EUROPEAN POLICY CENTRE

German macro: how it's different and why that matters

edited by

George Bratsiotis and David Cobham

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Introduction

by George Bratsiotis[1] and David Cobham[2]

The papers in this ebook arise from a seminar on 'German macro: *How it's Different and Why that Matters*', which was held at Heriot-Watt University in December 2015, with financial support from the Scottish Institute for Research in Economics (SIRE) and the Money, Macro & Finance Research Group (MMF). Six of the papers were presented there in earlier versions, and the editors sought some additional papers to complete the range of perspectives offered.

The starting point for the project was the question of whether the macroeconomics of the German political establishment does indeed differ, as it often seems to do, from standard western macroeconomics: in particular, the former appears to neglect demand management (although it may be quite interventionist in other ways), to reject debt relief and to emphasise structural reform designed to improve competitiveness as the (only) key to economic growth. How far is this true? How much of whatever difference exists is due to a well worked out set of ideas in the form of *Ordoliberalism*? How does it relate to Germany's own experiences in different periods? How far is this the result of political preferences and how much do the idiosyncrasies of these German views matter, for the development of the Eurozone and indeed the health of the German economy?

Of the papers included here (published in alphabetical order of authors), the two that deal most explicitly with the differences between conventional and German establishment macroeconomics are those by Peter Bofinger and Lars Feld. Both of these are members of the German Council of Economic Experts, but Bofinger is a dissenting member (see for example his minority statement in the Council's 2015 report on the consequences of the Greek crisis) whereas Feld is a leading member of the majority. Bofinger analyses the German 'macroeconomic policy paradigm' and relates it both to the views of Walter Eucken, whom he sees as having rejected Keynesian demand management and called for price and wage flexibility as the way to avoid demand deficiency, and to the policies actually undertaken in

[1] University of Manchester, co-director of the Centre for Growth and Business Cycle Research.
[2] Heriot-Watt University.

Europe in response to the crisis. Feld, on the other hand, argues that although Ordoliberalism may have played a distinctive role in the background, German macroeconomic thought is not so different from what can be found in the US. However, he makes no mention of the very different interventionist policies pursued by the US (and the UK) following the financial crisis, with immediate quantitative easing and other measures to boost the US economy. Feld also makes no mention of aggregate demand in connection with the Eurozone crisis or of the costs imposed on the peoples of Greece and elsewhere, and presents the widely criticized (particularly in the US) policies undertaken by Europe's leaders as fundamentally correct.

Michael Burda, who focuses more narrowly on German economists (as opposed to the political establishment), agrees with Feld in playing down the role of ordoliberal ideas, but argues that German economists differ from others in their failure to distinguish between positive and normative economics. In effect, he says, they support policies which are in the German national interest. One crucial point here, which is expounded most clearly by Bofinger, is that the German economy is significantly more open than the other large European economies, so that it has less to gain from national aggregate demand expansion. Bofinger and Burda, and Jacques Mélitz, also put emphasis on the wage moderation of Germany in the mid-2000s, which greatly improved Germany's competitiveness within the Eurozone and therefore provided an increase in external demand.[3]

Panicos Demetriades stresses the neglect of the role of aggregate demand, which he says has been prominent among German policymakers since 2005, when Angela Merkel became Chancellor. Bernd Hayo and Florian Neumeier relate the differences between German and other economists to the (strongly conservative) attitudes of the German public towards inflation and public debt, with these attitudes conceived as part of the 'socialisation' of German economists.[4] Brigitte Granville relates Ordoliberalism to Germany's inter-war experience of hyperinflation and the suppression of democracy,[5] but points out that the rules do not always apply to Germany itself: the Macroeconomic Imbalance Procedure, for example, allows larger current account surpluses than deficits, but even so has not been applied to Germany (which has had an average surplus above the 6% limit for many years).

[3] On this see also Carlin and Soskice (2009) and Dustmann et al. (2014).
[4] See Howarth and Rommerskirchen (2015) for an alternative view. Charlotte Rommerskirchen presented some of this material in her contribution at the seminar, but was unable to write it up for the ebook.
[5] At the seminar Wendy Carlin, who was unable to write up her contribution for this publication, related German attitudes also to the experience of the late 1940s and succeeding decades, in which strong German growth appeared to be based on structural reform and wage moderation, but benefited from a growing world economy.

Granville's emphasis on German economists' pursuit of German national interests is also echoed, in part, by Charles Wyplosz (as well as Burda, as discussed above).

One common theme in establishment German discussions of the Eurozone crisis is the need to avoid arrangements which entail moral hazard, and this is key to the emphasis of the (majority of the) German Council of Economic Experts on the need for the 'unity of liability and control'[6] (which can in turn be related back to Eucken's work, as argued by both Bofinger and Feld). However, the concept of moral hazard is sometimes used without much precision or explanation. Wyplosz, analyses it in some detail, highlighting the inappropriate way it which it has been applied; for example, with emphasis on the behaviour of borrowers rather than lenders (while bankers who stood to lose from their own bad lending decisions were advising core country governments to lend to periphery governments so that their loans could be repaid).

One lacuna in typical expositions of German macro views is the academic literature on expansionary fiscal contractions (EFCs) and on the growth effects of high public debt to GDP ratios. This literature is hardly referred to in these expositions, although curiously, one of the first writings on EFCs refers to the 'German view' (Giavazzi and Pagano, 1990). David Cobham provides a survey of recent work in this area, showing that the empirical case for expansionary fiscal contractions has been essentially refuted, while the argument, (originally due to Reinhart and Rogoff, 2010) that high debt ratios lead to a collapse of economic growth, has also been shown to be theoretically questionable and empirically misguided.

On the question of how much the different views held in Germany matter, Demetriades discusses the influence of these views on fiscal and monetary policy discussions in the Eurozone, not just via the arguments of government or Bundesbank representatives in Brussels or Frankfurt but also through the European Popular Party in the European Parliament and the views of German allies such as Finland, the Netherlands and Slovakia. There seems little doubt that German views have carried a lot of weight and led to policy decisions being different and/or taken later than they might otherwise have been. Granville argues that the club's rules are "stacked against the weakest members" and the "rebalancing mechanism is jammed", while many others of the authors here talk about the effects of such

[6] See, for example, German Council of Economic Experts (2015), or Feld et al. (2016)

decision-making. Demetriades draws out most clearly the implications for Greece and other countries: a "never ending vicious cycle of austerity". Most authors take the view that German policy proposals are to the benefit of the German economy, but Granville points out that a permanent current account surplus cannot be to the advantage of the German population, while Fabian Zuleeg highlights the costs to all Eurozone countries of the current political stalemate.

In his contribution, Mélitz argues there is a fundamental fault line between Germany and the Southern members of the Eurozone. This fault line reflects Germany's ability to use wage discipline to control its competitiveness and hence the demand for its products, so that it has no need of independent monetary (or fiscal) policy. He suggests that this fault line can be handled only by the creation of two separate euros, one for the North, around Germany, and one for the South (including France), which would be allowed to move against each other, with the Southern euro managed by a new central bank, which would operate arrangements for joint deposit insurance and joint bank resolution.

Fabian Zuleeg focuses on the policy response to the Eurozone crisis and the extent to which it has been shaped by German views. He emphasises that Germany has not always got its way: there have been bailouts, and the European Central Bank is now finally doing quantitative easing. Moreover, its influence is stronger in crisis situations, where it wields some kind of veto, than in the day-to-day construction of new rules. The implication is that Europe is not becoming 'more German' in any simple way; rather, Europe is stymied: "what Europe needs is more Germany, but a Germany that recognises that its relative hegemony implies that it needs to take the lead in constructing European compromises", compromises which can enable the crisis to be overcome.

What should we conclude from all this? One clear message that emerged from this conference, particularly from contributors who have a good inside knowledge of the implementation of European economic policy, is that economic policy decisions are heavily affected by political and legal factors and processes, combined with conflicting economic preferences driven mainly by self-interest, but also by traditional views and different perceptions about 'debt'. Germany, being clearly the *economic*, but also to a large degree the *political*, 'hegemon' in this European Union, inevitably bears the greatest responsibility for Europe's policy responses to the 2007 global financial crisis and the subsequent Eurozone crisis. In the German political (and to a lesser extent academic) establishment, there is a preference for structural reform over demand management and a strong opposition to both debt relief and debt itself and these reflect perceived German national interests as well as specific economic perspectives. These preferences have in turn had a major influence on the policy response to the recent financial and Eurozone crisis and may fully explain the economic indecision and political stalemate that has characterised European economic policy in recent years.

Therefore, one clear conclusion from all this is that Europe has an urgent need for further debate and discussion that will help identify the economic policy and legislative reforms that need to be introduced in order to ensure that European economic policy will always place Eurozone-wide interests above national interests and perceived national populist views and traditions. We hope this small volume will contribute to this debate.

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German macroeconomics: the long shadow of Walter Eucken

by Peter Bofinger[1]

1 Introduction

There is no doubt that the macroeconomic debate and actual macroeconomic policy in Germany differ considerably from other countries. At first sight this is difficult to explain, as in academia the same textbooks and models are used as in other countries. But behind the formal theoretical apparatus stands a *specific paradigm of macroeconomics* which was developed by Walter Eucken and which is diametrically opposed to Keynesian economics. From the experience of the Great Depression Keynes drew the conclusion that active demand management is necessary. Eucken, however, developed from the specific German experience of the 1930s a theory according to which 'full employment policy' leads to a centrally planned economy. While Keynes saw the Depression as a result of the inherent instability of the market economy, Eucken attributed it to an insufficient flexibility of wages and an inadequate monetary order. In his view with flexible prices and wages and an adequate monetary order the instability of the market system can be avoided. Eucken's dismissal of macroeconomic policy helps to explain the German focus on balanced budgets, price stability and structural reforms and the neglect of aggregate demand at the German as well as at the European level. The obvious fact that the German economy did quite well with this approach can be explained by its very pronounced openness. Thus in spite of its size Germany can be regarded as a relatively small economy which can rely on the rest of the world to sustain its aggregate demand. As this is not the case with the Eurozone (EZ), the application of the German paradigm leads to negative outcomes.

2 The German macroeconomic policy paradigm

The German *macroeconomic policy paradigm* rest on three pillars:

- An almost religious fixation[2] on *balanced fiscal budgets* which reflects a very sceptical assessment of the effectiveness of demand management and the ability of

[1] Universität Würzburg and CEPR, member of German Council of Economic Experts

governments to identify profitable investment projects. In 2009 this philosophy was legally enshrined in the so-called *debt brake* which has become a part of the federal constitution. The 'fiscal compact' which was enacted in 2012 obliges the other member states to implement similar regulations in their national constitutions. The neglect of the demand side effects of fiscal policy shapes the German approach to the EZ crisis and the insistence on austerity at any price.[3]

- A very strong preference for *price stability* as the overarching target of monetary policy with an asymmetric tolerance for deviations. While inflation rates above the ECB's target of "below, but close to 2%" are regarded as dangerous, to many economists the actual EZ inflation rate of 1% is not a matter of concern (Issing 2016).
- A deep conviction that *flexible prices* are the most important contribution to the solution of unemployment problems. This is reflected in the German '*wage moderation*' of the years 2000 to 2007 which was designed as a strategy to reduce unemployment in Germany (Bofinger 2016). This also explains the plea of German economists for structural reforms as the main solution to the problems in the EZ.

This specific German paradigm has effectively shaped German *macroeconomic policy*, which stands in strong contrast to the policies of other major economies. This applies above all to fiscal policy since the crisis. While the United States, the United Kingdom and Japan allowed very high deficits for a prolonged period of time, in Germany the deficit was rather limited and already in 2011 it was almost back to balance (Chart 1).

A German influence can also be identified in the *monetary policy* of the ECB. Its reaction to the Great Recession was much weaker than the reaction of other major central banks. In 2011 the ECB even raised its policy rate although the EZ was in the middle of the crisis. And while the other major central banks had started comprehensive quantitative easing programs rather early, the ECB waited until 2015.

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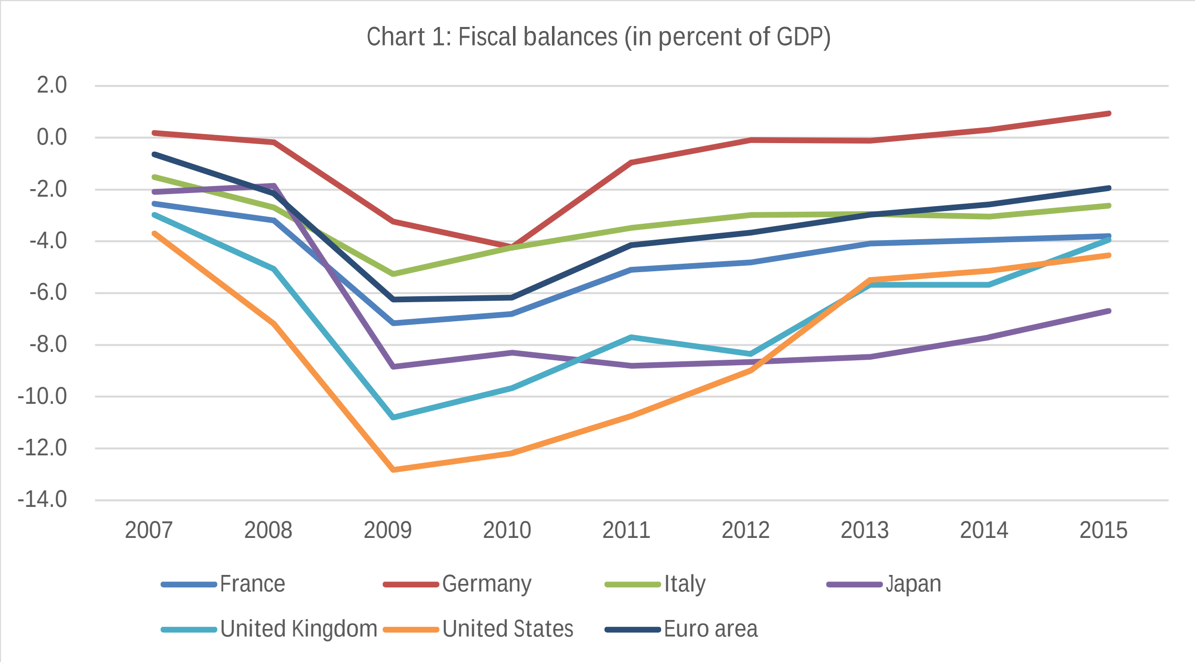
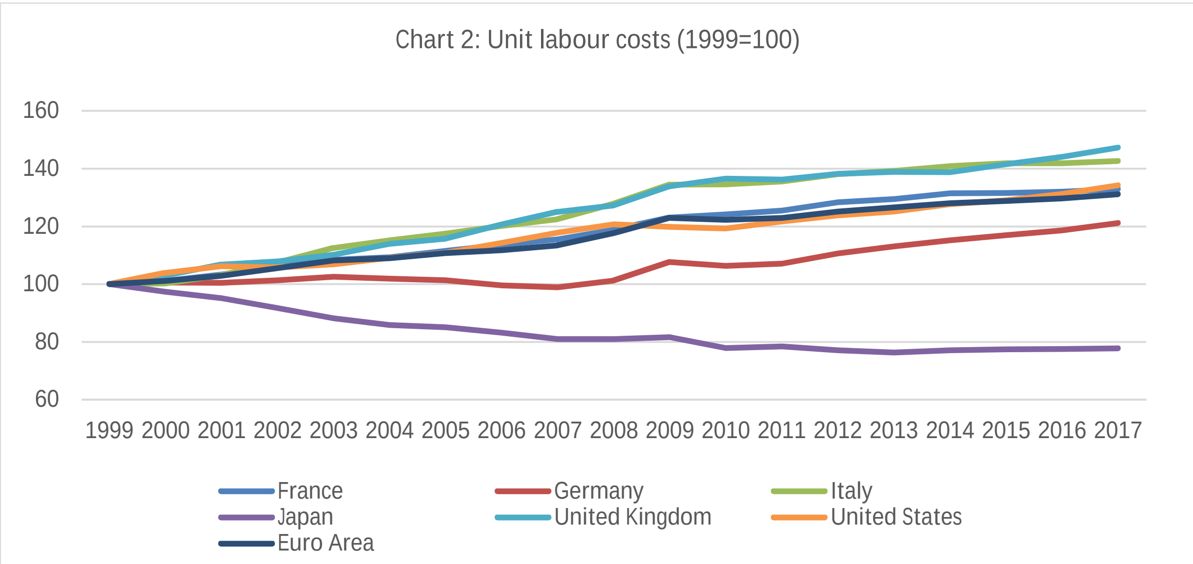
[2] This is reflected in the label of the '*black zero'* which describes the slight budget surplus of the German Federal Government since 2014. It is celebrated in the media and the public as an epochal achievement.

[3] An example of the complete neglect of the demand side effects of austerity is provided by the analysis of the 'Greek Tragedy' by Hans-Werner Sinn (2015, p. 10). This leads him to the question: "At first sight, it may seem puzzling that Greece's economy, despite the huge financial help it has received, has not improved and actually appears sicker than ever." But instead of referring to the effects of an "unprecedented" budget consolidation (IMF 2013, p. 39), he presents an odd 'Dutch disease' story.



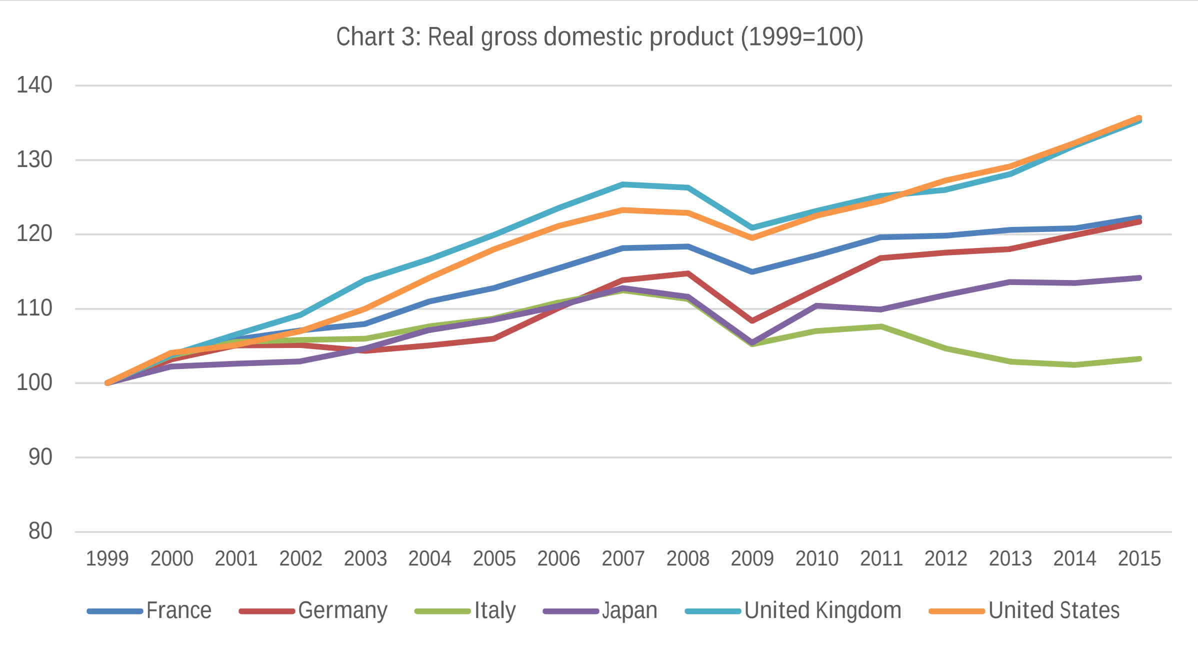
Source: OECD, *Economic Outlook*, Annex Tables

The German approach to unemployment is reflected in the development of *unit labour costs*. With the exception of Japan, since the start of the monetary union all the other major advanced countries have had much stronger increases in unit labour costs than Germany (Chart 2).



