PRIME MINISTER

IMPACT OF GERMAN MONETARY UNION

You were keen to see an analysis of the likely effects of German Monetary Union. I now attach a first draft of the Treasury's thinking; they are still doing further work to refine the analysis. As you requested Brian has spoken to Alan Walters to ask him to let you have a private note; we hope that will be available by the weekend.

As expected the primary Treasury analysis points to no firm conclusions. But the main points to emerge are:-

- the anticipated monetary implications (paragraph 5) are relatively small, possibly boosting the broad money supply by around 2 per cent;

- the economic fundamentals arising from union imply the need for an increase in the DM. That will be reinforced if monetary policy is tightened. But short-term market movements in the DM are unpredictable;

- assuming there was an upward movement in the DM this would lead to increased pressure for an ERM alignment. Equally, higher interest rates for the ERM countries could lead to downward pressure on sterling.

You may want to discuss all of this at your next bilateral with the Chancellor, scheduled for a week today (21 February). By that time, we may be a bit clearer about what is happening in the German monetary talks. And you should have the note from Alan (although you will want to consider whether or not to reveal to the Chancellor that you have it).

PG

PAUL GRAY

14 FEBRUARY 1990

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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

13 February 1990

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Paul

GERMAN MONETARY UNION ECONOMIC AFFECTS

... I attach a note by Treasury officials that the Chancellor thought the Prime Minister might like to see. It is a preliminary review of the implications of Germany monetary union; we will continue to work on the analysis as events develop in the coming weeks.

Yours

JSG

JOHN GIEVE

CONFIDENTIAL

GERMAN ECONOMIC AND MONETARY UNIONS

The Federal Government is now talking to the GDR about monetary union. At this stage the precise form that currency union could take is very unclear. The Federal government is reported as favouring making the DM the official currency of the GDR over a short period of perhaps 48 hours during which time ostmarks could be exchanged for deutschemarks. Difficult questions arise as to the rate of exchange and the treatment of non-liquid financial assets and liabilities denominated in ostmarks. The timing is also very uncertain: the East German Finance Minister has said that the GDR could not agree to currency union before the 18th March elections, although events may force an earlier decision.

2. The scale and scope of the accompanying economic integration is also uncertain. The Federal government has said that 'the GDR must irrevocably accept the full introduction of the FRG economic system'. This would probably mean that monetary and fiscal policy would be determined by the FRG authorities. Eventually, full economic integration can be expected with market determined prices and wages; the creation of a FRG style financial system with a full range of banking and savings institutions and market interest rates, and one system of company and financial law.

3. Full economic union between the GDR and FRG will take time to accomplish after the monetary union, whatever the political changes. In the short run the mechanics of currency union itself will have profound implications. The rate at which ostmarks are exchanged for DMs will be a key factor in determining the overall economic effects. Lower nominal wages and productivity in the GDR imply that an exchange rate considerably less than 1 for 1 would be appropriate. But too low an exchange rate reduces E. German purchasing power and does little to remove the incentive to move West. Too high an exchange rate raises costs in the GDR, increasing the probability of large scale unemployment and bankruptcy. It is likely that the Bundesbank in particular will

favour a lower rather than higher exchange rate to minimize the effect of any monetary overhang.

4. The decision on the details of the currency union leads to a consideration of the wider economic effects within Germany.

Monetary Implications

5. After the changeover the German monetary base will be raised immediately by the 15bn ostmarks now in circulation, revalued at the rate of exchange. Over a slightly longer period greater expansion of German money supply may be expected as E. Germans spend some of the 150bn ostmarks currently held in savings banks for want of goods to buy. If we assume an exchange rate of 4:1 (this compares with the official rate of 1:1 and the black market rate of around 7:1) and that E. Germans reduced their holdings in savings banks to W. German proportions, the West German money supply (M3) might be boosted by around 2 per cent. Allowing for E. German activity and employment, perhaps equivalent to 5-10 per cent of FRG GNP, this rise in money supply does not imply any automatic need for the Bundesbank to raise interest rates: much will depend on the wider demand effects. This tends to support Pohl's view that financing currency union will be manageable.

Demand effects

6. After years deprived of access to West German goods because of the non-convertibility of the ostmark, E. Germans will have every incentive to purchase West German consumer goods, especially durables, soon after currency union. Their savings balances may enable them to do so. The size of this effect will of course depend on the rate of exchange of ostmarks for DM, and also on the arrangements made for the conversion of these balances into deutschemarks: full convertibility may not be permitted immediately.

