in an open letter against the collective action and the proposed banking union in particular. It is further warned against the moral hazard that a collectivisation of bank loans would allow (Abele, Sinn et al., 2012).

The only way out of the debacle is the formation of a budgetary union which follows principles similar to those of the stability law. To prevent contagion and externalities, to allow the establishment of stability, Europe must follow the path of closer political union. However, opposition is strong, not only in the deficit stricken nations but also in the more prosperous parts.

7. The Fiscal and Monetary Union: Snow-White and Red-Rose

Only in conjunction can the two unite and beat the dwarf of nationalism and allow the bear to turn into a prince, the prince of a European political union. It has become apparent that the institutional design of the European Monetary Union has been unable to create and guarantee fiscal discipline among its member states. The lack of fiscal convergence has become evident during the recent European sovereign debt crisis. The stability and growth pact was proved limited as control mechanisms and enforcement options were non-existent.

In the Maastricht Treaty of 7th February 1992 a common monetary policy was agreed amongst the member states with the intention to introduce a single currency. The Stability and Growth Pact was agreed to motivate fiscal and financial stability within the union. The Pact provided two main targets for fiscal discipline:

- Net borrowing must not exceed 3% of the GDP
- Total indebtedness must not exceed 60% of GDP

The European economic framework has lacked the constitutional basis for economic policy; instead the vacuum has been filled with national laws. On 7th September 2011 the German Constitutional Court decided that public finances fall into the area of protection of the German people and that the Bundestag is bound to protect this substance. The European Stability Mechanisms was consequently seen as potentially restricting German financial decision-making authority and financial sovereignty. Prior to the drafting of the European Stability Mechanism, the no-bailout-clause of the European treaties (lastly reiterated in the Lisbon Treaty 2009) prevented the undermining of financial sovereignty of future parliaments and generations. National budgetary authority constituted a central part of the national democratic process and execution. It has set distinct limits for European fiscal integration.

A major change occurred when the fiscal compact was agreed between 25 out of 27 nations in January 2012 (UK and Czech Republic remain outside). The fiscal compact imposes quasi-automatic sanctions on countries that breach EU budget deficit limits. On the institutional level there have existed temporary instruments since 2010 that are designed to prevent or counter crises of debt and liquidity: these are

- European Financial Stability Fund (EFSF) and
- European Balance of Payment Mechanism.

The European Financial Stability Facility (EFSF) was created by the members of the Euro currency area to safeguard financial stability within an macroeconomic adjustment programme. It has been a response to the financial crisis and the macroeconomic effects. The Economic and Financial Affairs Council (Ecofin) agreed to issues bonds and other debt instruments on the primary capital markets to provide liquidity to members. The EFSF has become a player in secondary markets due to its recapitalisation programme and allows room for the policy of European macrofinance. The European Balance of Payment Mechanism is a medium-term financial assistance programme that grants loans to members of the Euro currency area. These two instruments have a limited life-span; their mandates end in 2015 and 2014 respectively. These measures will eventually be replaced by the permanent European Financial Stability Mechanism (EFSM). The EFSM as part of the European Stability Mechanism (ESM) has been inaugurated on 8 October 2012. Its aim is to provide financial assistance to member states subject to appropriate conditions. Is this the first step towards a fiscal union and to balanced budget rules? These rules will become subject to member nations’ legal discussions and are designed to tighten Euro currency area members’ budget discipline. It creates an institutional basis that can deal with severe national debt problems and debt problems of large financial institutions but needs to develop further into a political union to allow the sustainability of the currency union.
### Euro area National Central Bank’s contribution to the ECB’s capital and Contribution to ESM capital

<table>
<thead>
<tr>
<th>Country</th>
<th>NCB’s Capital key %</th>
<th>ESM Contribution Key (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Kingdom of Belgium</td>
<td>2.4256</td>
<td>3.4771</td>
</tr>
<tr>
<td>The Federal Republic of Germany</td>
<td>18.9373</td>
<td>27.1464</td>
</tr>
<tr>
<td>The Republic of Estonia</td>
<td>0.1790</td>
<td>0.1860</td>
</tr>
<tr>
<td>The Republic of Ireland</td>
<td>1.1107</td>
<td>1.5922</td>
</tr>
<tr>
<td>The Hellenic Republic</td>
<td>1.9649</td>
<td>2.8167</td>
</tr>
<tr>
<td>The Kingdom of Spain</td>
<td>8.3040</td>
<td>11.9037</td>
</tr>
<tr>
<td>The French Republic</td>
<td>14.2212</td>
<td>20.3859</td>
</tr>
<tr>
<td>The Italian Republic</td>
<td>12.4966</td>
<td>17.9137</td>
</tr>
<tr>
<td>The Republic of Cyprus</td>
<td>0.1369</td>
<td>0.1962</td>
</tr>
<tr>
<td>The Grand Duchy of Luxembourg</td>
<td>0.1747</td>
<td>0.2504</td>
</tr>
<tr>
<td>The Republic of Malta</td>
<td>0.0632</td>
<td>0.0731</td>
</tr>
<tr>
<td>The Kingdom of the Netherlands</td>
<td>3.9882</td>
<td>5.7170</td>
</tr>
<tr>
<td>The republic of Austria</td>
<td>1.9417</td>
<td>2.7834</td>
</tr>
<tr>
<td>The Portuguese Republic</td>
<td>1.7504</td>
<td>2.5092</td>
</tr>
<tr>
<td>The Republic of Slovenia</td>
<td>0.3288</td>
<td>0.4276</td>
</tr>
<tr>
<td>The Slovak Republic</td>
<td>0.6934</td>
<td>0.8240</td>
</tr>
<tr>
<td>The Republic of Finland</td>
<td>1.2539</td>
<td>1.7975</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>69.9705</strong></td>
<td><strong>100.00</strong></td>
</tr>
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Source: European Central Bank, Eurosystem, 2011