Source: *European Economy*, Statistical Appendix

Whatever one may think of the German macroeconomic paradigm there is no doubt that it has been relatively beneficial for *German economic performance* at least in the longer run (Chart 3). While German growth was weaker than in the United States and the United Kingdom, it was in line with France and better than in Italy and Japan. Especially impressive is the reduction of unemployment in Germany since 2005.



Source: IMF, World Economic Outlook Database

3 The living heritage of Walter Eucken

At first sight the specific macroeconomic policy paradigm is difficult to explain. German university students read the same macroeconomic textbooks as students in other countries and at the advanced level the standard DSGE models are taught and applied. But behind the formal theoretical apparatus one can identify a specific paradigm to economic policy which is called '*Ordnungspolitik*' and which in this form does not exist in other countries. While there are no university courses on this topic, 'Ordnungspolitik' plays an important role in German academic debate on policy issues and actual economic policy.

For an understanding of this paradigm it is useful to have a closer look at the works of Walter Eucken (1891-1950). Eucken taught at Freiburg University from 1927 until his death and he is regarded as the spiritus rector (guiding spirit) of the so-called 'Freiburger Schule'. The recent celebrations of his 125th birthday underline his impact for present-day policy makers. In her speech at this occasion Angela Merkel (2016) emphasized that the principles of the 'Freiburger Schule' had lost nothing in relevance and importance. [4]

Walter Eucken's philosophy of economics can be presented in *a positive and a negative message* (Oliver 1960). The *positive message* is presented in his 'constitutive' and 'regulatory principles'. Without going into detail these principles do not look very original, they are almost trivia.[5] As Oliver (1960) argues they are very similar to the programme which was developed by the Chicago School, above all by Henry Simons (1948).[6] In fact, most economists outside Germany would more or less agree with these principles as a precondition for an optimum allocation of resources.

Table 1: Eucken's constituent (K) and regulatory (R) principles

K1	Functioning price system
K2	Primacy of the monetary order
K3	Open markets
K4	Private property
K5	Freedom of contract
K6	Liability [legal]
K7	Continuity of economic policy
R1	Antitrust policy
R2	Income policy
R3	Correction of externalities
R4	Correction of anomalous labour supply

Source: Van Suntum et al. (2011)

[4] „Die ordoliberalen Grundsätze der Freiburger Schule haben nichts an Aktualität und Bedeutung verloren." And: „Vieles, was heute aktuell ist, baut auf der Arbeit großer ökonomischer Vordenker auf, unter denen Walter Eucken zweifellos eine ganz besondere Rolle einnimmt. Seine ordnungspolitischen Grundsätze helfen immer wieder, den Blick für das Ganze nicht zu verlieren. Sie sind verständlich und geben Orientierung."

[5] See for instance Vanberg (2011, p.6): "The ordo-liberalism of the Freiburg School starts from the very premise that the market order is a constitutional order, that it is defined by its institutional framework and, as such, subject to (explicit or implicit) constitutional choice. It assumes that the working properties of market processes depend on the nature of the legal-institutional frameworks within which they take place, and that the issue of which rules are and which are not desirable elements of such frameworks ought to be judged as a constitutional issue, i.e. in terms of the relative desirability of relevant constitutional alternatives."

[6] See Henry C. Simons, *Economic Policy for a Free Society*, Chicago: University of Chicago Press, 1948

For the macroeconomic policy paradigm the more interesting elements of Eucken's philosophy concern his *negative messages*. They include not only an outright dismissal of *central planning* which was prevalent at the time when Eucken was active but also a very strong critique of what he calls the '*policy of full employment*'. He uses this term for a Keynesian style expansionary fiscal policy but without mentioning Keynes. In his works Eucken only discusses the German experience in the 1930s which was dominated by the takeover of the Nazi government in 1933. Eucken draws a direct line from the 'policy of full employment' to price controls, rationing and central planning:

"Thus the policy of full employment, like the corporative structure of the labour market, resulted in a marked tendency towards central control of the economy. The one, like the other, was conducive to an unstable economic system with a tendency to move in the direction of central control. So there were two strong historical forces impelling German economic policy along the path to central control: firstly, the formation of comprehensive economic and social pressure groups, and secondly, the policy of full employment." (Eucken 1952a, p. 60)

Thus, it was not the Nazis that brought Germany under dictatorship, but trade unions (the "corporative structure of the labour market") and Keynesian demand policies. The complete neglect of the extreme political situation in Germany in the years from 1933 to 1945 also becomes obvious in Eucken's analysis of the consequences of Hitler's economic policy:

"It is one [a disturbance, P.B.] in which, though all factors are engaged, human activities are not properly co-ordinated and investments are not in line with one another, with the result that bottlenecks form." (Eucken 1952a, p. 80)

A more awkward description of the German war economy is difficult to imagine. From this very flawed analysis of the German experience in the years 1933 to 1945 Eucken develops *a general theory of 'full employment policy'*.

"Thus, our review of the German experience leads us to a grave and serious conclusion: Economic policy is faced with a dilemma: on the one hand, mass unemployment necessitates a full employment policy; on the other the policy of full employment makes for an instability on other markets, which is extremely dangerous, and in addition forces economic policy in the direction of central planning. *This dilemma is perhaps the most crucial economic and social problem of our time*." (Eucken 1952a, p. 66).

In the path from 'full employment policy' to centralization Eucken sees an important role for *inflation*:

"Not only did the inflations destroy the price system and hence all free types of economic order, not only did they engender or decisively foster the tendency to central planning, but they were also a precondition for the existence of central planning." (Eucken 1952a, p. 73)

Eucken's *solution* to the dilemma is related to his analysis of the main *causes of the deflation* in the years 1929-33.[7] In his view, price and wages were not sufficiently flexible:

"In the crisis year, 1931, Berlin builders, for instance, had to reckon with relatively firm prices of materials, such as iron and cement, which were fixed by syndicates, and also with relatively fixed wages, where housing prices were dropping rapidly." (Eucken 1952a, p. 78)

In addition, the *monetary system* had a destabilizing effect on the economy:

"When price fell, money contracted further, and so on indefinitely, the fall in prices causing contraction of money and a further fall in prices. " (Eucken 1952a, p. 67)

This leads Eucken to the conclusion:

"It can be firmly established that unstable market forms and monetary systems are bound to lead to cumulative depression and mass unemployment. This being so, economic policy should concentrate on developing systems conducive to market equilibrium, and in this respect the configuration of the monetary system is particularly important." (Eucken 1952a, p. 67)

And if this can be properly organised, a *permanently stable equilibrium* can be reached:

[7] In his book „Grundsätze der Wirtschaftspolitik" (Eucken 1952b, p. 309) he even goes so far as to explain the outbreak of the Great Depression as the result of demand management in the United States, the United Kingdom and Germany.

“The policy of full employment will then no longer be necessary and the great dilemma will have been overcome.” (Eucken 1952a, p. 67)

These are strong conclusions. They stand in some contrast to Eucken’s view on the theory of the business cycle that he develops in his book *Grundlagen der Nationalökonomie* (Principles of Economics). In this book (Eucken 1949) he adopts a completely *agnostic standpoint*. He maintains that theories trying to make general statements on seemingly regularly occurring changes in economic development are bound to fail.[8]

All in all Eucken’s economic philosophy can be regarded as the complete *antithesis to Keynes*. As Riese (1972) argued, both Eucken and Keynes were children of the Great Depression.[9] But while Keynes developed a theory which explains why market economies are not perfectly self-stabilizing even if prices are fully flexible, Eucken saw the instability as caused by insufficient price flexibility and a destabilizing monetary system. Thus, Riese (1972, p. 45) is correct when he argues that the messages of Keynes and Eucken are incompatible.[10]

In retrospect it is quite astonishing that Eucken thought he could develop *general economic principles* from the very specific historical experience of Germany in the years 1933 to 1945.[11] It may be due to the difficult times when he was writing his books that he does not make any explicit reference to the dictatorship of the Nazis and the very specific economic and political conditions of a country that is in a ‘total war’. It is also difficult to explain why Eucken does not discuss the writings of John Maynard Keynes that were published in the 1930s or, for example, those of Hayek (1929). In fact he does not make any specific reference to the leading economists of his time or to the vast theoretical literature on economic cycles

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[8] Eucken (1949, p. 182): „*Es gibt keinen Normal-Zyklus der Natur*. Daraus ergibt sich, dass „dynamische Theorien“ oder „Konjunkturtheorien“, die allgeingültige Aussagen über angeblich regelmäßig wiederkehrende Verschiebungen des konkreten wirtschaftlichen Alltags versuchen, scheitern *müssen*.“ (Italics by Eucken)

[9] Riese (1972, p. 45): „Während KEYNES die Grundlagen der damals herrschenden neoklassischen Theorie daraufhin untersuchte, ob sie noch zur Erklärung des Wirtschaftsablaufes ausreichte und aus der Einsicht in ihre Mängeleine Theorie der staatlichen Aktivität entstand, ergriff EUCKEN das Grauen über die Schlechtigkeit der Welt und er empfahl die Zuflucht zum Mythos einer natürlichen Ordnung. KEYNES ist, so gesehen, die angelsächsische, EUCKEN die deutsche Antwort auf die Weltwirtschaftskrise.“

[10] In the 1960s the German Finance Minister Karl Schiller tried to reach “a synthesis of the Freiburg imperative with the Keynesian message” (“Synthese zwischen Freiburger Imperativ und keynesianischer Botschaft”). But Eucken would not have agreed to this.

[11] This is even more astonishing as Eucken (1949, p. 183) explicitly argues that economic developments should be regarded as elements of the concrete historical situation.

that was available at the time he worked. Eucken also makes no attempt to support his reasoning with any statistical material. The severe limitations of his analyses and his complete unawareness of this may be regarded as a symptom of the isolation of German intellectuals under the comprehensive totalitarianism of the Nazis and the growing devastations of World War II.[12] In fact, Eucken died as early as March 1950 so he had almost no chance to discuss his views with a broader international academic community.

If one compares Eucken's narrow macroeconomic analyses with the comprehensive theories of Keynes, Hayek or Schumpeter his long-standing popularity and reputation in Germany is hard to understand. Above all there is no doubt his crude dismissal of 'full employment policies' has been refuted by the evidence. Jewkes (1952a), who wrote an introduction to the English translation of Eucken's works, mentioned the rather successful full employment policies of the United States and the United Kingdom which did not lead to a centrally planned economy. And since then repeated applications of 'full employment policies' have contributed to macroeconomic stabilization in the global economy without leading to central planning. On the contrary, the centrally planned economies have lost ground in many countries.

In the 1950s Eucken's popularity in Germany can be explained by a lack of internationalisation of the German academic community. But today it is difficult to understand why German politicians and academics still regard him as an outstanding economist and why his philosophy still shapes the German paradigm of macroeconomics. One explanation could be that he is simply used as a symbol of a neoliberal approach and that most of his followers have never read his works on macroeconomic issues.

But there is no doubt that Eucken's heritage is very much alive in the German macroeconomic paradigm as it has been already described:

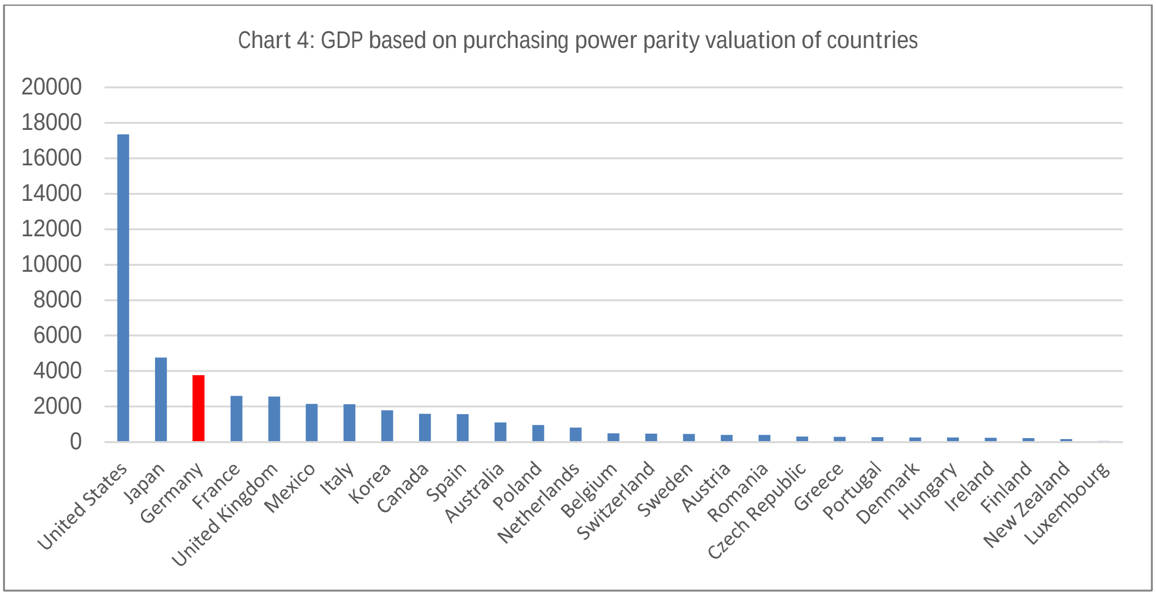
- Eucken's aversion to 'full employment policy' by means of fiscal policy is reflected in the German approach to fiscal policy at the national and the European level;

[12] This intellectual isolation is confirmed by Vanberg (2011, p.6): "(…) the Freiburg ordo-liberalism appears to be an essentially original German "invention" for which no significant direct influences from other sources can be discerned."

- Eucken's negative attitude towards trade unions and corporatism is reflected in proposals for 'structural reforms' which reduce the bargaining power of trade unions;
- Eucken's theory that inflation destroys "all free types of economic order" (p.73) shapes the German attitude towards monetary policy.

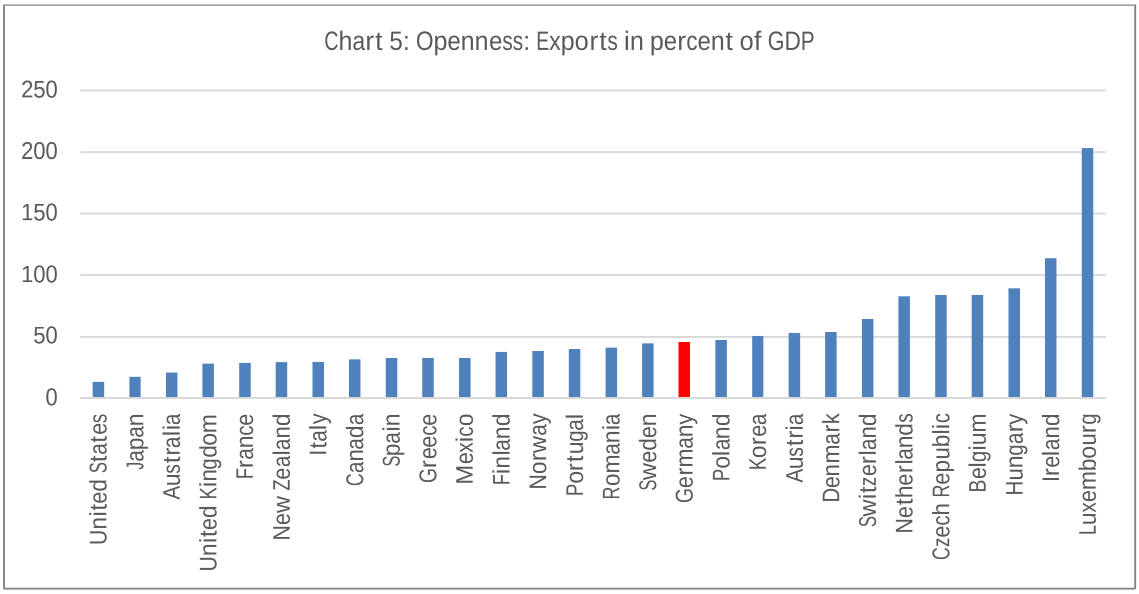
4 Why has German macroeconomic policy been successful?

The strong support for the anti-Keynesian paradigm in Germany can be explained by the quite successful economic performance of the German economy since World War II and again since the mid-2000s. Given the limitations of the theoretical framework of the German Ordnungspolitik this raises an obvious conundrum. It can be solved if one takes into account the relatively large size of the German economy and its pronounced openness. In terms of GDP German is the third largest economy in the group of advanced economies (Chart 4).



Source: IMF, World Economic Outlook Database

But in terms of openness (exports as percent of GDP) Germany ranks among relatively small economies (Chart 5). Due to this openness the German economy is able to follow a passive macroeconomic policy approach as it strongly benefits from macroeconomic policies pursued in other major countries. In other words the German economy is supported by the 'full employment policies' of other countries. This is reflected in the very large fiscal deficits in all other major economies in the period after 2007 which successfully helped to avoid a reappearance of the Great Depression. In other words, the German economy is supported by the demand management policies of other countries that are heavily criticized by mainstream German economists.



Source: World Economic Outlook Database

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German macroeconomics or German macroeconomists?[1]

by Michael C. Burda[2]

1 Introduction

It is an understatement to say that economics in Germany is getting a bad rap these days. Economists in this country are made out to be living in a different universe, harping on nonexistent problems, endorsing austerity when it is least needed, committing the fallacy of composition at every possible juncture, and simply getting it wrong. In particular, German macroeconomics has been under intense scrutiny in the international press. In this essay I would like to come to the defense of Germany's economists, at least partially, by arguing that the positions they take – especially in the public debate – reflect national interests in a very crowded and self-interested European theatre. Whether or not they should be doing it in the way they do is another, and not uncontroversial, matter. But they are doing it, and there can be little doubt about that.

2 The Wisdom of the Wise Men

Let's start with the 'wise men' - the *Sachverständigenrat* (the German Council of Economic Experts). This independent advisory council was established in 1966 as an independent source of expertise, summarized in its weighty annual report. The Council has been the butt of considerable criticism, some in this volume; it has rejected debt relief for Europe's periphery, Eurobonds, and the minimum wage as well as, more recently, the continuation of monetary easing. It is often characterized by its detractors as a hotbed of voodoo economics detached from current academic research standards.[3]

Nothing could be further from the truth. Members of the Council publish in serious academic journals, belong to respectable international scholarly associations, and cook with the same

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[1] This essay is based on a "Letter from Germany" for the Royal Economic Society Newsletter, July 2015. I am grateful to Wolfgang Franz, Volker Wieland, and Charles Wyplosz for useful discussions.

[2] Humboldt University Berlin .