7. Currency union will also greatly reduce the risks of investing in the East. Substantial additional investment by West German and other firms can therefore be expected, putting pressure on capital goods producing industries.

8. There will be considerable pressure for additional public expenditure, especially on housing and unemployment benefits. The FRG Cabinet has already agreed additional aid for the East of DM7bn, and this will be financed by increasing the federal deficit. Considerably larger sums, figures of DM20-40bn, equivalent to about 3-6 per cent of FRG general government expenditure, have also been mentioned. The FRG government has also indicated that it will pay unemployment benefit in East Germany.

9. West Germany has a current account surplus, almost 5 per cent of GDP in 1989. Some of the additional demand, especially on consumer durables and investment goods, will therefore be reflected in a reduced current account surplus. But this will not happen automatically, and some appreciation of the real exchange rate, brought about by higher domestic prices and/or a higher nominal DM would seem to be implied.

Supply Effects

10. There will be major gains, especially in the medium and longer term, from the supply side. In East Germany, a market system will offer much greater incentives for work and production, increasing productivity from existing plant and encouraging new investment, helped by much better access to the capital markets and to Western management techniques. There will be some partially offsetting losses from closing down East German plants that fail to meet Western standards of pollution control. In West Germany, the extra influx of often skilled workers will add to output potential and will have a little dampening effect on wage inflation.

Effect on inflation, interest rates and exchange rates

11. Most of these developments will put upward pressure on inflation and DM interest rates. Higher public spending and corporate borrowing for investment in East Germany would itself tend to raise longer-term interest rates (indeed the expectation of these effects has contributed to a rise of over ½% in long-term DM interest rates over the last week). The extra demand and expected pressures in the East to raise wages towards West German levels before warranted by productivity improvements, will add to inflationary pressure in the new wider DM area. In turn this should lead the Bundesbank to tighten policy by raising interest rates.

12. The economic fundamentals would seem to imply a need for DM appreciation independently of what is happening on interest rates. The change in the mix of monetary and fiscal policy, together with the need to shift resources out of the balance of payments point to this. The recent rise in the DM suggests that the markets may also be taking this view. But market sentiment is fickle. Economic collapse in the GDR, political and economic uncertainty in the FRG, and rapid changes in current account might lead to a fall in the DM. The safest conclusion is that a period of turbulence for the DM cannot be ruled out as the German economy absorbs the effects of currency and economic union.

13. Overall, this adds up to a much more difficult background for the operation of German economic and monetary policy. At the same time, the Bundesbank finds itself brought more into the political arena than in recent years. Much depends on how it reacts. Higher DM interest rates and a strengthening of the DM could make a ERM realignment hard to avoid.

Labour market and migration

14. A key question for the FRG authorities is whether currency union stems the flow of immigrants, which it is clearly designed to do. After unification GDR prices, now DM denominated, would

need to be broadly equalized with those in the FRG for similar goods. Otherwise West Germans would have an incentive to import goods from the East, exacerbating shortages there. As already discussed, the rate of exchange of ostmarks would be an important influence on the incentive to migrate after currency unification, primarily though its implication for standards of living and unemployment in the East. But conditions in the West would also be important. There is already great pressure in the housing market in the FRG, and rises in house prices and rents would tend to limit the attractions of migration. The ability of the FRG labour market to absorb quickly the existing migrants would be a factor. In the medium to long term the degree of labour market flexibility and the path of wages would determine the extent of any 'regional problem' in Germany.

Effects on the UK

15. If the above analysis is correct in concluding that German currency union increases the likelihood of higher DM interest rates and may lead to a strengthening of the DM, then the results are not particularly welcome for the UK. A fall in sterling against the DM (and against all ERM currencies if there is not a realignment), implying a fall in the sterling effective rate, would tend to raise UK costs and prices. This might make it difficult to avoid following a general ERM-wide rise in interest rates without risking a further fall in sterling.

16. In the slightly longer term:

- increased German domestic demand would lead to greater UK export opportunities, both directly in Germany and indirectly in other countries as German exports are diverted to East Germany;

- UK firms may increase their investment in East Germany. The impact of this on the UK balance of payments would depend on whether that investment is diverted from other countries, diverted from the UK or additional; and in the last two cases on whether it were financed from sterling or foreign currency resources. Similarly there may be some diversion of inward investment from the UK to East Germany. However it seems unlikely that any of these effects would be large.

