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MR. POWELL

cc Mr. Turnbull
   Professor Griffiths

GERMAN MONETARY UNION

We have now got a first draft of a note by Alan Walters, as attached. I imagine the Prime Minister will find this useful, although to my mind it does not provide any major new insights. The Prime Minister has already said she wants to discuss with the Chancellor at their bilateral on Wednesday the earlier Treasury note on this subject, and I plan to put Alan's note in the folder for that meeting tomorrow night.

PAUL GRAY
19 February 1990

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(ECL)

A.Walters.
Feb 15th 1990

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# Monetary Unification of the Germanies

## Forms

The unification envisaged by Chancellor Kohl is that the GDR adopt the Deutschemark in toto. Any financial assets would be converted from Ostmarks at rates yet to be decided. The conversion may be done on a designated "day" ( a big bang) or alternatively the operation may be phased over weeks or even months, (a long wimper). Under the phased approach the two marks would have to coexist, and this essentially means that there be no fixed exchange rate or, indeed, a promise or even the appearance of a promise, of a particular conversion ratio. In practice I believe that a phased approach will be feasible only if some accounts, such as the saving accounts, are blocked and made, albeit temporarily, inconvertible at the going exchange rate. Even with a big bang one-day approach there will be similar problems up to the announcement of the conversion rate and conditions. Nevertheless the big bang would avoid much of the turmoil, and I would expect Pohl to urge that it all be done quickly.

An alternative unification is through a currency board arrangement. This would retain an Ostmark which would be linked to the Deutschemark through convertibility of the Ostmark notes into Deutschemark currency notes. Arbitrage would ensure that this convertibility spread to all other financial assets. The advantage of the currency board arrangement is that it does preserve an East German currency, and the possibility, in extremis, of adjusting it against the Deutschemark. (With one currency there is no such possibility). In view of the enormous uncertainties of the adjustments of incomes, prices, contractual and accounting systems, property rights, etc, I should have thought that no-one knows, or indeed has the foggiest idea of how the East German economy will cope with all this dramatic change. (Note that the change is an order of magnitude greater than that which followed the FRG reforms of 1947; the FRG was basically a capitalist economy). Any choice of a conversion ratio may be desperately wrong (as happened with Churchill's fix at $4.83 in 1925, or the Chilean fix to the dollar in 1979). Indeed there is much more chance of it being wrong than under "normal" circumstances. A currency board would provide a period of convalescence, for political as well as economic reasons; and after that period of massive adjustments, the FRG could then more easily slip into a full monetary union for a Greater Germany.

From all the reports, I adduce that the option of an interim currency board has not even been broached. Probably this is partly because it has, in the past, been associated with colonies and the implication of inferior status. (Although the French have always claimed their colonies as part of metropolitan France).

To fix ideas I shall assume that the currency board option is out and that the planned reform is in the form of a big bang.

## The Conversion Rate and Conditions

The official rate of one ostmark = one Deutschemark is an accounting fiction, but it is also the basis for considerable subsidies in the GDR on official imports from the convertible currency countries. The free market rate has been roughly seven ostmarks for one Deutschemark. This is a much closer approximation to the buying power of the currencies. But this is in the context of the very distorted and regulated pricing system, with all the shortages (which are reflected inter alia in queueing costs), and the various forms of rationing used in the GDR. The statistics are so chaotic and quite incapable of determining "price" in the sense used in Western market economies, so it is absurd to try and measure direct price comparisons to determine purchasing power parity. In short we have to trust the free rate as the best approximation to the equilibrium rate.

But this free rate is also skewed by expectations and the various probabilities associated with different conversion rates likely to be offered by the FRG. If, for example, the perception is that the Bundesbank will convert at 3, then it will pay to sell Deutschemark (indeed to borrow Dmark for sale) and acquire Ostmark at 7 and make a tidy profit on the coversion when the Bundesbank obliges. Thus the increase in demand for Ostmark will reduce the free market rate (and the profitability of arbitrage), until it approaches the Bundesbank conversion rate of 3. The point is that the de facto conversion rate, when known, will determine the free market rate. And even rumours of conversion rates of circa 2.5 to one (as circulated by Sam Brittan in "The Politics of the Mark" FT Feb 15th 90) will bring the free market rate down (this does not seem to have occured to Sam !), and may well account for the easing of the rate to 5 or so in recent days.

This market rate, however, will be far from the pre-union equilibrium rate of 7. This later rate is determined by goods arbitrage. Thus if the market rate is forced down to 4 by the Bundesbank conversion announcement, and if we imagine, for the time being, that the Deutschemark prices in FRG remain constant, the demand for East German goods will collapse as the prices (in terms of Deutschemark terms) are increased by the 7 to 3 ratio. I do not know how quickly the prices in the GDR will adjust downwards in response to the reduced demand, but owing to the rigidities which we know something about, I would suspect that it will take some time for tradeable goods prices to adjust.