[3] See for example "Of Rules and Order" in the *Economist* 9 May 2015. The steady tirades of the New York Times' Paul Krugman and the FT's Martin Wolf have received support from Wolfgang Munchau, who wrote about "Wacky economics" in the *Financial Times* (FT, 16 November 2014) and Simon Wren-Lewis on his *mainly macro* blog about deranged Teutonic world views.

utensils as other economists. The 'wise men' are expected to provide independent and sometimes unwanted advice to the government in the form of an annual report. They are not partisan advocates of government policy; they are expected, however, to advise in the perceived interests of the country. While not specified in the original legislation, a tradition has emerged that sitting governments consider and consult with corporatist interests – labour, industry, finance – when nominating Council members. Evidently this is a tradition which ebbs and flows with the political importance of economic issues of the day. While my friends on the Council would certainly deny any influence-peddling or quids pro quo, it is seems unlikely that those appointed on the 'trade union ticket' (e.g. Peter Bofinger) would be more likely to criticize the minimum wage or increases thereof than a member nominated after consultation with employers' associations (e.g. Volker Wieland). If there is influence, however, it is orders of magnitude more subtle: rather than acting at the behest of those who nominated them, it is more probable that potential candidates are vetted beforehand and pass muster, meaning they may be nominated as much for their normative leanings as their positive prowess.[4]

Yet despite this, the Council has exhibited much more independence than might be expected. It is noteworthy that Wolfgang Franz, first nominated by the trade unions for the period 1994-1999, was not asked to return for a second term.[5] This was a consequence of his public endorsement of wage moderation as a response to long-standing malaise in the German labour market in the 1990s, when unemployment more than doubled and could hardly be interpreted as demand-deficient. Most economists, including most in the UK, recognized the German situation as the consequence of an overvalued exchange rate caused by reunification and locked in by the adoption of the euro. Later Franz would be nominated by the 'employers' side' and actively supported the vaunted (and successful) 'Hartz' labour market reforms, effectively implementing the internal devaluation predicted by Calmfors (1995). Peter Bofinger, a contributor to this conference volume, was also nominated by the trade unions and has cast a number of dissenting pro-union votes on issues related to aggregate demand, minimum wage and other labour market policies. Similarly, Volker Wieland, a

[4] In the Council's enabling legislation ("Gesetz über die Bildung eines Sachverständigenrates zur Begutachtung der gesamtwirtschaftlichen Entwicklung" of 14 August 1963), it is stated explicitly that members of the Council may neither be members of the government or governmental bodies (except professors or heads of economic research institutes), nor represent or be employed by the trade unions or employers' associations directly.

[5] Private conversation with W. Franz, February 2016. This is oddly reminiscent of the fate suffered by Martin Feldstein when he, as Chairman of US President Reagan's Council of Economic Advisers, criticized the large deficits resulting from the administration's tax cuts.

distinguished and widely-cited expert on monetary policy, recently endorsed an end to ECB quantitative easing in what could be interpreted as a Frankfurt-friendly position, as German banks and their business model have suffered under the regime of Mario Draghi. Under the aegis of Christoph Schmidt, the Council has frequently slammed the current Grand Coalition government's policy mix, especially its choice of minimum wage level and its backtracking on family and retirement policy.

3 Positive v. Normative Economics

Yet all this does not indict the state of economic science or research in Germany, but rather points to the perils of taking policy positions. Lionel Robbins famously enjoined us to refrain from normative judgments and to stick to 'positive economics':

"All this is not to say that economists should not deliver themselves on ethical or normative questions, any more than an argument that botany is not concerned with aesthetics is to say that botanists should not have views of their own on the laying-out of gardens. Whatever may be our philosophical views as to the possibility of scientific ethics, as social beings we have to assume some such conception, and there is no reason why economists alone among their fellows should deny themselves the liberty of dogmatising. On the contrary, it is highly desirable that they should not do so." (Robbins, 1927)

It is remarkably ironic that the original law which created the *Sachverständigenrat* in 1963 tasked its members with producing impartial economic assessment and analysis, while proscribing specific policy recommendations.[6] In practice, the Council frequently issues normative judgments that often contradict positions taken by the government, not to speak of economists from other Eurozone countries, the UK, or the United States. Salient examples are their anti-minimum wage stance, the criticism of quantitative easing, the endorsement of fiscal consolidation in face of flagging aggregate demand in the Eurozone, and their proposal of a Europe-wide sovereign debt relief programme. Yet it is natural to expect these

[6] „Der Sachverständigenrat soll Fehlentwicklungen und Möglichkeiten zu deren Vermeidung oder deren Beseitigung aufzeigen, jedoch keine Empfehlungen für bestimmte wirtschafts- und sozialpolitische Maßnahmen aussprechen." (The Council of Experts should point out adverse developments and possible options towards ameliorating them, nevertheless make no recommendations for particular economic and social policy measures.") See Gesetz über die Bildung eines Sachverständigenrates zur Begutachtung der Gesamtwirtschaftlichen Entwicklung (1963) §2.

recommendations to reflect a national perspective, especially when national taxpayers are on the hook.

The members of the Council of Economic Experts are not lobbyists, but are chosen to assess the state of the economy and make recommendations, presumably in the interest of the nation's economic well-being. Thus, it would be completely wrong to claim that members of the Council are shills for the government's policies. In my two decades in Germany, I have observed an increasing tendency for the Council to issue policy recommendations and even criticize sitting governments. Clearly they are doing so because their writ is to further German national and economic interests, not to provide a pure positivistic evaluation of where the economy is going and what, for example, a fiscal expansion or tax cut would do to aggregate demand, inflation, and unemployment. This alone would be pretty uninteresting and significantly less glamorous, and it is not surprising that the Council has gone much further, and thus winds up on the front lines of political discussion.[7]

Nevertheless, there remains a significant mythology about German economics – also motivating this conference volume – which I would like to refute most vigorously. In what follows, I will try to de-mystify German economics by showing it to be a reflection of particular German economists, who in turn are thinking of national interests, for better or worse.

4 Myth #1: Economists in Germany fundamentally reject Keynesian ideas

This is nonsense. The importance of aggregate demand in the short-run determination of output and employment is standard, not only in the courses I teach in Berlin, but in those given by all colleagues I know who teach macro. (That includes Peter Bofinger, who certainly knows better than to claim to be the 'last Mohican' of Keynesian thought). People conveniently forget that Germany was out front implementing Keynesian ideas in the years before the war - Keynes even said as much, somewhat ignominiously, in his preface to the first German edition of the *General Theory*. During post-war reconstruction, Economics Minister Karl Schiller's central focus was on *Globalsteuerung* (aggregate demand

[7] When I was invited in 2003 to serve on the Council, the 'invitation' came from the 'industry ticket' and it was clear to me that members are under enormous political pressure inconsistent with my own research goals. I concluded that there would not be much room for manoeuvre and in the end, I declined the offer.

management). In fact, provisions of the *Stabilitätsgesetz* of 1967 (the law which mandated demand management policy) explicitly address economic growth, inflation, unemployment and the current account balance as the 'impossible square' and even provide for contingent fiscal policy projects off-the-shelf which could be implemented in times of recession or crisis. Germany reacted as vigorously to the Great Recession as its EU partners. Volker Wieland, a member of the Council, has contributed widely to a literature based on the premise that monetary policy has persistent and real effects on the economy in the short to medium run – hardly unorthodox.

So why the current stubborn resistance to *Globalsteuerung* in most German policy circles? My take on this – which the reader can take or leave - is simply national interest. First, the Anglo-Saxon world has an exaggerated view of Germany's role in the global economy (in fact, the share in world GDP is a whopping 4.9%), and even in EU Europe (only about 22%). An all-out Keynesian pump-priming binge in Germany would surely reduce its current account surplus, but wouldn't put much of a dent in world or even EU aggregate demand. Second, Germany is an open economy with the sum of exports and imports as a fraction of GDP equalling almost 90% - compare this with Italy, Spain, France and the UK, which range from 55 to 65%. Those who can still remember the old-fashioned multiplier know that it moves inversely with the marginal propensity to import. Even a 'Neanderthal' or 'hydraulic' Keynesian would have to question the benefits accruing to Germany from such a policy. It is disingenuous to expect individual sovereign countries to engage in aggregate demand policy for the benefit of others if domestic voters themselves can't be convinced of their own welfare gains.

Finally, most modern macroeconomists have a more nuanced view of fiscal demand management and the multiplier – and would reject the hydraulic Keynesian view of the world in which prices are constant and consumers mechanically spend a constant fraction of their income. A more modern perspective holds that only income-constrained households matter for the multiplier – it would be simply silly to argue that 100% or even half of highly banked German households consume hand-to-mouth from disposable income. While remarkable consensus has been reached that fiscal policy at the zero lower bound is effective, this also only applies to closed economies and only as long as the good faith and credit of borrowing countries remains intact. Incidentally, a lively discussion in Germany is currently underway among mainstream economists, led by Carl Christian von Weizsäcker and Marcel Fratzscher, who have endorsed taking advantage of government low interest rates and investing in infrastructure, with both short-run Keynesian and long-term supply-side gains.

5 Myth #2: German economists feed at the trough of 'Ordoliberalism' and worship at the altar of supply side policies

Many of the more disparaging articles I mentioned in the introduction criticize 'Ordoliberalism.' Ordoliberalism is defined in Wikipedia (presumably by its proponents) as a liberal (i.e. free market) regime with relatively stable rules to control the excesses of unbridled capitalism. Allegedly, it arose around the rejection of state socialism under the Nazi regime, and embodies ideas of Hayek, in particular a strong preference for decentralized market outcomes over state planning as well as an endorsement of the rule of law. Going after anti-trust violators and supporting a framework for stable contractual relations (especially loan contracts) are favourite elements of *Ordnungspolitik*; a friendly interpretation would draw in macroeconomic principles favouring rules over discretion. While this sounds harmless, it doesn't represent economic science based on mainstream methods of our field, and never was. While it might be interpreted as a normative analysis of regulatory regimes, *Ordnungspolitik* does not stem from the rigorous analysis we are accustomed to, but derives from an Austrian (i.e. Hayekian) rejection of formal analysis of these questions. Ordoliberalism is best described as a strong policy preference, perhaps even elevated to the status of religion. I have never seen a serious analysis of the welfare effects of an ordoliberal regime. But maybe I am reading the wrong journals.

As far as the supply side is concerned, the story is different. There is very good rigorous analysis – also from Germany, on how changes in labour market regulations, the welfare state, taxation, and the efficiency of job search can affect the long-term productive potential of economies. The success of the Hartz labour market reforms a decade ago is proof that supply-side policies can work; it is no accident that since 2003 employment, stagnant for decades, has risen by 13% (Burda 2016). In the decade after unification, Germany had lost enormous competitiveness and was the *Economist's* sick man of Europe. Post-unification inflation had raised nominal wages while European integration was putting downward pressure on prices. Paying for unification without explicit tax increases meant going through the back door of social security contributions, which led to elevated payroll taxes and severely distorted labour markets. The reforms of 2003-2005 addressed those problems at the expense of political careers; a decade later Germany can celebrate its labour market successes.

It is not surprising that Germans, who had to wait long enough for their own supply-side reforms to work, have considerably less patience for short-term views of the world and tend to think in terms of chains of Keynesian short runs, which eventually must be made consistent with what policy wants to do in the long run. This may be hard to deal with, but it is not voodoo economics, and goes pretty far in explaining Germany's focus on reforms in the current Greek drama.

6 Myth #3: Economists in Germany obsess on moral hazard and austerity

Attitudes towards moral hazard and austerity are always in the eyes of the beholder. It's hardly surprising that Germany is more interested in sustainable solutions to southern European problems (and hopefully the lending practices in the north that gave rise to them) as opposed to the recipient perspective of kicking the can down the road and hoping that structural problems go away on their own. In principle, governments should practice austerity in good times, not bad. Along with France, Germany failed to impose the stability rules and sanctions on themselves in 2003 – after insisting throughout the Maastricht Treaty negotiations on tough membership criteria for monetary union as well as the Stability and Growth Pact. The obiter dictum of consistency now dictates that Germany toe the line on austerity or risk losing all credibility on fiscal discipline in the monetary union. The coming fiscal consequences of the refugee crisis will challenge this fiscal discipline, possibly at the risk of losing the monetary union in the process.

To the extent that policymaking is the product of the interactions of hard-nosed politicians and policymakers, a positive analysis of economic policy yields high returns. Economists here certainly do take a much more cynical view of policy and political economy. When I arrived in Berlin in the early 1990s, the discussion surrounding the European Monetary Union project was uniformly sceptical. The suspicion was that politicians do what they please in response to short-term political incentives, not what our models predict for policy in a vacuum. In view of current events, those sceptics were pretty much on the mark.

Germans understand intimately the pitfalls and political economy of moral hazard and it is hardly surprising that their economists have similar views. The states of Germany are jointly and severally liable for each other's debt; predictably, the smaller states have allowed their debt to soar since the 1980s in the aftermath of structural decline and despite promises to balance budgets. Bremen's debt per capita increased from about 5000 EUR in 1980 to 30000 in 2015, or 500%; in Saarland, it rose from 1600 EUR per capita to almost 14000 EUR or 775% (for the country, debt per capita increased 'only' by 200% over the same period). While it appears plausible and perhaps unavoidable to bail out Bremen, Saarland (or Berlin), doing the same for 10 million Greeks is another question. Understandably, moral hazard becomes a categorical imperative.

7 Conclusion: National Interests trump positive economics

An important line of defence of German economists is simply projection of national interests. To paraphrase Clausewitz, national economic policy is war prosecuted by other means. Because many German academics cannot separate the normative from the positive, simple patriotism can wind up expressed as bad economics. Yet it is surely disingenuous and certainly incorrect to implicate the belief system of economists of a country when one disagrees with the policies their government is following, even if these policies sometimes fly in the face of mainstream economics and economists.

I have tried to debunk myths circulating in the media and the blogosphere about 'the way German economists think,' and argue that the input of those economists into many national policies is greatly exaggerated. This does not exonerate Germany for choosing policy advising institutions which claim to be independent and non-partisan on the one hand, yet are tasked with advocating German interests on the other. Nor does it excuse economists in Germany for the sin of making gratuitous policy pronouncements without cleanly separating the normative from the positive. But the facts remain: For its size, Germany is more open than any other European country, and thus is likely to be sceptical about the national benefits of demand stimulus; Germany cheated on the Maastricht criteria in 2003 with France and destroyed considerable credibility regarding fiscal probity; Germany has had a string of bad experiences with its own federal states in a system of joint and collective liability.

Rather than ordoliberal religion, economics in Germany is a mixture of national self-interest and healthy mistrust informed by experience. Like every European nation and above all the UK, Germany sees itself as part of a mosaic of self-interested sovereign nations. The sober reality is that each has its own history of "long-standing animosities based on history, nationality, and religion" (Feldstein 1997). In the end, German economists who can't refrain from voicing their opinions will tend to peddle economics that serve Germany's own self-interests, just as we'd expect of the British if and when they decide to leave the EU, of the Irish when it comes to synchronizing tax rates, or of the US when interest rates are finally raised. If it is to succeed, the European project needs to intensify its efforts in those areas where national interests are synchronous and leave the difficult bit on the table for future generations to resolve.

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The weakness of the academic case for austerity

by David Cobham[1]

1 Introduction

One of the puzzles of the last few years is that public opinion in many European countries has bought the argument that fiscal austerity is somehow necessary and unavoidable, while the academic case for it is so weak. This paper provides a short and simple review of the (general, rather than specifically German) academic literature on both (the possibility of) expansionary fiscal contractions (EFCs) and the relationship between debt ratios and growth rates (the related question of the size of the fiscal multiplier is covered briefly in Panicos Demetriades' contribution).

2 Expansionary fiscal contractions

An early contribution on EFCs is that of Giavazzi and Pagano (1990). They contrasted a standard Keynesian view of the effects of fiscal consolidation with what they called the 'German view', though it should be said that that view has been taken forward in the subsequent academic literature mainly by Italian economists, notably Alberto Alesina, and it is not clear how important this literature is to the 'German macro' ideas discussed elsewhere in these papers. In the Keynesian view tax rises and public expenditure cuts must have a direct negative effect on aggregate demand and hence, via the multiplier, on income. But in the German view fiscal consolidation could also have indirect positive effects on expectations which would lead to increases in investment that would generate increases in output and income. This argument can be reinforced by appeal to 'Ricardian Equivalence', whereby consumers understand that tax rises will be followed in due course by tax cuts so that they do not reduce their consumption in response to the tax rises, and this eliminates the direct part of the fall in aggregate demand; to the proposition that cuts in public expenditure will free up resources for private economic activity which is supposedly more productive; and to an IS-LM-based argument that fiscal contraction will lead to falls in interest rates which 'crowd in'

[1] Heriot-Watt University.

investment in a way that partly offsets the immediate negative effect on income of fiscal consolidation.

It is widely recognised that the conditions required for Ricardian Equivalence to hold are unlikely to be satisfied, particularly in the midst of a severe recession: consumers need to be far-sighted and to be concerned about their legacies to the next generation, and they need to have perfect access to capital markets (so that they can dissave during the tax rise and repay when the taxes are cut again). But the long-term existence of unemployment benefit schemes in most industrialised countries and the widespread emergence of food banks in the aftermath of the financial crisis surely demonstrate not just that those conditions are not fulfilled, but that society in general does not believe they are fulfilled.

However, much of the work on EFCs has revolved around empirical evidence: Giavazzi and Pagano had studied two particular cases of alleged EFC, and a series of papers by Alesina (e.g. Alesina and Perotti, 1995; Alesina and Ardagna, 1998, 2010, 2013) took this much further. While the initial focus of these papers was on the finding that expenditure-cut-based fiscal consolidations were less damaging and/or more beneficial than tax-rise-based consolidations, the emphasis soon switched to the claim that in many cases expenditure-cut-based fiscal contractions had been followed by expansions in output and income, and also by successful and lasting reductions in fiscal deficits. This work, as Islam and Chowdhury (n.d.) have pointed out, came to be highly influential in European policymaking circles, even though the expansionary and deficit-improving findings typically held for less than half of the cases considered; and other research came to question even those findings.

The crucial issue in the empirical debate is that, because tax revenues tend to rise when income rises and fall when income falls, while social security benefits tend to be higher in recessions and lower in booms, it is difficult to separate the effect of the economy on the budget from the effect of the budget on the economy. For example, if the deficit data that are used contain cyclical effects then some cases of large falls in the deficit will be cases where the deficit is falling partly because the economy is expanding: these cases will not be ones where sharp budget cuts contributed to good growth, rather the opposite. Alesina and his co-authors typically made rather simple cyclical adjustments, based on movements in unemployment rates, in their identification of the sharp fiscal contractions they went on to examine. But there is a widespread suspicion that the resultant series of tax revenues and expenditures still show significant cyclical effects.[2] The IMF's (2010) mea culpa offered an alternative identification of such contractions which used published government statements and plans to pinpoint deliberate government actions designed to reduce the deficit, as set out in more detail in Guajardo et al (2011). With this dataset these authors found unequivocally that fiscal contractions were indeed contractionary rather than expansionary. Their methodology was endorsed by Perotti (2011) in his retraction of the views set out in, or at least attributed to, his (1995) paper with Alesina. Perotti (2011) also re-examined four of the episodes of alleged EFC, argued that the discretionary consolidations (and the share of public expenditure cuts within them) were smaller than Alesina and Perotti (1995) had thought, and emphasised the crucial role played in these cases by changes in exchange rates or interest rates or wage growth which were caused by or associated with the fiscal consolidations. As he points out, such changes are not likely in the context of fiscal consolidations within the Eurozone – and the required interest rate changes cannot occur when interest rates are already at their effective lower bound.