Implications for Economic and Monetary Union

17. The monetary unification of the FRG and GDR is in some ways easier and in some ways more difficult than EMU. It is likely to be easier because it would be taking place under strong political agreement in an area of high potential labour mobility and because there would be no need for new institutions. The Bundesbank would simply take over as the central bank for the new larger currency area. It is harder because it would be taking place in advance of economic integration, whereas in the Community the single market will be in place before full monetary union.

18. What are the implications for the speed of progress towards EMU? If German monetary unification works, it will strengthen the hand of those arguing for rapid progress to EMU. If difficulties emerge on the way, then it will set that process back. In the immediate future, a period of fluctuation in German interest rates and exchange rates, and possible ERM realignments, would on one view be convincing evidence that the right conditions for more fixed exchange rates in the Community had not yet arrived. Others, such as M. Beregovoy for example, argue, however, that increased uncertainty should hasten the path to EMU. However currency union in Germany in no way strengthens or weakens the economic arguments for or against EMU. It should be noted that currency union in Germany is likely to divert Bundesbank attention from EMU.

H M Treasury
13 February 1990

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ANNEX 4: ECONOMIC IMPLICATIONS OF GERMAN MONETARY UNION

Introduction

Current indications are that monetary unification may follow soon after the GDR elections on 18th March. Details are unclear, but it is likely that for a short period Ostmarks cash balances would be converted to Deutschemarks, while savings balances would also be converted, perhaps at a lower rate or with some restraint on liquidity. A rescue package involving substantial FRG expenditure in the East on housing and other infrastructures and on income support is also likely. A gradual process of economic integration and convergence would follow. There will be some impact on the UK and other European economies.

2. The GDR is both relatively small and backward. It has a population of 16 million compared with 61 million in the FRG, GNP of perhaps 10 per cent and productivity below one half of FRG levels, though GNP statistics are virtually meaningless.

Effects on Germany

3. The flow of immigrants from the East, now running at an annual rate of about 700,000 a year, threatens economic collapse in the East and social problems in the West. Both the speed with which living standards in the East can be raised and the availability of jobs and affordable accommodation in the West will influence the chances of stemming the flow. In the early stages a key factor will be the rate at which Ostmarks are converted. A low figure, for example 4:1, reduces East German purchasing power and does little to remove the incentive to move West. A high figure would mean high wage costs in the East and increase unemployment there.

4. Conversion of Ostmark cash balances to Deutschemarks would raise the money supply by a small amount. Since there would also be extra East German activity, this aspect of monetary union need

not be inflationary. However, extra expenditure out of Ostmark savings balances held for want of goods to buy could add to demand pressure if full convertibility at a high rate were allowed. And the expected increase in government expenditure and private investment together with the liberalization of wages and prices in the East also point to some increase in inflationary pressure. The Bundesbank will be keen to extinguish this, so a rise in German interest rates seems quite likely. German long bond rates have risen by over 1 per cent since the beginning of the year, perhaps in anticipation of a rise in short rates.

5. The German current account surplus, currently running at about 4½ per cent of GNP, may fall substantially as a result of the extra expenditure. But there may be increased capital inflows associated with the higher investment. On balance, and especially in the short term, there may be a boost to the Deutschemark, perhaps with a period of turbulence. Overall, this adds up to a more difficult background for the operation of German economic and monetary policy, but one that is manageable given the authorities', particularly the Bundesbank's, skill in economic management and their anti-inflationary credibility.

Implications for the UK and other European economies

6. In the short run the main impact of monetary unification outside Germany will be felt through interest and exchange rates. Higher Deutschemark interest rates, which may lead to a strengthening of the Deutschemark in the short run, would not be welcome for the UK. A fall in sterling against the Deutschemark (and against all ERM currencies if there is no realignment), would imply a fall in the sterling effective rate, putting upward pressure on UK inflation.

7. In the slightly longer term the UK and the other West European economies (above all, those with spare capacity) may benefit from increased German domestic demand leading to greater export opportunities, both directly in Germany and indirectly in

other countries as German exports are diverted to the home market. The UK and other European economies would also share in the increased investment in East Germany, although this effect is unlikely to be large.

Conclusions

8. Monetary unification could set off a period of greater uncertainty in Germany, the economy that has had the lowest inflation and greatest monetary stability in Europe. But it would be wrong to exaggerate the likely magnitudes. The enlarged Germany is likely to grow faster and have a lower current account surplus than has the FRG over the last decade. This would be beneficial to the world economy, especially the main trading partners in Europe.