#### Table 1: Contribution to ESM Capital

The vacuum of political union becomes apparent when one considers the respective steps taken by Germany in response to the crisis. When Greece applied for financial aid from the EU and the IMF in April 2010 as a result of its over-indebtedness, possible public bankruptcy and insolvency, the members of the Euro currency area agreed bilateral financial aid to Greece. Germany subsequently passed the relevant law which was approved by the Federal Constitutional Court in September 2011. In May and June 2010, a European rescue package was agreed which partly follows from European regulations and partly from newly formed instruments in the form of a joint-stock company of an inter-governmental agreement between Euro states. It became apparent that the European Treaty had to be amended to safeguard the Euro currency area as a whole with a permanent mechanism rather than a temporary instrument such as the EFSF. On 25th March 2011, the European Council extended Article 136 by paragraph (3) stating

“The member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality” (BVerfGe 129, 124).

The Treaty establishing the European Financial Stability Mechanism followed suit which extended the previous agreement by providing further instruments such as i) precautionary financial assistance, ii) financial assistance via loans for the recapitalisation of financial institutions or the indebted nation, and iii) the buying of government bonds of the indebted member on financial markets. As a result the European Stability Mechanism has become an institution itself – an institution that has an authorised capital stock of € 700 bn with an initial total aggregate nominal value of € 80 bn. The capital stock is divided into paid-in shares and callable shares. This institution is lead by the Board of Governors, the Board of Directors and a Managing Director. Governors are national government representatives, directors are individuals with high economic and financial competence who are appointed by the respective governors as is the Managing Director. The voting rights within the two boards are derived from the capital structure of the ECB. The CEO of EFSF Klaus Regling declared in a speech that “it would also be a mistake to see the euro narrowly, exclusively as a project of economics.” (2012a). The Euro currency must not be singularly evaluated in a nutshell but must be evaluated against the wider project of the creation of a political union.

The contribution keys support the potential anxiety towards the fiscal implications for individual nations. However, on 12th September 2012, the Federal Constitutional Court refused a temporary injunction against the establishment of the European Stability Mechanism under the pro-
visor of two conditions. The proposed law which was accepted by the Bundestag on 29th June 2012 was signed and ratified by the Federal Republic of Germany on 13th September 2012 (Deutscher Bundestag, 2012). One of the provisos is that the European Stability Mechanism does not impose financial obligations on Germany without the agreement of the German representative. This clearly limits the extent of European legal authority and places political superiority to the individual nation. Effectively, the capital stock cannot be increased without prior agreement of the German representative. Time will tell whether this is indeed the first step towards consolidation.

8. Conclusions: Still Awaiting King Golden Hair’s Arrival

The institutional framework of the European monetary union created i) wrong signals due to the policy of averages and ii) the lack of fiscal consolidation that allowed markets to ignore signals. Markets provided inefficient information and the fallacy of the interest rate average allowed financial behaviour that proved devastating to those nations lacking fiscal sustainability or prudence. Rational financial behaviour coupled with irresponsible fiscal policy and the de facto bailout provisions proved potentially fatal for the institution of the EMU. The new European institutional requirement is yet limited by its lack of European constitutional consensus. As long as collective action in the form of a budgetary union is not constitutionally accepted by member states, the Euro currency zone is likely to experience further scenarios of contagion, disequilibria and externality. Instead the new institutional stability framework envisages deficit proceedings or penalties for Euro currency member nations that are out of line. Sanctions for nations that are running unacceptable debts or fiscal deficits can only be successful if they are placed within a constructive positive frame. The vacuum of a political union cannot simply be filled with policies of penalisation framework envisages deficit proceedings or penalisation.

As a result, the current policy of fiscal stabilisation on its own will not solve the current sovereign debt or financial crisis. It is merely a necessary means for the future of European economies. In the short term, adjustments must take place that allow the functional instruments to take action. This is preliminary fire fighting. Instead, in many peripheral European countries, prices and wages are too high, competitiveness has been lost and large current account deficits have accumulated. For example, Greece needs to reduce its costs by some 30% and regain competitiveness and sustainability through a de facto effective depreciation, i.e. make production and output cheaper. What is called for is a revival of the concerted action to allow macroeconomic stability. The creation of the ESM can be the first step towards economic consolidation but the economic union requires more emphasis on redefined concerted action to allow long-term stability that rests on the equilibrium of economic and political distribution.

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