Jorda and Taylor (2013; see also Taylor, 2013) provide a striking review and extension of these debates. They first use the change in the cyclically adjusted primary deficit, the variable used by Alesina and his colleagues. Overall, they are able to replicate the result that fiscal contractions are expansionary, but when they distinguish between consolidations occurring when the economy is in a boom (positive output gap) and those occurring when the economy is in a slump (negative output gap), they find that the expansionary finding applies only in the former cases; in the latter cases the fiscal multiplier (the effect on GDP of a deficit reduction) is negative but insignificant. On the other hand when they use the IMF/Guajardo et al dataset to identify fiscal consolidations they find that the fiscal multiplier is significantly negative in slumps and positive but insignificant in booms. They then present evidence that even the IMF dataset is not completely purged of cyclical effects. This leads them to employ more sophisticated two-stage econometric techniques to get closer to a genuinely randomised experiment, and here they find that fiscal contractions are contractionary in both booms and slumps, but considerably more so in slumps. Finally, they use their estimates to undertake a counterfactual simulation for the UK, to see how differently output would have grown in the absence of austerity: the answer is that 3 percentage points of the 5.2 points gap between the

[2] The question of cyclical adjustment is taken even further in work by Darby and Melitz (2008), who show that elements of government expenditure other than social security payments show systematic cyclical variations. Their insights have not been incorporated into this debate.

Office for Budget Responsibility's 2010 forecast of GDP in 2013 and the outturn for that year were due to the austerity measures. Alesina et al (2015) have focused on the austerity measures introduced in various countries since the crisis, using a new dataset and some new methods; their results suggest that the measures did indeed contribute to the output fluctuations countries experienced and confirm their previous findings that expenditure cuts are less damaging to output than tax rises, but they offer no statement about the optimality of the austerity measures introduced. As discussant of this paper, Taylor (2015, p431) argued that the evidence produced by the authors implied they had now come into line with the emerging consensus that the case for expansionary austerity is "effectively over", although they had not said so in as many words.

3 Debt ratios and growth rates

A second strand of the pro-austerity argument is due to Reinhart and Rogoff (R&R, 2010, 2012), who raised the question of whether there is a threshold to the government debt/GDP ratio such that beyond that threshold growth deteriorates significantly: if such a threshold exists governments would be justified in taking strong action to avoid hitting the threshold. Using a new dataset on government debt and considering ratios in the bands 0-30%, 30-60%, 60-90% and over 90%, Reinhart and Rogoff identified the growth rate for each advanced country in the year for which its debt ratio fell in each band. When they put their results together they found that when the government debt/GDP ratio exceeds 90% the economic growth rate is sharply lower. This finding was seized on by politicians seeking to defend austerity policies, such as the UK finance minister George Osborne and the European Commissioner Olli Rehn.

However, Herndon et al (2011) found a number of errors in the R&R spreadsheet. First, R&R omit Australia for the years 1946-9, New Zealand for 1946-9, and Canada for 1946-50. The New Zealand exclusion is particularly important because those years were all years of over 90% debt, with growth of 7.7, 11.9, -9.9 and 10.8%, i.e. an average over the four years of 5.1%. Secondly, the R&R spreadsheet which Herndon et al accessed had a 'coding error': Australia, Austria, Belgium, Canada and Denmark (i.e. the first five countries of the alphabet) were omitted from the averages. Thirdly, the R&R method uses a rather odd weighting: R&R assign each country in each year to one of their four debt ratio categories, then average for each country the growth in each year for each category, then weight those averages equally when they combine different countries: for example, the UK had an average of 2.4% growth over 19 years when in the >90% category, while the US had -2.0% growth for its four years in the same category, but those two numbers are weighted equally. In addition, these errors interact to make the results 'stronger' in R&R's direction. When the growth data are corrected by Herndon et al in line with the above, then the growth for the four bands is 4.2, 3.1, 3.2, and 2.2%, which contrasts with R&R's 4.1, 2.9, 3.4, and 0.1%: there is still some slowdown as the debt ratio rises but there is no sharp falling off a cliff of the kind R&R found. Reinhart and Rogoff's (2013) reply to Herndon et al. essentially accepts that they have identified serious errors, but insists that the basic finding, that growth is typically lower when debt ratios are higher, still holds even if the deterioration is now gradual rather than dramatic.

Further light is thrown on these issues by Pescatori et al (2013) who use another new dataset but provide a more comprehensive perspective. First, they consider growth over time horizons of one, five, ten and fifteen years in order to minimise the reverse causality effects from growth on the debt/GDP ratios (higher/lower growth of GDP tending to lower/raise the ratio, when what we want to analyse is the effect of the ratio on the growth rate). Secondly, they consider a finer set of debt ratio thresholds – 10, 20, 30…140% - rather than the four bands considered by R&R. Thus they identify episodes where a country's debt goes above each threshold, and look at the growth rate over each of their time horizons. A country can have multiple but not overlapping episodes, so each country has a relatively small number of episodes. These episodes are then pooled together and weighted equally when computing the averages. Their result for the one year time horizon is broadly consistent with R&R: growth is much lower, in fact negative, in the year after the debt ratio hits 90%; but their results for longer horizons are very different: growth tends to decline for the 5-year time-horizon, but only very slightly for the 10- and 15-year horizons, and in all cases remains positive. They also differentiate between when debt ratios are rising and when they are falling: growth turns out to be much better when the ratio is falling than when it is rising. They are therefore able to conclude that there is no simple debt ratio beyond which a country's medium-term prospects deteriorate sharply.[3]

However, this issue also needs to be placed within a wider perspective. If we ask what are the determinants of economic growth, any economist will offer a range of factors which may

[3] However, they argue, this does not mean that debt ratios do not matter: higher debt ratios are typically associated, for example, with greater GDP volatility, which is also undesirable.

even not include the government debt/GDP ratio. Moreover, much of the data that generates the threshold finding clearly reflects particular historical developments. For example, the fast-growing European countries in the 1950s and 1960s were growing fast because their economies had suffered so severely during and immediately after the Second World War (from military activity and from punitive confiscations by the victors) and they were catching up again. They also had low debt ratios because of high inflation in the immediate aftermath of the war. On the other hand, countries like the UK had much higher debt ratios, because of war finance that had not been much reduced in value by inflation, and did not have the same distance to catch up because their economies had suffered less. Considerations like this suggest that the simple question raised by R&R was too simple to be genuinely fruitful, even without spreadsheet errors.

4 Conclusion

What comes out of all this is that the academic case for austerity is weak. The evidence does not show clearly that fiscal contractions result in economic expansion, and there are good reasons both analytical and empirical to the contrary. The evidence that higher debt/GDP ratios lead to substantial declines in growth is also unconvincing. In that case there is a serious question as to why politicians have often insisted on austerity – a question for another day, perhaps – but the immediate conclusion is that the fiscal austerity imposed in so many countries has no serious intellectual justification.

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German macroeconomics: channels of influence

By Panicos O. Demetriades[1]

1 The fiscal policy channel and political mechanisms

Although 'German macroeconomics' may or may not exist as a school of thought in economics, the term itself, rightly or wrongly, has come to be synonymous with fiscal austerity and, more generally, neglect of the role of aggregate demand in the macroeconomy. Such views are certainly not confined to Germany. In all likelihood they have emanated elsewhere, since they can easily be rationalised within the context of the New Classical school. They have, however, certainly been embraced by German policy makers since 2005 when Angela Merkel became the Chancellor of Germany. This matters because German policy makers have been able to 'export' them to the rest of the European Union and especially so to the euro area. Euro area programme countries, namely Portugal, Ireland, Greece and Cyprus have had to adhere to strict austerity policies as part of their economic adjustment programmes, which were intended to address economic and banking sector imbalances. The Eurogroup - the 'informal' meeting of euro area finance ministers - has been particularly instrumental in imposing these policies, as it has overseen the design and implementation of these programmes. Compliance was regularly monitored by teams of technical experts from the European Commission, the ECB, and the IMF who report to the Euro Working Group, a technical committee that makes recommendations to the Eurogroup. Loan instalments to the recipient country were only released when positive assessments were made by technical experts. Programme implementation was particularly problematic in the case of Greece, which led to many delays and much uncertainty that escalated to frequent open discussions of the possibility of Greece exiting the euro area ('Grexit').

While fiscal consolidation was necessary to address fiscal imbalances, it is now clear that austerity may have gone too far, particularly in the case of Greece, in effect by relying - often implicitly - on underestimates of the fiscal multiplier. Typically, proponents of austerity had assumed values of the multiplier that are less than unity, drawing on studies of increases in

[1] Professor of Financial Economics, University of Leicester. Formerly: Governor of the Central Bank of Cyprus and member of the ECB Governing Council (3 May 2012-10 April 2014). The views expressed in this article are personal.

defence spending in the United States (e.g. Barro and Redlick, 2010). Assuming the multiplier is less than 1 allows cuts to government spending to be more draconian, as the effects of such cuts in GDP are mitigated by increases in private spending. The reality has, of course, been rather different, which seems to have surprised the IMF[2] and other advocates of austerity but hasn't surprised Keynesian economists who have long argued that the value of the multiplier can be especially large during recessions.[3] In the case of Greece, the IMF's own forecasts which were based on low values of the multiplier were responsible for successive rounds of austerity. With GDP falling much faster than the expenditure cuts, GDP and fiscal deficit targets were regularly missed, as tax revenues are dependent on economic activity. Even more tragically, unemployment kept rising to socially unsustainable levels whilst the public debt ratio showed no sign of declining. The never ending vicious cycle of austerity, causing greater and greater pain with no sight of correcting the problem it is meant to address, has brought austerity policies into disrepute, if not to an end. Proponents of austerity have often emphasised the need for structural reforms focusing on the supply side to restore economic growth.

Programme countries and their experiences, as well as the political mechanisms through which austerity was 'exported', are a good example of why German macroeconomics matters. They are not, however, the only one. Another political mechanism that has helped to shape the landscape of fiscal policy in the European Union in the style dictated by German macroeconomics has been the European Popular Party (EPP), which has the largest representation in the European Parliament. German Christian Democrats play a central role in the EPP and are able through the EPP to have a major influence on decisions at ECOFIN - the EU finance minister's meetings - and at EU Council meetings. It is no coincidence that EPP leaders' meetings usually precede EU Council meetings.[4] Germany is certainly not on its own in the EU and that is why it is able to influence economic policy at EU level much more effectively than perhaps any other country. The EPP is of course not the only channel through which German macroeconomics is exported. Bilateral channels have also traditionally been very important, particularly the alliance with France, although the relationship between the

[2] See, for example, Blanchard and Leigh (2013).

[3] A recent empirical study that finds a value of the multiplier that is substantially higher than unity is Acconcia, Corsetti and Simonelli (2014).

[4] This can also explain the UK's inability to influence economic policy at EU level (the Conservative party is not part of the EPP).

two countries has been strained more recently over disagreements about the stance towards fiscal policy.

2 Monetary policy

A second and equally important channel of influence of German macroeconomics on economic policy, albeit a less transparent one, is monetary policy in the euro area. Monetary policy in the euro area is, of course in the hands of the ECB, which is an independent institution in which Germany has little, if any, direct say. This is because the Governing Council of the ECB comprises the governors of 19 euro area countries’ central banks and the six members of the ECB’s executive board, all of whom act in an individual capacity and not as representatives of any given country. Moreover, there are only two German voices on the ECB’s Governing Council: in addition to the Bundesbank president, one member of the executive board has traditionally been selected by the German government. The influence of German macroeconomics on the ECB’s Governing Council should thus be expected to be minimal. In reality, however, German macroeconomics has a disproportionate influence on monetary policy in the euro area for the following reasons:

(i) The two German voices on the ECB tend to reflect the views of the German macroeconomics school of thought, even if acting in an individual capacity, since they are both selected by the German government and are subject to the daily scrutiny of German public opinion. Moreover, the Bundesbank President reports to the Board of the Bundesbank and is accountable to the German Parliament; although this is not meant to be on matters relating to monetary policy, what is and what is not monetary policy is not always very clear. For example, when the ECB introduced the OMT programme in 2012 to address the risk of a euro break up, various parties in Germany launched a constitutional challenge against the ECB, claiming that the OMT was outside its mandate, that it contravened the prohibition of monetary financing and that the involvement of the Bundesbank breached the German constitution.

(ii) The German macroeconomics school of thought and its views are quite popular in other countries in the euro area (e.g. Finland, Luxembourg, the Netherlands and Slovakia). As such, they are likely to resonate well with several other members of the Governing Council.

(iii) The ECB is located in Frankfurt, the financial hub of Germany. As such, it is, in some sense, 'surrounded', if not altogether 'infiltrated' (for example through staff recruitment), by German macroeconomic views. A related, if not altogether separate, reason is that the German media have a keen interest in the ECB and are always keen to spot what they see as the softer stance of the ECB as compared to the Bundesbank's hardline views, which are highly respected.

(iv) The occasional open dissent by the German members of the Governing Council on monetary policy decisions, which has brought disagreement into the open, has helped to generate further suspicion of the ECB from within Germany. Such public discord undermines the effectiveness of monetary policy by raising questions over the commitment of the Governing Council to medium term issues, such as the commitment to non-standard measures and the credibility of its forward guidance, making the task of the ECB's President at the monthly press briefings even more difficult.[5] Given the challenges this entails, the ECB's executive board and the President are known to work hard to accommodate the views of the Bundesbank's President in order to reach consensus, or at least to prevent frequent public dissent.

Evidence on whether German macroeconomics is having a disproportionate influence on the ECB's monetary policy can be obtained by close examination of the ECB's record on meeting its inflation target of 2%. The average inflation rate since the introduction of the euro has been 1.8%, which is consistent with the objective of maintaining price stability, interpreted by the ECB as an inflation rate that is below but close to 2%. However, the average inflation rate of 1.8% masks considerable variation over time, which is depicted in Figure 1. Specifically, at the time of writing [2 February 2016] the inflation rate has been less than 1.0% since October 2013, which represents a period of 25 months. By contrast, the longest period for which the inflation rate was above 3.0% was November 2007-October 2008, i.e. twelve months. An uncomfortable asymmetry has, therefore, emerged which suggests that the ECB is less comfortable with significant upward deviations from the inflation target than with downward ones.

[5] See, for example, a recent article in the *Financial Times* (24 January 2016) by Wolfgang Munchau, "Mario Draghi's inflation targets miss the mark", which argues that the ECB keeps failing because it is not fully committed to the inflation target.

Figure 1. Inflation rates in the euro area

Euro area (changing composition) - HICP - Overall index, Annual rate of change, Eurostat, Neither seasonally nor working day adjusted

It is highly unlikely that the ECB would have been equally comfortable or uncomfortable with inflation rates exceeding 3.0% for such an extended period. Such an asymmetry indicates that monetary policy in the euro area may have been unduly tight, which is consistent with the view that German macroeconomics, given its relative neglect of aggregate demand factors, may be having a disproportionate influence on monetary policy. It also suggests that the ECB should have acted earlier not only in reducing interest rates but also in introducing its asset purchase programme (QE), which has been the source of considerable public dissent from German members of the Governing Council since its inception. Although the programme was in the end introduced, the 'wait and see' stance adopted by the ECB on both standard and non-standard policy measures may reflect an understandable desire to achieve consensus, which, ultimately, provides the dissenting minority with a disproportionate influence on monetary policy.

3 Concluding remarks

German macroeconomics matters not just for Germany but for the entire euro area and also for the rest of the EU. This article has explained the channels and mechanisms through which it has had a disproportionate effect on both fiscal policy in the EU and monetary policy in the euro area. While German policy makers may be proud that they have been successful in exporting their policy preferences to their partners in the rest of Europe, they need to also consider the possibility that the true model may be different from what they believe. If indeed the true model of the economy is one in which aggregate demand plays a greater role than is afforded by German macroeconomics, their success may have deleterious longer-term consequences. The SYRIZA government in Greece, elected on the back of anti-austerity sentiment in January 2015, is a good example of this. Its election nearly led to the break-up of the euro when negotiations between Greece and its creditors came close to collapsing in the summer of 2015. The risks are possibly even greater when it comes to the influence of German macroeconomic views on monetary policy. As the ECB's ability to demonstrate its commitment to price stability and to protect the singleness of monetary policy is increasingly coming under question, deflation risk and financial fragility in the euro area can easily resurface and so can the risks of the euro unraveling.[6] History has taught us that unnecessarily tight monetary policy can have as devastating consequences as excessively easy monetary policy. In a monetary union without 100% political commitment to its irrevocability, any such errors can prove lethal.

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[6] Financial fragility is, in fact, already surfacing in Italy, where the authorities have recently created a complex scheme to deal with €350 billion of problem loans. See, for example, Wolfgang Munchau, "Athens and Rome expose Europe's greatest faultlines", *Financial Times*, 31 January 2016.

Is German (macro-) economic policy different?

by Lars P. Feld[1]

Some observers in the Anglo-Saxon world wonder why German economic policy, in particular regarding solutions for the Eurocrisis, strongly emphasizes structural reforms and improvement of competitiveness instead of demand management and debt relief. Is there a difference between German macroeconomics and the rest of the world? Does the particularly German, ordoliberal school of economics play a role in Germany's policy? Or is it its own historical experience, perhaps even pure political preferences, that shape this position? For some commentators, German ordoliberalism has to be accused as the main suspect leading to "the wacky economics of Germany's parallel universe" (Wolfgang Munchau, *FT*, 17 November 2014).[2] In this paper, I will argue that there is nothing special about German macroeconomics or its economic policy, but that it follows basic political preferences, not heavily depending on the parties in power at the federal level. However, German emphasis of rules as guiding principles of economic policy has to do with German ordoliberalism.

Before outlining this argument, a caveat is in place. The following discussion focuses on economic policy. There is no argument in this paper as to whether German economists as part of European economics are competitive as compared to their American colleagues. A long-ranging academic debate has provided empirical evidence on the American domination among eminent economists, the reasons for it, but also a reduction of U.S. economists' dominance across time (Frey and Pommerehne 1988, Frey and Eichenberger 1993, Kocher and Sutter 2001, Frey and Rost 2010, Haucap and Muck 2015). Meanwhile, journal publications of German, Swiss or Austrian economists, e.g., in the fields of experimental economics or public economics, show that there is no longer much difference.

Moreover, it should be noted that there is no German economics as such. A look at the distribution of the research activities of German-speaking economists quickly reveals how diverse their interests and views are. This also holds with respect to macroeconomics. As

[1] Prof. Dr. Lars P. Feld is Professor of Economic Policy at the University of Freiburg, Director of the Walter Eucken Institute and Member of the German Council of Economic Experts (GCEE).

[2] See also the following contributions from *The Economist*: 'Slow, but popular' (8 December 2012), 'Ordoliberalism revisited' (18 October 2014), 'The sputtering engine' (22 November 2014) and 'Of rules and order' (9 May 2015, Vol. 415, No. 8937, pp. 21-22).

generally observed, the New Keynesian paradigm dominates the research of German macro- and monetary economists. However, as the views of Stanford University's John Taylor and New York Times columnist Paul Krugman diverge, so do the views of Peter Bofinger and Volker Wieland, both members of the German Council of Economic Experts (GCEE). Just as those American economists have strong views and express them, but also use well-established methods from positive economics in conducting their research, German economists also cross the dividing line between normative and positive economics.