But of course Deutschemark prices in the FRG are bound to rise in the short run, and this increase will persist in the long run if the Bundesbank does not carry out open market operations to counter the increase in the money supply (in Dmark terms) generated by the 4 to 1 conversion. The elements contributing to the German price increase are:

(a) the fact that anyone holding Ostmarks up to (say) January 1990 will make a substantial capital gain, and no doubt part of this will be spent primarily in West Germany,

(b) the joint money supply in purchasing power terms will be increased by the conversion operation, which, unless mopped up by sales of bonds (and consequential increases of interest rates - although much of this may well have already occured in anticipation of the inevitable), will have a once and for all effect on the price level. Strictly it will not give rise to any persistent additional increases in prices.

(Incidentally there seems to me to be many authorities in the media who claim that exactly the opposite results will occur. For example Michael Shea of Brown

Brother Harriman said "The West German inflation problem would be much greater at a ..a rate of six ... than at a rate of three (Ostmarks to Deutschemark)" WSJ Feb 15th 1990. I confess that I am baffled.)

Clearly there is also likely to be a secondary reaction to a 3 to 1 conversion ratio. The fall in the demand for East German goods and the unemployment and dislocation so created will result in a clamour for help from the East. Politically it will be difficult to resist. It will be argued that it would be best to pay the Eastern populace subsidies to stay in the East, rather than having them descend on the FRG and claim the welfare benefits there. Best to keep them in the albeit miserable residences in the East. The budgetary cost ? We can only guess, but my view would be that the minimum would be some $2,000 per capita - which would cost over $30 billion a year, and I suspect that $50 bn would be nearer to the actual cost. I suppose that the FRG government would take some measures to ensure that the East Germans who remained were not pauperised by such aid. Whether this budgetary cost is financed, on the one hand, by cutting other expenditures (defence?),or on the other hand, by borrowing or by increases in taxation does obviously affect the outcome but in fairly predicatable ways.

## Quantifying the Monetary Effects

Much comfort is being taken in the fact that the East German money supply (M3) amounts to some 200 billion Ostmarks. Reckoning at the official rate this is about 16 per cent of the M3 of the FRG. At 3 to 1, it is only about 5 percent of the FRG money supply. Thus it is said to be easily contained, and many economist have opined that the credit overhang is manageable without anything more than an additional half a percent on inflation (and I assume that is meant to be a once and for all price increase of one half of one percent). This may be so. If the purchasing power parity rate is 1 to 6 (say), and the demand for real balances in the East does not change (a heroic assumption), then the excess money supply created will be about nearly 2.7 percent of the money supply of the joint Germanics. If this were phased over five years, with no additional bond sales to offset it, the inflation rate would be an additional half a percent spread out a couple of years or so behind that monetary expansion.

From the arguments above, however, I think that the big bang effect would give rise to that 2.7 percent appearing in the year of conversion. It could be spread out by bond sales, but that would increase already high interest rates, causing great difficulties in the EMS and in relations with the Bush administration. Neither option is pleasant and no doubt Pohl will take what he considers to be the alternative which injures the reputation of the Bundesbank least - probably taking one percent on inflation and the rest on the bond market.

## Some Bad Ideas

I am worried about the number of bad ideas that are apparently being embraced. One, reported with approval by Sam Brittan op cit, suggests that, not only would there be a phased system (with all the disadvantages referred to above), but there would also be convertibility only of a fraction of savings deposits and presumably other financial instruments. Bonds would be issued as a (voluntary ?) exit for the balance. This is a sort of copy of the currency reforms in Austria and Germany after World War II, except that the high-balance holders were completely expropriated. The argument then was that anyone who held a lot of cash was likely to be a black-marketeer and deserved his loss. Today in East Germany the cash of the black market and the party officials is the Deutschemark not the Ostmark. The Ostmark savings are generally owned by small savers. I believe it would be morally wrong - and certainly wrong in terms of the ethic of a free society - to give the savers an inferior rate from the non-savers. And one would get all the political pressures and expectations effects spilling over and poisoning the atmosphere.

Lastly I think the conversion should not be motivated by the need to transfer resources to East Germany. The sole thrust should be to find the conversion rate that keeps East German industry and wage rates competitive under expected conditions of technology and efficiency. Any transfers needed should be carried through directly and not through the conversion rate. Then the FRG can tailor its subsidies to those who deserve and need it, rather than to those who are quick on the uptake in the currency markets.

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**Telecopy Transmittal**

Date 2/16

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To Brian Griffith

Company No. 10

Location London

Fax # 011 441 222 8141

From SIR ALAN WALTERS

Comments

Here is my
first draft

ext. 3175
3188

1776 Eye Street, NW
Washington, DC 20006
(202) 223-6665
(202) 296-3858 Facsimile (6th Fl)
(202)785-4052 Facsimile (5th Fl)

One Memorial Drive
Cambridge, MA 02142
(617) 225-2700
(617) 225-2524 Facsimile (16th Fl)
(617) 225-2519 Facsimile (4th Fl)

599 Lexington Avenue
New York, NY 10022
(212) 319-1177
(212) 758-7674 Facsimile

Embarcadero Center West Tower
275 Battery Street
San Francisco, CA 94111
(415) 399-0500
(415) 399-0545 Facsimile

Putnam, Hayes & Bartlett Limited
Lansdowne House
Berkeley Square
London, W1X 5DH
England, UK
011 441 408 1116
011 441 629 9994 Facsimile

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