Thus, the question to be addressed in this paper should be properly stated: Is the dominant view in German macroeconomic *policy* different, and, if so, why is it? When it comes to economic policy, the dividing line between positive and normative economics becomes fuzzy anyway. To understand current macroeconomic policy positions in Germany, it is necessary to provide an overview of the development of economic thinking in German politics since the Second World War, beginning with a brief explanation of what ordoliberalism is, followed by a necessarily personal discussion of the development of German macroeconomic policy across time. Finally I will interpret German positions during the Eurocrisis in the light of this analysis, taking into account political preferences and historical experiences.

What Is Ordoliberalism?

At first sight, Ordoliberalism seems to be a purely German particularity, but this is too shortsighted. German ordoliberals aimed at distinguishing their liberal economic thinking from the classical liberalism of the 19th century. Laissez-faire economic policy should be replaced, according to ordoliberal authors like Walter Eucken, Wilhelm Röpke or Alexander Rüstow, by a government providing a rules-based (constitutional) framework under which market forces could operate, but without intervening in day-to-day economic decisions. Most important to Eucken and the Freiburg School of Economics was competition policy.[3] Based on their analysis of the cartelization and monopolization of the economy during the Weimar Republic and the disastrous impact of those processes on economic performance, Eucken asked for a rigorous competition policy requiring a state that is strong enough to stand above

[3] For an introduction to the Freiburg School, see Vanberg (2004). The Freiburg School is one branch of German Ordoliberalism in addition to the conservative Ordoliberalism of Wilhelm Röpke and Alexander Rüstow as well as the social Ordoliberalism of Alfred Müller-Armack.

special interests (Eucken 1952/2004).[4] In addition, Eucken's principles of economics allow for a range of government policies correcting market failures or undesired market outcomes. Keeping in mind the state of economic thinking at that time, much of his analysis could well be embedded into modern welfare economics, but also provides arguments for a welfare state. A distinguishing element of Eucken's thinking, however, is his insistence that government policy should be focused on the rules-based framework enabling market forces to result in efficient outcomes, provided these outcomes are the result of market competition.

Essentially, these arguments are not different from the general equilibrium Arrow-Debreu-model in microeconomics. The rules-based thinking is indeed different and rather related to the Old Chicago School of Henry Simons and Frank Knight that similarly influenced the public choice and constitutional economics school founded by James Buchanan (Vanberg 2014).[5] Three of Eucken's principles of economics provide additional support for this contention. First, Eucken was convinced that a prudent economic constitution must be based on monetary stability (the "primacy of currency policy"). Second, Eucken emphasized the liability principle, i.e., those who reap the benefits of their economic conditions must also bear the costs and thus the risks of making losses. Third, the constancy of government policy completes Eucken's set of principles of economics. The importance of stable money and the liability principle in Eucken's work may support the claim that German macroeconomic policy during the Eurocrisis corresponds to ordoliberal thinking (Weidmann 2014). The constancy of government policy rather alludes to time inconsistency problems and thus precedes the debates of rules vs. discretion in macroeconomic policy (Kydland and Prescott 1977, Barro and Gordon 1983).

Eucken's views about Keynesian economic thinking are not generally known. This may be due to the outbreak of the Second World War after the publication of Keynes' (1936) General Theory, but is perhaps rather the result of Eucken's early death in 1950, sometime before the economic debate in Germany seriously adopted Keynesianism. Again, the contention that Eucken would probably be opposed to Keynesian thinking, e.g. because his views appeared to be close to Hayek's or Röpke's in other respects, may be premature. Eucken supported the

[4] Eucken opted for methodological reasons to take the political process as given (Eucken, 1940/1950, pp. 213-216), leaving his concept of the state largely unexplained. This has been interpreted to conceal an authoritarian conviction (Kirchgässner 1988). For a recent evaluation of Eucken's stance on democracy, countering the accusation of authoritarianism, see Nientiedt and Köhler (2016).

[5] For similarities between research programmes in Chicago and Freiburg in the 1930s, see Köhler and Kolev (2013), but also see Simons (1934/1948).

so-called Lautenbach plan, a proposal aimed at preventing a liquidity trap in 1931, thus being in opposition to Hayek's thoughts about policies to overcome the Great Depression. Wilhelm Lautenbach was Keynesian before Keynes' General Theory and proposed expansionary fiscal policies to overcome the Great Depression, having these views reflected in the report of the Brauns Commission to chancellor Brüning.[6] Wilhelm Röpke, who was a member of the Brauns Commission and thus supported the proposal of a credit expansion, opposed Keynesian policies of full employment later (Röpke 1952). He thus serves as example of an ordoliberal opposition to Keynesian thinking, but Eucken does not.

In the time that remained to him after the Second World War, Eucken indeed had other things to do than to grapple with Keynes and his thoughts. Germany was destroyed and divided, it had to be rebuilt, and its economy had to be revived. Moreover, the plans of the Allies were fluid as the Cold War cast its shadows. In that period after the war Eucken's principles of economic policy directly gained political influence. Eucken was one of the founding members of the Scientific Advisory Board to the Administration of Economic Affairs and later the German Federal Ministry of Economic Affairs, and regularly corresponded with Ludwig Erhard, from 1948 onwards director of the Administration of Economic Affairs in the common economic zone. More importantly, one of Eucken's students, Leonhard Miksch, held a position in Erhard's administration. Miksch, intensively exchanging views with Eucken, drafted the law that liberalized prices together with the currency reform in June 1948.[7]

The German 'economic miracle' after these reforms has been attributed ever since to Ludwig Erhard and his ordoliberal advisers, in particular the Freiburg School of Economics. Whether this contention holds in this strong version may be contestable. Some influence on German economic development after the war must, for example, be attributed to the London debt agreement in 1953. Still, the immediate transition from a system of administered prices, inherited from the National Socialists, to a market economy together with a new stable currency certainly played an important role. All of a sudden, the rationing and shortages prevailing before Erhard's reforms were replaced by full windows in the shops.

[6] For the Lautenbach plan, see Lautenbach (1931, 1952), for the Brauns Commission see Röpke (1931).
[7] Miksch's influence on Ludwig Erhard at the 'Verwaltung für Wirtschaft' during the spring of 1948 has been recently discussed with new archival material (Feld and Köhler 2015).

The Development of German Macroeconomic Policy[8]

While the beginning of economic policy in Germany after the Second World War was influenced by ordoliberalism, Keynesianism quickly replaced it in the next two decades. This can also be inferred by an analysis of the reports and the protocols of the Scientific Advisory Board to the Federal Ministry of Economic Affairs. The board initially supported Erhard's ordoliberal reforms, but moved to the adoption of Keynesian ideas during the 1950s and 1960s. Eucken and Miksch had already passed away in 1950 when the Scientific Advisory Board to the Ministry of Economic Affairs and its sister institution, the Scientific Advisory Board to the Federal Finance Ministry, in 1956 proposed to pool economic policy advice in a German Council of Economic Experts (GCEE).[9] Erhard was at first critical of this proposal because he feared an emerging influence of Keynesianism or even economic planning. In the end, he supported the proposal and the GCEE became founded by law in 1963.

I mention these three economic advisory institutions prominently because they have brought together the dominant economic thinking in Germany, and perhaps also influenced economic policy since their foundation. In contrast to other advisory boards or commissions of the federal government in Germany (and to most other similar institutions in the world), all three economic advisory institutions are independent in several dimensions. It has thus happened frequently that they have criticized the economic or fiscal policies of the government. In their hybrid construction, they advise the government, but also have influence on economic policy through the public and the media. Following their reports and comparing them with actual policy reveals interesting patterns of the changing economic paradigms in German economic policy.

The GCEE is certainly a child of post-war Keynesian thinking in Germany. The GCEE law requires it to analyse the macroeconomic situation in Germany by studying whether price stability, external balance and high employment could be achieved with continuous and decent economic growth. These different macroeconomic goals were also included in the Law to Promote Stability and Growth in 1967. Although Karl Schiller, Minister of Economic Affairs and the architect of this Law, viewed his concept as merely supplementing the

[8] In this section, I draw on Feld, Köhler and Nientiedt (2015).

[9] For a detailed discussion, see Blesgen's (2000) biography of Erich Preiser, Professor at the Universities of Heidelberg from 1947 to 1956 and of Munich from 1956 to 1967, founding member of the Scientific Advisory Board to the Ministry of Economic Affairs and an early Keynesian. He was key to the foundation of the GCEE.

Freiburg imperative with Keynesian demand management, modern observers of this policy stress the dominance of Keynesianism (Giersch, Paqué and Schmieding 1992, Hagemann 2000, p. 115).

In his analysis of German monetary policy after the war, Richter (1999, pp. 19-20) notes that monetary policy was also regarded as being part of an overall concept of full employment policy. Specifically, the central bank was expected to foster economic growth by keeping interest rates low (Richter 1999, pp. 48-50). In line with this approach, the Bundesbank employed a measure of bank liquidity to guide its monetary policy decisions. This policy was aimed at three goals simultaneously: price stability, high employment and external balance (ibid, pp. 55-59). Notably, the German central bank deviated from the goal of price stability in order to boost aggregate demand: when confronted with the first recession after the war in 1967, the bank found it necessary to stabilize the business cycle by monetary measures (ibid, p. 65). Moreover, Richter underlines that ordoliberal arguments did not play an important role in the monetary policy debates of the late 1940s and 1950s.

In the beginning of the 1970s, Monetarism emerged as a major intellectual force in the German discussion of monetary policy (Giersch, Paqué and Schmieding 1992). Following the arguments by Milton Friedman and (Swiss economist) Karl Brunner, economists such as Hans Monissen and Manfred J.M. Neumann strongly recommended that the expansion (or contraction) of the quantity of money should be used as an indicator of monetary policy measures (e.g. Neumann 1972). Monetarist theory also maintained that central banks should primarily be concerned with price stability (Friedman 1968, pp. 14-17). When Germany had to redesign its monetary policy approach after the end of the Bretton Woods system in 1973, the Bundesbank accepted the monetarist prescription and chose monetary targeting as its modus operandi (Richter 1999, p. 78). In 1974, the German central bank announced a money supply target for the first time − and continued to do so even after a number of central banks adopted inflation targeting in the 1990s. Thus, from the mid-seventies onwards, the Bundesbank followed a monetary policy rule reflecting the ideas of Friedman.

The German Council of Economic Experts was influential in developing concepts for monetary targeting which supported the Bundesbank's policy change (GCEE 1973). More importantly, it induced the paradigm shift in German economic policy from Keynesianism to Supply-side Economics. In its annual report in 1976, the GCEE wrote that it is the responsibility of supply-oriented economic policy to improve the conditions for private investment and structural change such that decent economic growth and high employment are achieved (GCEE 1976, paragraph 296). This was the same year as that when Herbert Stein coined the term Supply-side Economics in the U.S., but sometime before it became popular under Ronald Reagan. In Germany, the new government of Helmut Kohl in 1982 slowly adopted the new concept by the GCEE.

The coalition between Christian Democrats and Free Democrats came to power after the Social-Liberal coalition of Helmut Schmidt broke up, triggered by the so-called Lambsdorff paper by the then Minister of Economic Affairs, Otto Graf Lambsdorff. The paper demanded a shift to supply-side policy, in particular reforms of the labour market, the social security system, tax reforms and a consolidation of public finances (Feld 2013). The Kohl government accomplished the latter two, but did not manage to reform the labour market and social security. Interestingly, it was Gerhard Schröder who undertook the reforms partly proposed already in the Lambsdorff paper. Schröder's reforms were informed by another report of the GCEE (2002), but preceded by a decentralization of wage setting (Dustmann et al 2014).

These brief remarks on three decades of economic policy, affected by important economic shocks like reunification, the introduction of the Euro or the financial crisis, indicate that the discussions about economic policy following from the supply-side oriented concept of the GCEE have continued until today. German macroeconomic policy continued to develop along international lines, quickly following the rational expectations revolution, but also New Keynesian modelling strategies. For example, in a discussion of economic policy in Germany, Hellwig and Neumann (1987) argue that fiscal consolidation may lead to non-Keynesian effects depending on the strength of rational expectations, thus preceding Alesina and Perotti (1997) or Alesina and Ardagna (1998) by ten years. Issing and Wieland (2013) provide a broader discussion with a focus on monetary economics. There is actually no difference between German and Anglo-Saxon macroeconomics. German economic policy adopted Keynesianism a bit more slowly than Monetarism or New Classical Macroeconomics. This does not, however, hold for New Keynesian macroeconomics, and the time lags followed the need for macroeconomic policy: Germany faced its first recession after the war in 1967.

However, ordoliberalism always played a role in the background. Despite the changing macroeconomic paradigms, Olaf Sievert, a long-time member and former chairman of the GCEE, the architect of German supply-side economics, emphasized that the council has always focused on the microeconomic foundations of economic activity as well as on ordoliberal − rather than interventionist – policy-making (Sievert 2003, p. 35). Other prominent examples of German economists who argue in favour of Ordnungspolitik include the members of the Kronberger Kreis,[10] the Bundesbank, exemplified by their past presidents such as Hans Tietmeyer and their current president Jens Weidmann, as well as Hans-Werner Sinn, who reasoned at the height of the financial crisis that the U.S. needed to subject their banks to a strong regulatory framework in the ordoliberal tradition (Sinn, 2009).[11]

German Positions During the Eurocrisis

This tour d'horizon of the adoption of new ideas in macroeconomics by German economists, economic policy advisers and politics highlights that German macroeconomics is not different from any other and that ordoliberalism played a second order role. Political necessities and preferences have shaped particular economic policies in Germany across time. Directly after the Second World War, Germany had to be rebuilt and the transition to a (social) market economy, informed by ordoliberal thought, was the best way to cope with these problems. With the first recession in 1966, Keynesianism had its breakthrough in German economic policy. After the fall of the Bretton Woods system, the Bundesbank used its newly gained discretion and quickly adopted the concepts of Monetarism. Additionally, Germans have had a difficult relationship with the idea of inflation for most of the 20th century. Paul Samuelson (1961, p. 677) famously remarked that whoever experienced the hyperinflation of the Weimar Republic could not discuss a compromise between price stability and growth. Thus, the Bundesbank's strategy also reflected popular opinion. The adoption of supply-side economics also followed political necessities, opportunities and preferences as would be expected given the results of more than fifty years of research in the

[10] The Kronberger Kreis is a circle of ordoliberal economists and lawyers founded in 1981. I am currently speaker of this circle.

[11] Before he concluded his career as President of the Bundesbank, Hans Tietmeyer worked at the Federal Ministry of Economic Affairs from 1962 to 1982. From 1982 to 1989, he was Secretary of State in the Federal Finance Ministry. He drafted the law to establish the GCEE, drafted the so-called Lambsdorff paper, and was important in the negotiations for German unification and EMU. In 1988, he escaped an assassination attempt by the Rote Armee Fraktion (RAF). Another influential person in the Federal Ministry of Economic Affairs was Otto Schlecht. Both Tietmeyer and Schlecht were strongly influenced by Ordoliberalism when studying economics.

fields of public choice, constitutional economics and political economics with its emphasis on the self-interest of political decision-makers. The influence of ideas should not be exaggerated.

The same holds with respect to German positions during the Great Recession following the financial crisis and followed by the Eurocrisis. During the Great Recession, the German government (and the Bundesbank) supported the expansionary monetary policy of the ECB, quickly started to rescue the German banking system and adopted expansionary fiscal policy measures. The GCEE (2008) and the Scientific Advisory Board to the Federal Finance Ministry (2008) advocated such a strategy. As the federal government feared adverse effects on its refinancing conditions because of this deficit spending, the latter additionally proposed the introduction of the debt brake in order to stabilize expectations of market participants that Germany would return to solid public finances. This may have helped Germany to become a safe haven during the Eurocrisis.

The position the German government took in the Eurocrisis to date also follows such pragmatism (Feld, Köhler and Nientiedt, 2015). It has accepted the policy of the ECB, although it is becoming more and more reluctant to do so. It has taken a prominent role in the rescue policy providing funds to Greece, Ireland, Portugal, Spain and Cyprus, although this may have infringed on the no bailout-clause of the European Treaties. It has pushed towards a banking union in order to reduce the connection between sovereigns and banks. It has even accepted a restructuring of Greek debt, in the beginning of 2012 in the form of private sector involvement and in the end of 2012 by facing maturity extension and interest rate reduction on its own loans to Greece. The first restructuring amounted to a debt reduction in present-value terms of about 70 percent, the second to about 50 percent.

The underlying rationale of EFSF and ESM programmes follows along the lines of IMF programmes. Countries that do not have access to finance anymore get fresh money in exchange for the promise to conduct reforms of their labour and product markets as well as a consolidation of their budgets. There is nothing particularly German or even ordoliberal in it. It is simply common practice in international finance. The conditions of such rescue programmes are always debated among the participating parties. No creditor wants to lose money. It is thus no surprise that the IMF urges Germany to accept another Greek restructuring while it does not accept a haircut on its own loans. No debtor country wants to impose too harsh reform measures on its own population which is demonstrating against them. Many of the accusations that Germany faces are driven by the strong interests of the different players, especially those active in financial markets. Without the willingness of public creditors to provide funds to countries in trouble, they would have had to impose real austerity.

Germany's emphasis on structural reforms and sound public finances does not simply follow from ordoliberalism. Of course, the rules-based framework of EMU is open to a reinterpretation in ordoliberal thinking (Feld, Köhler and Nientiedt, 2015). Monetary policy is centralized, with fiscal and other economic policies on purpose remaining with the national authority, but in the hope that national policies are disciplined by the financial markets. The Maastricht criteria and the Stability and Growth Pact, and later the Fiscal Compact, serve as devices that help countries to achieve sound fiscal policies and avoid harsh reactions in the financial markets. These are all clear ordoliberal principles aiming at a congruence of liability and control. However, as the broad discussion about fixed and flexible exchange rates since the 1950s shows, a monetary union is only sustainable if there is a minimum degree of convergence of the economic policies of its members. If the instrument of exchange rate adjustments is no longer available, other mechanisms of adjustment become more important. If member states do not want to establish a fiscal transfer system between themselves, wage and price flexibility on the one hand and mobility of labour and capital on the other hand have to manage the necessary adjustment to economic shocks. Put differently, alternatives to the current policy in the Eurozone rely on additional finances external to each country in trouble. Germany's position as unwilling to establish policies that lead to such transfer systems should be understood as in its own interest. If any other country were willing to step in and pay, be it the US, Britain or France, it is not a bold hypothesis that Germany would be happy to accept that.

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Versailles in Athens: The implications of German government policy for Greece

by Brigitte Granville[1]

1 Collective Memory

In Granville, Martorell Cruz and Prevezer (2015) we focus on the way that history and culture interact (Boldizzoni, 2011; Douglas, 1986 and Temin, 1997) to form a collective memory or a 'shared mental model' comprising a set of prior assumptions and categorizations used by people in making choices (Tversky and Kahneman, 1974). Drawing on the social psychology literature, decision-making is explained not by rationality but by individuals and groups being conditioned by a country's shared mental model (Denzau and North, 1994; Mantzavinos, North and Shariq, 2004).

Although this concept of 'shared mental model' could quickly degenerate into national stereotypes, the cognitive process lying at the foundation of the social order cannot be explained by rational choice theory, as Mary Douglas (1986) argued. In this short essay, the historical event which is the most widely identified as being part of the collective German memory and at the roots of German policy towards the Greek and wider Eurozone (EZ) crisis is the country's inter-war experience of hyperinflation and the destruction of democracy (Ferguson and Granville, 2000). The lesson drawn from those calamities was that a strong state was needed to create the framework for the economy to function through rules and laws (Bonefeld, 2012).

Collective memory and economic patterns

The rules-based tenets of Ordoliberalism leave open the question of the actual content of the rules concerned: this question was answered in practice by the nature of Germany's growth model. For reasons that may be traced back partly to the Weimar experience and partly to the post-war reconstruction period, Germany committed itself to balancing the government

[1]Queen Mary University of London, Center for Globalization Research.

budget and using interest rates to fight inflation. The social security and cohesion that came from high levels of employment and reliable wages was achieved at the cost of a long-term bias against domestic demand and a reliance on external demand. Streeck (2010) argues that in addition to Ordoliberalism collective memory is influenced by a Durkheimian concept of the state which led in the post-war reconstruction period to the idea of social obligations. This Durkheimian spirit of collective public and national interest which infused the economic policies accompanying reunification in 1990 gave rise to fiscal pressures and loss of competitiveness that were then corrected by a striving to return to the ‘Order’ – only now, according to Streek (2010), in the Williamson (1985) framework of increased efficiency associated with the Hartz reforms under the Schroder government in 2001-02.

For Streeck (2010), this Williamsonian framework was developed during the 1980s, under pressure of the liberalization of capital markets. The hold of the Durkheimian ideas of solidaristic social obligations gave way to a more segmented approach, where coordination and cooperative alliances on a company basis between employers and workforce are pursued for the sake of mutual efficiency gains for those in the core economy, at the cost of what Streeck calls disorganization in the fringe sectors. These Williamsonian ideas of the state’s role bear some comparison with the earlier ideas of Ordoliberalism, but there is less emphasis in Williamson (1985) on order and more on contractual individual advantage.

Those Hartz reforms nevertheless maintained the German tradition of demand repression – and, as it happened, they coincided with the launch of the euro. Thus it was that the core conceptual error of the single currency was gravely aggravated. This error may be labelled ‘mythical convergence’.

2 Mythical convergence[2]

The motivations of the founders of the economic and monetary union (EMU) – France and Germany – was the quest for stability (James, 2012) in the spirit of “the discipline and certainty of the gold standard” (Bordo and James, 2013: 1) to ensure the smooth functioning of the common market. By fixing the nominal exchange rate and therefore eliminating exchange risk, convergence between the stronger and weaker economies that share the euro –

[2] This section draws on Granville and Nagly (2014 and 2015).

the so called 'core' and 'periphery' – would be achieved through the smooth flow of capital from the surplus to the deficit countries loosening the latter's external constraint and improving their output capacities and productivity (James, 2012).

The very opposite has turned out to be the case. The early literature (Thirlwall, 1991; Feldstein, 1992; Godley, 1992; Gourinchas, 2002), warned that balance of payments problems within the monetary union – far from disappearing – would steadily deepen in the event of economic divergence between EZ members, especially diverging levels of competitiveness (proxied by unit labour costs). Indeed, divergence in trade and competitiveness performance has been exacerbated by real effective exchange rate (REER) appreciation, largely driven by nominal appreciation of the common currency post-1999 (Chen, Milesi-Ferretti and Tressel, 2012).

Without the 'safety valve' of external devaluation, divergent competitiveness is addressed in two ways: internal devaluation that is "a depreciation of the real exchange rate in the deficit countries via a cut in their unit labour costs, either through higher productivity or lower nominal wages" (Belke and Dreger, 2013:14) or cross-border financial flows – that is, transfers.

As already mentioned, however, pre-existing ULC divergence was aggravated by Germany's Hartz reforms at the very onset of the euro. Germany engaged in a new wave of internal devaluation, by depressing its real wage growth in order to enhance its price competitiveness (Cesaratto and Stirati 2010). Table 1 shows the deepening of the divergence of competitiveness measured by unit labour costs (ULC) with Germany.

TABLE 1 - UNIT LABOUR COST, PERCENT CHANGE BETWEEN Q3 1999 AND Q4 2008

	France	Germany	Greece	Italy	Portugal
ULC	5.2	-15.94	19.79	12.54	10.03
relative to Germany	21.14	0	35.73	28.48	25.98

Note: Competitiveness indicator: relative unit labour costs, overall economy. Index: 2005=100, seasonally adjusted.

Source: Authors' calculation in Granville and Nagly (2014) on data from OECD Economic Outlook

When, after the 2008 global financial crisis, this divergence could no longer be papered over by private sector transfers and the public sector had to step in to rescue Greece and the other countries that had lost market access, Germany presided over what has become a rules-based transfer union – that is, in accordance with the 'no bail-out' principles of the monetary union, official transfers are made conditional on fiscal tightening designed to ensure compliance with the rules laid down in the relevant treaties from Maastricht to the Fiscal Compact which entered in force in January 2013.

In this way, Greece and the other troubled countries of the EZ periphery were dragged into the inferno of internal devaluation with small competitiveness gains and dramatic consequences in terms of output losses and unemployment (Bagnai, 2015; Papanikos, 2015). Greece experienced a depression comparable to the decline in output and employment that Germany suffered from 1930 to 1932.

The way out of this spiral lies in a fiscally-led demand expansion in Germany. And, as it happens, such an expansion is called for by the rules of the Eurozone – specifically, the EU's Macroeconomic Imbalance Procedure (MIP).

3 The rebalancing mechanism is jammed

In a rules-based monetary union, the adjustment mechanism of nominal exchange rate realignments has to be replaced by the implementation of rules in a fair and symmetrical manner. But the rules-based monetary union stopped at the core. The situation may be compared to a club, whose initial rules were set according to the collective memory and economic structure of the club's core member, Germany. Many of the club's rules are consequently stacked against the weakest members – that is, the countries caught in the cycle of inferior competitiveness. Two examples illustrate how the rebalancing mechanism is jammed.

Germany's macroeconomic imbalances

The relevant rule is the Macroeconomic Imbalance Procedure. The MIP states that the European Commission should launch infringement proceedings against countries that run:

"3 year average of the *current account balance* as a percentage of GDP, with indicative thresholds of +6% and - 4%." (European Commission, 2014).

In other words, the rules should apply to Germany too where according to the European Commission (2015: 14):

"The current account surplus increased from 6.7 % of GDP in 2013 to 7.4 % in 2014, well above the Macroeconomic Imbalance Procedure indicative three-year threshold of 6 % of GDP."

Since 2004, that is for 11 years, Germany has had an average current account surplus of 6 per cent of GDP (IMF, 2015: 11). The surplus not only makes it harder for the Eurozone crisis countries to claw their way out of trouble; it is not in Germany's own economic interest. The surpluses are being recycled into capital flows abroad with a negative rate of return, eroding the wealth base that the country will need over the next ten years as it goes into precipitous demographic decline. Germany's jobless rate fell in 2015 to a post-reunification low of 4.7%. The country should therefore be enjoying a surge of consumption. But the German finance ministry is instead running a budget surplus of 0.6% of GDP.

If the rules were applied symmetrically to both core and periphery members of the Eurozone, under the MIP, an excessive imbalance procedure would be launched whereby Germany could be ordered to present an 'action plan' to cut the surplus. If that failed, Berlin could be forced to pay a deposit of up to 0.1% of GDP into a special account, while it is on probation. Ultimately, this money can be seized if nothing is done.

Greece's liquidity crisis

The perfect example as regards Greece is the European Central Bank (ECB)'s emergency liquidity assistance (ELA) facility, which the Greek banks were forced to tap through the Greek central bank from February 2015 onwards, when the ECB decided to stop accepting Greek banks' collateral. The rules governing the ELA facility state that:
"responsibility for the provision of ELA lies with the NCB [national central bank] concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the NCB . . ." (ECB, 2014)

and therefore not shared according to the NCBs' capital keys in the ECB. Yet, while the NCB must take the lending risk of ELA, the final say lies with the ECB:

"Article 14.4 of the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ECB) assigns the Governing council of the ECB responsibility for restricting ELA operations if it considers that these operations interfere with the objectives and tasks of the Eurosystem. Such decisions are taken by the Governing Council with a majority of two-thirds of the votes cast."

As a result, the ECB was able to bring about a partial shut-down of the Greek banking system at the peak of the crisis in July-August 2015.

4 Conclusion

In areas where the rules might be applied in a way that runs counter to the policy preferences of the German elite – as in the case of the Macroeconomic Imbalance Procedure – those rules are not applied. The reason for this is that the paramount political priority is to hold the Eurozone together, and this means working within the limits of the politically possible in Germany.

One obvious way out of this situation would be for one or more of the economically depressed Eurozone countries to say that they no longer wish to remain in this rules-based club whose rules are selectively applied. In other words, they wish to opt out.

The prospect of the Eurozone breaking up has economic and financial dimensions. On the one hand, if a club member decides to leave the club because he cannot abide by the rules, that decision should be perfectly acceptable to the ordoliberal mind. On the other hand, the consequences of a Eurozone break-up might jeopardise the price stability priority of German Ordoliberalism.

The reason for this is that ECB refinancing facilities have made the deficit EZ members dependent on central bank money. These credits as stressed by Buiter et al (2011) are extended without clear technical assessment of central bank equity and collateral. Thus if Greece (and/or other troubled EZ countries) were to leave the monetary union, the collateral used for Target2 and ELA would be depreciated upon conversion into reinstated local currencies. The European System of Central Banks would therefore see its equity reduced, if not wiped out. Since neither the ECB nor the NCBs are required to hold positive equity, a Greek exit does not imply recapitalizing the ECB. The decision on how to react to any such equity loss would depend on whether the ECB was principally concerned with its own solvency on paper, or whether it continued to stick to its operational mandate, as examined by Buiter and Rahbari (2012: 45). If the ECB decided to correct a negative net worth position on its balance sheet by recapitalizing itself, this could be inflationary.

Germany would thus be faced with the unappetizing choice of tolerating a formally insolvent central bank or inflationary recapitalization of the central bank and probably also several commercial banks. It may be for this economic reason that the July 2015 Schäuble Grexit proposal was overruled by Chancellor Merkel or was never serious in the first place but designed rather to deter major Eurozone members in economic difficulty such as France and Italy from pressuring Germany to accept a different kind of Eurozone by implying that Germany would be relaxed about the alternative of a Eurozone break-up – when, in reality, Germany would be far from relaxed.

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The social context for German economists: Public attitudes towards macroeconomic policy in Germany

by Bernd Hayo and Florian Neumeier[1]

1 Introduction

German economists appear to give macroeconomic policy advice that is different from that offered by economists in other countries such as France or the United Kingdom. For example, casual observation suggests that many German economists are relatively more critical of monetary policies that have the potential to endanger price stability and relatively more favourably disposed toward 'austerity'-based fiscal policy. Why is this the case? Perhaps it is due to a different reading of economic theory and empirical evidence in Germany's academic institutions. Or, in other words, maybe the difference between German economists and their counterparts in other countries is due to purely rational differences in training and education. This is an interesting line of thought, but not the one we pursue in this paper.

Instead, we explain the positions taken by German economists based on a broader social science perspective. Our starting point is that economists are part of the society in which they live and work. We argue that their mode of thinking about and perception of economics is influenced by how they were socialised as well as by their everyday social environment. Most personal experience occurs in structured social contexts, leading sociological theory (e.g., Berger and Luckmann, 1966; Bourdieu, 1984; Giddens, 1984; Bourdieu and Wacquant, 1992) to posit that the social environment plays a decisive role in the development of an individual's system of lasting, transposable dispositions, also called habitus. Agents of socialisation, such as the family, peer groups and educational institutions, as well as any other community or association with which an individual is affiliated, are particularly important in this process. Through social interaction, these agents predispose individuals to interpretations, meanings, appraisals, and patterns of behaviour, manifested in rules, codes of conduct, common ends, beliefs, ideals, and the like (Berger and Luckmann, 1966). Thus, socialisation shapes an individual's cognition and, when internalised, operates below the level of consciousness (Elias, 1994; Crossley, 2001). In addition, sociological research

[1] University of Marburg.

suggests that educational and occupational choices may depend on the social environment, too (e.g. Bourdieu, 1984).

In our paper, we attempt to understand the specific macroeconomic positions of German economists by studying the beliefs held by the human community in which they live, based on the idea that these beliefs will have had an influence on the economists' personal habitus. This is an admittedly broad-brush attempt, of course, as the specific socialisation of individuals will differ, sometimes significantly. However, since we are trying to understand widely-held beliefs of economists, we think that this procedure is valid. In the remainder of the paper, we first study attitudes towards inflation (Section 2) and then attitudes towards fiscal consolidation (Section 3). Section 4 concludes.

2 Inflation Aversion

Between 1976 and 1993, on average, about 20 per cent of Germans thought fighting inflation should be the government's most important goal.[2] Has that changed more recently? Table 1 reports answers to the question about what Germany's goals should be in 2011, which was asked of a representative sample of the German population.[3] The table shows that even during periods of very low inflation rates, fighting rising prices is still an important policy issue for Germans.

Table 1: Distribution of attitudes towards Germany's goals

Answer Categories	**Proportion**
Fighting rising prices	32%
Maintaining order	27%
More democracy	27%
Protecting freedom of speech	14%
Total	100%

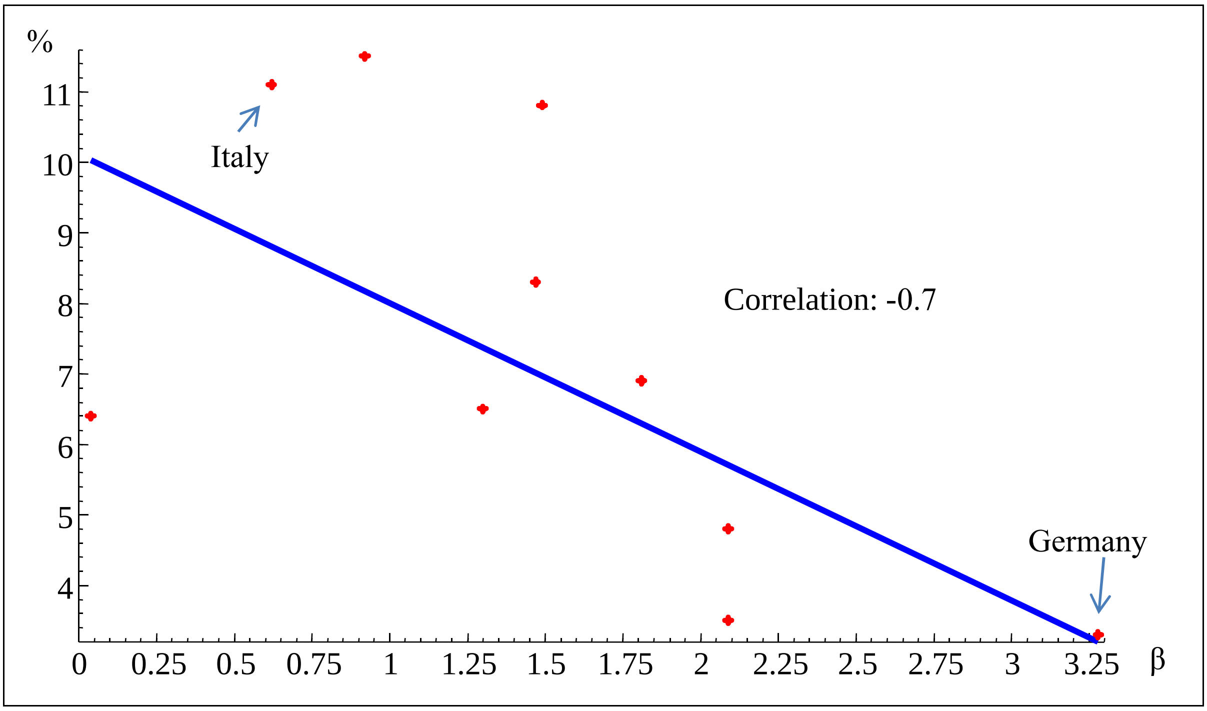
Notes: Results based on 2,006 observations. The face-to-face interviews were conducted by GfK in October 2011.

[2] Source: Hayo (1998), reported value derived from Eurobarometer data.
[3] See Hayo and Neuenkirch (2014) for a description of the dataset.

Hayo (1998) argues that in a comparative analysis of inflation attitudes, it is important to control for the current inflation rate. Using a regression approach, he derives estimates of inflation sensitivity for various EU countries. In Figure 1, these estimated inflation sensitivities are plotted on the horizontal axis and the average rate of inflation in 10 EU countries is plotted on the vertical axis.

According to Figure 1, there is a sizeable negative correlation between a country's 'inflation sensitivity' and its average inflation rate. Two countries are highlighted in the figure: Italy, reflecting a 'low inflation sensitivity–high inflation' combination in the upper-left corner and Germany, reflecting a 'high inflation sensitivity–low inflation' combination in the lower-right corner. Thus, when compared to other Europeans, Germans appear to be particularly concerned about price stability.

Figure 1: Inflation sensitivity in the EU 10 and average inflation rates (1976–1993)



But why should Germans be more inflation averse than members of other societies? There are at least two reasons for why inflation attitudes may differ: (i) personal experience and (ii) inflation culture. Regarding personal experience, Ehrmann and Tzamourani (2012), based on World Values Survey data, present evidence that both the experience of relatively high inflation rates as well as the specific experience of hyperinflation can result in relatively stronger aversion to rising prices. Thus, personal experience may translate into specific and long-lasting attitudes toward inflation.

We do not find this explanation fully satisfactory, however. For one thing, it is based on the assumption that first-hand experience is needed to sustain social institutions. In light of the existence of many age-old formal and informal institutions in society, this assumption simply does not hold in general. For example, certain important events inscribe themselves on the 'memory of societies' to such an extent that, with time, the event stands alone, even though everyone who experienced it has died. This is likely to be the case with hyperinflation in Germany in the 1920s. Thus, inflation aversion may have become an integral part of people's primary or secondary socialisation, through, for example, their parents, which then works as a substitute for personal experience. Moreover, positive experiences with an institution could make it self-supporting. For example, after people see that stable prices are possible given a specific design of the central bank, they may start supporting the institution itself.

A more general issue is the question of how individual memories feed into the political decision-making process. For instance, the hyperinflations listed in Ehrmann and Tzamourani (2012) occurred in Germany in the 1920s and in Greece, Italy, and Japan in the mid-1940s. Yet, despite these personal inflation memories, Greece and Italy had some of the highest inflation rates in Europe in the decades after World War II.

Thus, it seems likely that over and above any personal memories of inflation, it is a country's 'inflation culture' that explains differences in inflation attitudes. For instance, De Jong (2002) uses a cultural classification developed by Hofstede (1980) to show that basic cultural attributes (in the sense of common norms and values), for example, acceptance of an unequal power distribution in a society or degree of risk aversion, matter. Countries in which inhabitants prefer an order of inequality and a centralisation of authority are characterised by low central bank independence; inflation is lower in countries populated by people who dislike uncertainty.

Applying a cultural sociology approach, Tognato (2012) argues that a 'Stabilitätskultur' (stability culture) emerged in Germany following World War II. The impossibility of continuing to identify with symbols associated with a morally corrupt political regime generated a desire for a new national focal point. The German 'Wirtschaftswunder' (economic miracle) provided exactly that and the Deutsche Mark became its symbol. The Bundesbank developed into the guardian of this symbol of the ‘new’ Germany, thereby winning public acceptance and trust. Hence, the Deutsche Mark evolved from being a mere vehicle for facilitating economic exchange to a socially relevant symbol that even had the power to unleash emotion such as respect, affection, or even fear.

To summarise, German economists have been socialised in a society steeped in inflation aversion and thus it is not a big surprise that they tend to be concerned about monetary policies perceived to endanger price stability.

3 Public Debt

Our next area of interest is the German public’s attitude towards public debt and fiscal consolidation. By means of a telephone survey conducted in Germany in 2011, Heinemann and Henninghausen (2012) study individuals’ support for the German federal government’s intention not to incur any additional debt in the coming years. The authors discover that roughly 68 per cent of the respondents support the government’s consolidation efforts even if it means higher taxes or fewer benefits.

In 2013, we conducted a specially designed representative survey of the German population using an extensive questionnaire. In one section of the survey, we asked about respondents’ attitude towards fiscal consolidation (Hayo and Neumeier, 2016a). First, we wanted to know whether they think the government should reduce public debt, keep the amount of public debt at the current level, or incur additional public debt. Second, if respondents were in favour of reducing public debt, we asked about their preferred speed of consolidation, that is, overproportional debt repayment in the near future, equal repayment over the years, or underproportional debt repayment in the near future. Table 2 summarises the relative frequency of the various answers, which are sorted from strong to weak consolidation preference.

Table 2: Distribution of attitudes toward fiscal consolidation

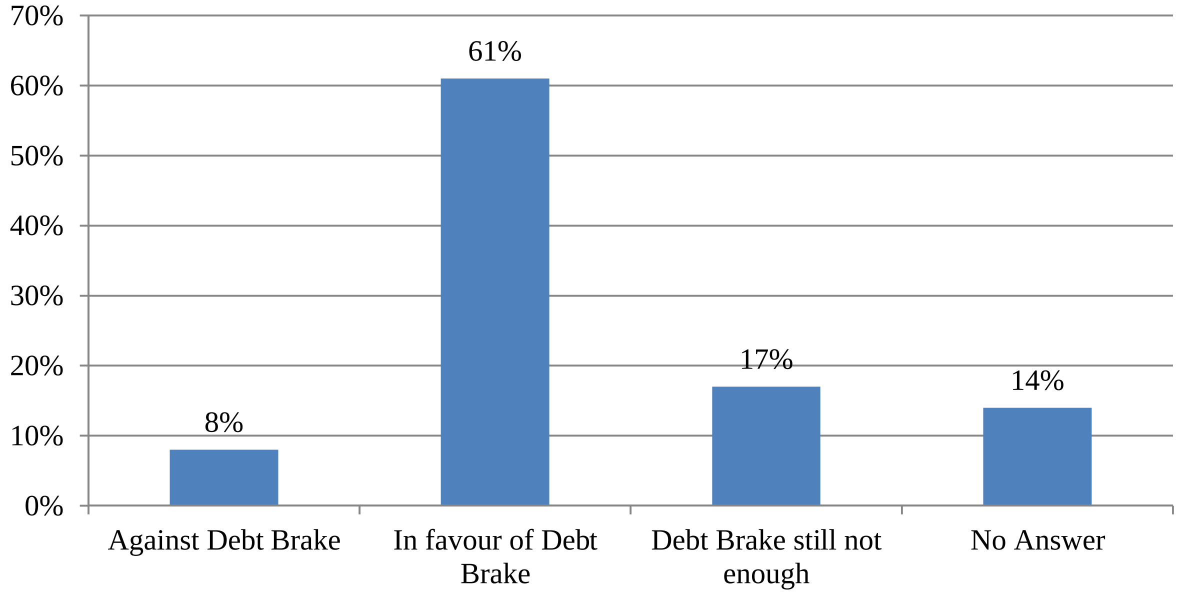
Answer categories	**Proportion**
Reducing a *larger* part of debt in the *near* future and a *smaller* part of debt in the *far* future	15%
Reducing debt evenly over the years	47%
Reducing a *smaller* part of debt in the *near* future and a *larger* part of debt in the *far* future	8%
Hold amount of debt constant	24%
Incur additional debt	2%
Don't know/no answer (coded as missing values)	5%
Total	100%

Notes: Results based on 2,042 observations. The face-to-face interviews were conducted by GfK in February 2013.

We found that a vast majority of Germans—70 per cent—would like to see the amount of public debt reduced. More than 45 per cent of all respondents would like to see an even distribution of debt repayment over time and 15 per cent prefer reducing a larger part of debt in the near future and a smaller part of debt in the far future. Thus, a substantial share of the German population favours fiscal consolidation even during the economic crisis in Europe. This may help explain why 'austerity' measures are viewed rather favourably by both German economists and policymakers.

Regarding fiscal policy flexibility, we asked the respondents about their views on the introduction of a balanced-budget rule, the 'debt brake', at the constitutional level (Hayo and Neumeier, 2016b). From 2016 onward, the structural public budget deficit at the federal government level must not exceed 0.35% of GDP. Exceptions can be made only in times of economic crises or in the event of a natural disaster. Figure 2 shows the relative frequencies of the answer categories.

Figure 2: Distribution of attitudes towards the German debt brake



Notes: Results based on 2,042 observations. The face-to-face interviews were conducted by GfK in February 2013.

Figure 2 shows that a vast majority, more than 60 per cent, of the population is in favour of the debt brake. Moreover, almost 20 per cent of the respondents think that the fiscal constraint implied by the debt brake does not go far enough, whereas less than 10 per cent are against it. Again, we believe that there is a striking correspondence between these attitudes and the positions taken by many German economists and policymakers during the European debt crisis. In fact, the German proposal to avoid a repetition of the debt crisis in the future was the Fiscal Compact, which is based on the idea of the debt brake.

4 Concluding Remarks

In this paper, we have taken a look at how the socialisation of German economists influences their policy stances. We posit that the relevant social environment for German economists will be similar to that of the majority of the German population. Using attitudes towards price stability and fiscal consolidation as examples, we show that Germans have clear opinions about these specific macroeconomic policy issues. Germans are characterised by a strong focus on keeping prices stable, which stands in sharp contrast to a number of other societies in Europe. When looking at fiscal consolidation, we find that in the middle of the European debt crisis, the German population wanted to see the government making substantial headway in terms of reducing public debt. Furthermore, they favoured severe restraints on fiscal policy at the constitutional level, as evidenced by the 'debt brake'. Thus, we believe it is possible to make a strong case for the existence of a 'stability culture' in Germany. And, unsurprisingly, at least to us, the various views that characterise this stability culture are strikingly similar to the positions advocated by German economists and economic policymakers during the recent crises in Europe. These include, for instance, their critical stance towards the ECB's decision to adopt quantitative easing and their insistence that Greece begin consolidating its budget in the middle of a deep economic recession.

Assuming a straightforward causal effect from public opinion to the professional views of economists and policymakers is probably too simple. It is likely that German economists take into account research and opinions from countries other than just Germany. They also play some role in shaping the public debate and educating the public. Indeed, it is quite possible that some views expressed by the public are simply reflections of what economists advocate. However, we doubt economists have much of an impact on the broader German public. Very few professional economists appear regularly in mass media; they are not exactly 'household names'. In addition, according to sociologists, the views and values acquired during socialisation operate below the level of consciousness and may even affect career decisions. That is, individuals who are socialised in an environment where economic questions are discussed may later choose to become economists. By then, however, they may already be predisposed to certain perspectives about the economy that will have an influence on their own views during their professional life.

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The Germany-South fault line in EMU and the case for a second euro

by Jacques Mélitz[1]

1 Introduction

There is a fault line in the EMU. Germany and the Southern members would be better off with separate currencies. This does not necessarily call for a return to national monetary independence in Southern Europe. Perhaps a second monetary union would be better. This would mean two euros in the current Eurozone, one based on the Maastricht Treaty, that would surround Germany, and a second one that would be founded on a new monetary constitution, to which France would belong together with Spain, Italy, Portugal and Greece, and there would be exchange rate movement between the two euros. I would like to develop this viewpoint. First, I will discuss the fault line in the system. Based on the argument, no set of revisions of the Maastricht Treaty can reconcile the members' conflicting interests. Germany benefits from the Maastricht rules. The Southern European countries and France do not. There may have been important policy errors made in the Eurozone. But avoiding these mistakes in the future will not suffice. The difficulties are more fundamental.

After discussing the fault line, I will develop the argument for a second euro in a separate section. Support for the EMU today despite its poor performance since 2008 rests largely on the view that the problems stem from incomplete political unification. On this view, further fiscal union is the answer and nothing must be done to impede its progress. I will also respond to this position in the closing section.

2 The fault line

Germany is an export-oriented economy. Since WWII, the country has generally been able to maintain its competitiveness relative to all of its European trade partners without nominal exchange rate depreciation. The same cannot be said for some of its European trade partners. The Southern European members of the EMU and France have repeatedly required exchange

[1] CREST and CEPII, Paris, December 2015.

rate depreciation to maintain their competitiveness relative to Germany. The pattern was set from the very start of the European Community (EC) in 1957 (which then comprised only the Benelux, France, Germany, and Italy) after post-WWII reconstruction. The German Deutsche Mark (DM) emerged early on as a strong currency relative to the other ones in the EC. It remained so following the breakdown of Bretton Woods under the 'European Snake' (1972-78) and the subsequent European Monetary System (EMS). Every realignment in the 'snake' and the EMS saw a rise in the parity of the DM relative to the other currencies in the system except the Dutch guilder. Never once did the DM fall in price relative to any other member currency.

With the arrival of EMU in 1999, nominal exchange rate adjustment became impossible. Such adjustment had already ceased to be much of an option in the mid- to late-nineties for those members of the EMS who desired to enter EMU at the start. Notwithstanding, the pre-EMU pattern re-emerged in the mid-2000s. The important difference is that, in the absence of possible exchange rate adjustment, the pattern took the form of huge current account imbalances between Germany and the rest. Germany manifested a whopping current account surplus of around 6 % of its GDP by 2008 that was essentially matched by deficits in Spain, Greece, Italy and Portugal while the EMU as a whole remained in current account balance. The situation has basically persisted since. Before the crisis of 2007-08, markets overlooked the problem. But starting with the first Greek bailout of May 2010, markets took notice and began to lose confidence in the ability of the borrowing members of EMU to repay (as witnessed by the emergence of big interest rate premiums on the debts of the governments of the borrowing countries).

It is now clear that the real exchange rate of German goods is much too low for long run sustainability of the foreign debt positions of a number of the members of the EMU. Sinn (2014, p. 120), who can hardly be suspected of exaggerating Germany's price advantage, proposes an estimate of 20 % for the required appreciation of German goods based on a well-done Goldman-Sachs study. The same study would imply a required depreciation of 20 to 30% for Greece, Portugal and Spain for long run sustainability of their foreign debts and, more surprisingly, one of 20% for France. The exact numbers[2] are not so much the issue as

[2] Which might also differ if the national adjustments took place simultaneously.

the fact that little has changed over the last half century or more regarding Germany's tendency to put the Southern European countries and France under relative price pressure.

It is of the utmost importance that Germany was able to achieve its strong performance since 2000 in the face of formidable obstacles. The German unification in 1991 had led the country deliberately to reduce its competitiveness abroad in order to promote a switch of production from export markets to home ones so as to build up infrastructure, clean up pollution and bolster construction in the new Eastern länder. The country's difficulties were heightened by its decision to move instantly, without transition, to equal legal treatment of Eastern and Western citizens in regard to unemployment benefits, public health and retirement insurance, public-sector wages and inter-länder transfers. As a result, Germany's tradable goods sector was confronted at once with both an appreciation of the Deutsche Mark and a substantial rise in its tax burden.

In accordance with the policy designs, the current account balance of the country turned negative in 1991 and remained so to the tune of around 0.8 of 1 percent of GDP for five consecutive years in 1991-1995 (OECD Economic Surveys). During that period, the country's real effective exchange rate rose by about 15 percent (World Economic Indicators).

At some point, however, the problem was to switch back to the normal state of affairs where exports spearheaded growth of the economy. This meant bringing the real exchange rate back down and improving competitiveness. However, by the mid- to late nineties the run-up to EMU had begun and nominal exchange rate depreciation had ceased to be a political option. This is when Germany's achievement becomes truly impressive. The entire appreciation of the real effective exchange rate through 1991-95 was erased by 2000-02. The current account returned to balance in the same years. From 2002 on, the country marched forward to the large current account surpluses to which reference was made above.

How did this happen? As Carlin and Soskice (2009) explain, most of the answer lies in wage discipline. Consumption-wages fell in the tradable goods sector through wage restraint. The net profit share in manufacturing rose from 5 to 15 percent in 1995-2005 (p. 75). Yet so great were the economic problems posed by unification that those years were also ones of mediocre or fair aggregate output and unemployment performance, and they were so not only nationally but in relation to the country's European partners. Then came the German response. The country adopted the Hartz reforms of the labour market in 2003, also known as Agenda 2010. These reforms ended long-term unemployment insurance and brought down unemployment benefits to the level of ordinary welfare support. The reforms are widely credited with contributing much to the relatively good output and employment performance of the country since 2005 or over the last ten years. The added wage discipline reinforced the competitiveness of Germany's export sector, which had already been impressive earlier, as noted before. The added wage discipline also contributed to strengthening the country's current account balance.

In sum, to all indications, Germany can handle its employment, economic and trade problems without independent monetary policy. The country needs little or no compensation for its surrender of monetary independence through collective insurance. As a result, there is little or no basis for striking a satisfactory deal in the Eurozone. I would like to develop this argument further.

Consider a group of countries who expect no real exchange rate movement in relation to one another. If they form a monetary union, they can partly compensate for their sacrifice of independence of their nominal exchange rate through programmes of joint insurance. The insurance can provide all of them some extra security at no *expected* cost. It can relate to unemployment, recession, financial-sector illiquidity, financial-sector insolvency, or all four. Suppose next that one member can expect to place the rest continuously under competitive price pressure. Let us assume a zero rate of inflation in the monetary union as a whole. Then in the long run this particular member will require a secular rise in nominal wages and prices to keep its total lending to the rest from rising in perpetuity and the borrowing members will require a secular fall in nominal wages and prices to keep their borrowing in check. But we know from wide macroeconomic evidence that we must then expect the countries that undergo the deflation to experience most of the strains in unemployment, output and finance. This last section of the union therefore can expect to be a net recipient of the insurance payments. The so-called insurance scheme is partly a plan of systematic transfer and redistribution. Unfortunately, this describes the situation in the Eurozone pretty well.

As a fundamental factor, Germany anticipated the problem from the start and as the dominant player in the construction of EMU was able to do something about it. The monetary provisions of the Maastricht Treaty are adapted to limit Germany's risks. By intent, the ECB is a weak central bank. This is not sufficiently appreciated. The ECB does not have as much monetary control as central banks are usually supposed to have. It has no clear mandate to engage in ordinary open market operations. The texts do not explicitly allow the ECB simply to purchase a government bond and increase the monetary base at will in the typical textbook manner. According to the logic of the Treaty, such action would be tantamount to permitting the central bank to favour the financing of a particular lower-level government. It would be like letting the Federal Reserve increase the monetary base by purchasing the bonds of Illinois (a state in financial difficulty). Instead, the Treaty makes monetary control by the ECB contingent on the willingness of commercial banks to lend to individual firms and households. If one searches the Eurosystem literature for the term 'open market operations,' he/she will find that it describes quantitative allotments of refinancing that must still be initiated by the private banks. Since 2010 the term has also sometimes served to refer – first, under the 'Securities Markets Programme' and more recently under the programme of 'Outright Monetary Transactions' – to purchases of bonds of member governments that are under financial stress with various strings attached. These are not open market operations in the ordinary sense. In addition, there is no provision for the ECB to act as a lender of last resort in the Maastricht Treaty. Needless to say, the Maastricht Treaty also does not provide for the collective fiscal support of the payments system in the case of danger to the system stemming from the collapse of the banking sector in any particular region.

All this makes perfect sense from a German point of view. But how reasonable are these provisions from the standpoint of a large segment of the other members of EMU? It was clearly of no help to a majority of the population in the euro area that once the official intervention rate on the interbank market approached the zero interest rate floor in 2008-10, the Maastricht rules left the ECB powerless to increase the money supply at all without engaging in legally questionable actions or emergency measures that required bending the rules. As a result, unsustainable premiums on Spanish and Italian bonds were able to arise in late 2011 following the second Greek bail-out (when the private lenders took a hit). It is clearly a good bet that those premiums would not have arisen if the ECB had possessed the ordinary ability of a central bank to raise the monetary base at will. As evidence, it sufficed for the President of the ECB simply to announce (July 27, 2012) that "within [our] mandate," the Bank would "do whatever it takes to preserve the euro" to bring down the interest rate differentials to manageable size. Very significantly, though, the President's statement was legally questionable, as some German observers, including leading members of the CES-IFO in Munich (Sinn and Fuest), did not fail to point out. The decision of the Court of Karlsruhe on February 7, 2014 reinforces this point of view. The German constitutional court explicitly rejects the ECB’s argument that its responsibility to save the EMU is grounds for the Outright Monetary Transactions (OMT) programme. True, in a more recent decision (June 16, 2015), the European Court of Justice upheld the legality of OMT, contrary to the German court. True too, by the previous March the ECB had begun a ‘quantitative easing’ programme, the closest thing to a programme of open market operations to appear thus far, but it did so as an emergency action outside the Maastricht Treaty. The recent refugee crisis in Europe has also allowed this initiative to go forward with far less resistance from Germany than it would otherwise have met.

In addition, unlike the situation in the U.S. during the savings and loan crisis in the 1980s and 1990s, once the financial crisis of 2007-08 hit, the Irish paid for the insolvency of their banking sector, the Spanish paid predominantly for theirs, and in Cyprus, it even looked for a while that small bank depositors would have to contribute heavily to pay for theirs following the second Greek bail-out in late 2011.

3 The case for a second euro

These observations naturally pose the question of whether a number of the countries in the Eurozone would not do better to form a second euro system based on a different set of rules. I believe this to be a serious question. Studies of business cycle symmetry in the EC in the run-up to EMU generally tended to show differences North-South but never any major differences in the cyclical performance of the Southern economies and France (see, e.g., Bayoumi and Eichengreen, 1992). Since EMU, the trade performances of the Southern group and France have not revealed any need for notable relative price changes within the group. Therefore, if these countries formed a separate monetary union, they would have little reason to hesitate to adopt a strong central bank in order to arm themselves with adequate macroeconomic policy tools. They would then at last have a central bank capable and fully licensed to engage in open market operations independently of commercial banks’ desire for liquidity and with the power of lender of last resort. The countries could also adopt joint deposit insurance and a joint bank resolution fund based on ordinary principles of insurance. Though they would no longer form as large a currency area as before, they would still constitute a large one and therefore would keep many of the benefits of a single currency and capital market integration. Notably, by choosing to form a monetary union rather than opt for separate currencies, they would avoid the Nash consequences of non-cooperative games among themselves via exchange rate competition. If we judge from their earlier behaviour between the breakdown of Bretton Woods and EMU, there is reason to believe that these countries (clearly France and Italy) put weight on avoiding such Nash consequences. In addition, of course, the members would profit from exchange rate flexibility relative to Germany.[3]

Of course, some precautions would be necessary for the expected benefits. Arming the new central bank with full powers of open market operations does pose an issue of moral hazard. But a number of satisfactory responses to the problem have been offered. The 'Blue bond' proposal of Depla and Weizsäcker (2012) is one. The euro-nomics group (Brunnermeier et al, 2012) makes a particularly attractive suggestion. The group proposes creating a new intermediary (which they call the 'European Debt Agency') that would hold an imposed combination of government securities (in fixed, irreversible weights) against which the intermediary would issue new securities (which they term 'European Safe Bonds') to the public that the central bank could subsequently buy and sell. The nice thing about this proposal is that it demonstrates the lack of any need to go even so far as to introduce new joint government bonds in order to provide for ordinary open market operations without creating moral hazard.

In addition, the proposed collective insurance clearly calls for banking union. Indeed the right sort of banking union would be stronger than any currently envisaged under that name in the EMU and stronger still than anything that can be expected to happen with German consent. The right action would be to treat all banks in the euro area as euro institutions, subject to progressively harmonized rules, and under the supervision of euro-wide authorities with far greater powers than the current European Banking Authority has. The relevant rules of bank behaviour would best include strict limits on the ability to hold home-government debts. Otherwise the joint bank resolution fund would be difficult to interpret as strict risk reduction and insurance.

[3] I have developed the argument in this paragraph more fully in Mélitz (2014).

However, if constructed properly, the second euro would even heighten fiscal discipline. The member governments would lose most if not all of their privileged access to home banks in order to finance deficits. In this way, the new rules would also break the 'doom loop' or 'diabolic loop' between government financing and bank financing that economists have identified as a particularly dangerous element of the current situation (Baldwin and Giavazzi, 2015, Brunnermeier et al, 2012, and Shambaugh, 2012).[4] Finally, nothing in the proposal would prevent the members of the second euro from sticking to the Stability and Growth Pact (SGP) and the more recent Fiscal Compact Treaty.

4 Conclusion

In closing, I would like to respond to two objections. The first is that the transition to the second euro would be unworkable. In answer, it should be noted that the costliness of the transition depends on when and how the reform takes place. The costs (that is, the opportunity costs) would be much lower in a period of storm, when the whole system is in danger of crashing. If a major reform is necessary anyway, then all the alternatives are costly. Yet if this is so, should we not entertain the merit of the proposal at all times in order to have a better idea of the direction we would like to go if the occasion arises and of which way we might like to lean at present? In addition, Dobbs (2012) makes an interesting suggestion about holding down the costs of an eventual transition (subsequently summarized in Dobbs and Spence, 2012). She considers a break-up of the euro into two or more currencies. The basic inspiration comes from equity finance when there is about to be a merger, buy-out or stock split. The idea is to let the market know in advance that all outstanding euro claims will have the same composite value of both (all 3, all 4, etc.) euros after the split no matter what people do with their assets or liabilities right now. Avoiding one-way bets if a break-up looms ahead is obviously fundamental.

Perhaps the most important objection to my proposal is the danger of any political division between Germany and France. Granted, any currency split between these two could have wider political repercussions. Though the proposal does not put into question any political institution in the EU besides the Eurosystem, it does go counter to any broader vision of a

[4] The 'doom loop' refers to the unfortunate sequence of events that we have witnessed in Europe where a home government first bails out home banks and in the aftermath the banks invest heavily in associated new government debt issues and the banks and the government now find themselves jointly at risk.

political union in the EU in the future. In this connection, last June 3rd, the respective Ministers of Finance in France and Germany, Emmanuel Macron and Sigmar Gabriel, issued a joint statement (repeated by Macron in an interview in the *Süddeutsche Zeitung International* last August 31) drawing up a broad design for a fiscal union and calling for advance toward the goal in order to save the euro. Yet no visible movement in that direction has occurred since; not even the slightest progress toward implementing the Single Bank Resolution Fund, the most important element of fiscal union on the political agenda. The problem of the refugees from Syria and the Near East may have intervened.

In any event, on my analysis there is a fundamental reason not to rest hope in this direction. The difficulty is that in the long run the Southern European countries and France can only benefit from a common currency with Germany on conditions that would be disadvantageous to Germany. The former countries require some insurance for the abandonment of their monetary independence which amounts to expected fiscal transfers from Germany. From the German side, therefore, the Macron-Gabriel proposal makes little political sense. This is a deep obstacle. In light of it, I believe, failure to consider a second euro may be burying one's head in the sand.

There have undoubtedly been mistakes in managing the euro since the crisis. However, avoiding those policy mistakes in the future would not be enough. True, as widely recognized at long last, it was a mistake to invite markets to think that the 'no bail-out' clause of the Maastricht Treaty along with the SGP implied that the debts of all member governments could be treated as nearly perfect substitutes. It was also a mistake not to write down Greece's debts to private creditors in May 2010, only to do so later in November 2011 after the situation had worsened, and it was probably a further mistake not to write down the total Greek debt more than was done either in 2011 or since. Yet had these policy mistakes not happened, Ireland, Portugal and Spain would not have escaped the miseries they faced after 2008 and the whole system would still probably have been shaken by a loss of market confidence. The blame for the troubles in Ireland, Portugal and Spain, which spread to Italy and threatened France, lies in the weakness of the ECB and the lack of any sort of joint insurance in the Eurosystem. Yet these features of the system are also a part of a deliberate German design. If we cannot even argue today that Germany was wrong to choose this design, fiscal union cannot go far. Should we therefore not consider the possibility of a second euro?

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Property rights, moral hazard and hysteresis

by Charles Wyplosz[1]

During the Eurozone crisis, moral hazard has often been invoked to discuss policy options. Unfortunately, many of the subtleties of the concept have been lost in the debate and wrong decisions have been taken because of its improper use. Once these decisions have changed the landscape, moral hazard has taken on new meaning and introduced a sharp disagreement between some leading German economists and their colleagues.

1 Principles

Early on, when the Greek crisis erupted, policymakers insisted that debts have to be repaid. Otherwise, they observed, a bad precedent would be established. This is a strong argument, but that cannot be the end of it. Obviously, it must be the rule that debts are honoured. Without this rule, there can be no lending. More widely, for debts to exist, there must be clear and enforced property rights. Yet, property rights are neither uniquely defined nor absolute (Demsetz, 1967). Similarly, rules usually include escape clauses to be invoked in rare unexpected circumstances.

The risk of a bad precedent is directly related to moral hazard. To recall, moral hazard occurs whenever someone takes risky decisions in the expectation that someone else will bear some of the costs that would arise if the action leads to losses. Yet, that does not imply that debts should never be written down. To start with, it is crucial to note that the reason why debt write-downs are undesirable is not that losses will be borne by an 'innocent bystander', but that it provides perverse incentives. One-off losses are bygones; if they do not affect future behavior, they do not create any moral hazard. In addition, it matters whether there are indeed innocent bystanders. Public debts are a two-way street. Governments may borrow without restraint if they expect that some of the debt will be written down. This is moral hazard, but lenders may also disregard risks and lend too much if they expect that someone else will pick up the debt if the borrower cannot honour it. They are not innocent bystanders. This too is moral hazard.

[1] Graduate Institute, Geneva.

2 Misleading application of principles

The decision to exclude any debt relief for the Greek government, and then for other governments, was made at the outset of the crisis. It is not an incontrovertible implication of the sanctity of property rights and of moral hazard. When instead Greece was ordered to borrow and to accept a whole range of conditions, many property rights were violated. For instance, Greek workers whose wages were slashed underwent a unilateral alteration of their work contracts. They were as close to innocent bystanders as one can imagine. The same cannot be said about bankers who had lent unreasonable amounts to successive Greek governments.

Focusing on the borrowing, not on the lending, side as a source of moral hazard was entirely a policy choice. It matters that French and German banks were among the large lenders and that their managers were 'advising' their governments.[2] At any rate, there was nothing moral about that. For, if we start delving into morality issues, we could take a leaf from an undisputed authority, the Bible, and reach the opposite conclusion:

"**23** Therefore the kingdom of heaven may be compared to a king who wished to settle
accounts with his servants. **24** When he began to settle, one was brought to him who owed him
ten thousand talents. **25** And since he could not pay, his master ordered him to be sold, with
his wife and children and all that he had, and payment to be made. **26** So the servant fell on his
knees, imploring him, 'Have patience with me, and I will pay you everything.' **27** And out of
pity for him, the master of that servant released him and forgave him the debt. **28** But when
that same servant went out, he found one of his fellow servants who owed him a hundred
denarii, and seizing him, he began to choke him, saying, 'Pay what you owe.' **29** So his fellow
servant fell down and pleaded with him, 'Have patience with me, and I will pay you.' **30** He
refused and went and put him in prison until he should pay the debt. **31** When his fellow
servants saw what had taken place, they were greatly distressed, and they went and reported
to their master all that had taken place. **32** Then his master summoned him and said to him,
'You wicked servant! I forgave you all that debt because you pleaded with me. **33** And should

[2] On the role of the Chairman of BNP-Parisbas, see 'BNP Paris Chairman to Retire', *Financial Times*, 9 May 2011. On the role of the CEO of Deutschebank, see 'Deutsche Bank's Chief Casts Long Shadow in Europe' *New York Times*, 11 June 2011.

not you have had mercy on your fellow servant, as I had mercy on you?' **34** And in anger his master delivered him to the jailers, until he should pay all his debt. **35** So also my heavenly Father will do to every one of you, if you do not forgive your brother from your heart."
Matthew 18:23–35

3 Most economists agreed

Many German economists graced the profession by publicly disagreeing with their government. A Plenum of 189 German economists published a statement that condemned the Greek bailout and called instead for debt restructuring.[3] Their argument was that some debts are so high that they will never be repaid, as also argued in Portes (2011) and Wyplosz (2009, 2011a) among others. They correctly noted that permanent credit is a source of moral hazard, in contrast with a never-again write-down. They remained silent, however, on how to make sure that it would not be repeated, yet they observed that the Stability and Growth Pact would not do the trick. Importantly for what was to follow, they warned that the ECB should refrain from buying distressed public debts.

4 Hysteresis

Once the policy had been set, the situation changed dramatically. The treatment imposed on Greece was quasi-automatically reproduced in Ireland, Portugal, Cyprus and, implicitly, in Spain. These countries were forced to borrow large amounts that massively increased their public debts. In return, they were requested to promptly reduce their budget deficits, which meant carrying out procyclical fiscal policies in the midst of historic economic depressions. As a consequence, the Eurozone became highly unstable as the soaring interest rate premia showed. In this desperate situation, crucial actions were needed and there were no good options. Each option was a distant Nth best, implying acute tradeoffs. This is where many German economists parted ways from their foreign colleagues. This was a sort of hysteresis effect on economic analysis.

[3] A presentation in English is Merz et al. (2011).

5 Disagreements set in

The first challenge was Greece and its soaring public debt, which kept alarming the markets. The policymakers finally recognized that some debt relief was unavoidable. The chosen solution was Private Sector Involvement (PSI), a default imposed on the private debt holders in 2012. By then, much of the private debt had been sold by banks to the public sector, including the EFSF and the ECB. Most of the private bond holders were Greek and Cypriot banks. There was limited debate among economists. In fact, it befell to some German economists (working abroad) to show that the bondholders were treated surprisingly generously, a clear instance of moral hazard (Hau, 2011; Zettemeyer et al., 2013).

The second challenge was to stabilize the whole of the Eurozone. The decisive step was taken by the ECB in September 2012 with its Open Market Transactions (OMT) programme. Moral hazard issues were now on the front burner. Once again, the issue was that the readiness of the ECB to buy bonds issued by now-distressed governments would provide incentives to build debt up again in the future. Of course, there was another side of the coin: the lending by the ECB was a risk that could cost taxpayers a lot. On the other hand, bringing interest rate spreads down in the teeth of acute financial market stress could only be achieved through a central bank commitment because central banks are unique in being able to make commitments of unlimited size. In other words, the ECB had to act as lender of last resort for distressed public debt.

As is well known, the Chairman of the Bundesbank dissented – and eventually resigned, ostensibly as a protest gesture – when the Governing Council of the Eurosystem took the decision. He was backed by a majority of German economists while non-German economists had long called for the move, which instantly brought lasting relief.[4] In fact, some German legal scholars took the issue to the German Constitutional Court, asking that the OMT programme should be ruled to have violated the German constitution.[5] Even though the programme was widely held to have been highly efficient in calming market tensions,

[4] An assortment of views can be found on the website of VoxEU. Among those calling for an ECB backstop are Delbecque (2011), Padoan et al. (2012), Wyplosz (2011b). German opposition, represented by Sinn (2011), was widespread as indicated below.

[5] This was a second attempt. In 2010, the same group had asked the Court to declare the Securities Market Programme (SMP) carried out by the ECB in 2010-11 illegal. The Court decided that the programme was legal but under these conditions: 1) that the commitment be explicitly limited *ex ante*; 2) that any loan involving German taxpayers be approved by the Bundestag.

without the ECB having to intervene at all, the German Constitutional Court indicated that it would determine whether OMTs were part of the monetary policy mandate of the ECB. The Court conducted hearings of some German economists, who argued that the OMT programme was not within the ECB's monetary policy mandate (Sinn, 2013). Concerned that a national court was about to decide what is monetary policy in the Eurozone, five European economists, backed by 246 economists from around the world, including Germans, issued a statement calling on the Court to desist (Fratzscher *et al.*, 2013). This led 136 German economics professors to issue their own statement, reproduced in the *Wall Street Journal* of 11 September 2013. They argued that "money finance of governments is rightly prohibited because it endangers the central bank's independence from governments. The central bank's duty is maintaining price stability, it is not reducing the sovereign risk premia member states have to pay in bond markets."

6 Interpretations

Both the 2011 call by 189 German economists and the 2013 call by international economists recognized the moral hazard issue but concluded that the economic risks were pressing and threatening enough to take precedence. The call by the 136 German economics professors focused on the legal obligations of the ECB, ignoring the risks. They echoed Sinn's testimony to the Constitutional Court, summarized in Sinn (2013), who considered that if the risks were deemed too high for some countries, then these countries should leave the Eurozone. Legal obligations (more precisely, their interpretation of the treaties) and associated moral hazard trumped the integrity of the Eurozone. The sharp disagreement was not really about economic analysis but rather about how to deal with the tradeoff between conflicting principles.

This is not surprising. When it comes to determining the Nth best solution, economists disagree because no model is complete enough to provide an undisputed solution. In fact some German economists backed the 'international view' while some non-German economists sided with the 'German view'. Yet, it is worth noting that legal considerations were seen as dominating in the German call while their opponents described them as a matter of interpretation. Clearly, ordoliberal principles dominate among German economists. This, however, is not the whole story. The call by the 136 German economics professors and Sinn (2013) explicitly referred to German interests while their opponents explicitly presented their arguments from a Eurozone viewpoint.

This surprising nationalistic approach is mirrored in the German Constitutional Court rulings. The first one, concerning the SMP programme, did not hesitate to subject Eurozone decisions to Bundestag approval, in effect giving the parliament a right of veto. The second ruling expressed grave reservations about the OMT programme's compatibility with German basic law. It asked the opinion of the European Court of Justice on whether the programme was compatible with Europe's primary law, while retaining the right to subsequently declare the programme illegal in Germany. The European Court ruled that there was no such incompatibility. The German Constitutional Court has not (yet?) followed up on its threat, which remains in place.

Is Germany more nationalistic than other countries? Another striking feature of the Eurozone crisis has been that similar tendencies have emerged among economists from other countries. For instance, majorities of economists from periphery countries under stress have come out in favor of Eurobonds, which imply joint European responsibility for national debts. In effect, this means that countries saddled with large debts could expect a guarantee from countries in a better position. When it comes to identify Nth best solutions, apparently, economists are surprisingly sensitive to home interests.

7 So are German economists really different?

A counterfactual may help in answering the question. Assume that Greece, or Italy, is the largest and most powerful country in the Eurozone. They would have argued in favour of debt relief or Eurobonds, and this is what would have happened. They would have exploited the myriad of economic theory ambiguities to make their point. They would not have sought to debate with their fellows from other countries. Call it the danger of hegemony.

The answer to hegemony is proper institutions. We need to develop a crisis management framework. We need to better define the role of the ECB. We need to free the central bank from the whims of national constitutional courts. And, we all agree, we need to restore the no-bailout rule. As economic historians teach us, if applied, this rule would have saved us most of the subsequent disagreements (Bordo *et al*., 2011).

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The Eurocrisis response: towards a German Europe?

by Fabian Zuleeg[1]

1 Introduction

This essay discusses the policy response to the crisis which has gripped the Eurozone for the last few years from the perspective of how influential German economic thinking has been in shaping this policy response. In particular, it assesses how far the economic philosophy of Ordoliberalism or 'Ordnungspolitik' has been the driver behind European austerity and its attempted enforcement.

2 What is Ordoliberalism and how does it influence the EU?

It is difficult to find a comprehensive definition of German Ordoliberalism. Broadly speaking, it is the belief that there is a strong role for the state in defining a framework for economic interaction but that the state should not interfere beyond this. In other words, it is a rules-based system, with a legal underpinning to enforce these rules and no or limited flexibility, ideally enforced by independent institutions, such as the German Bundesverfassungsgericht (Constitutional Court) or the Bundesbank. It implies that individual economic and political actors cannot be trusted in crisis situations and need to be constrained by effective rules to prevent sub-optimal outcomes.

Such a system is seen by its proponents as providing a large degree of stability and predictability. This is often contrasted to politicians trying to influence political developments, especially elections, by providing a short term fiscal stimulus or windfall gain that will prove costly in the long run, or, by circumventing the rules, undermining the long term credibility of the whole system.

The underpinning philosophy of Ordoliberalism appears to appeal to many in Germany, with a strong preference for rules-based systems coupled with a distrust of 'Anglo-Saxon Casino Capitalism' and a strong, historically-rooted aversion to economic instability, debt, inflation

[1] Chief Executive and Chief Economist, European Policy Centre.

and its political consequences. Throughout the crisis there was reference to the Swabian Housewife as a reminder to everybody that 'you cannot live beyond your means'.[2] While it can be debated whether this general perception of economic policy is part of Ordo-liberalism, it is the combination of such attitudes with the rules-based, legalistic system that has influenced the EU debate.

When applied to interactions between the EU's Member States, Ordoliberalism implies adherence to the rules laid down in the Treaties, with little room for political negotiations or open-ended commitments such as the ones made by the ECB later in the crisis. Within the debate on Eurozone governance, it has been argued that this philosophy is behind the inflexible response to the Eurocrisis.[3] When countries were starting to run into public debt problems, the emphasis was on maintaining the rules and instilling greater fiscal discipline, with new economic governance instruments being created where implementation of the rules in the Treaties, in particular the Stability and Growth Pact, was seen as too weak.[4]

3 Germany – the constrained hegemon

This narrative of the crisis raises the question of how effective German dominance is within the Eurozone. Undoubtedly, with the crisis, Germany has become the most influential country in the Eurozone, as well as the wider EU, not least as any Eurozone response that requires funding has to be underpinned by Germany. Politically, Germany has been very visible, both in the discussion of how the existing rules need to be enforced and in judicial challenges to what some see as 'excessive' flexibility or even illegal overreaching of their competences by EU institutions such as the ECB. Equally, Germany has been influential in determining what new rules might be necessary to enforce fiscal discipline, including the Fiscal Compact,[5] which in essence translates the German debt brake to the European level. During the crisis the role of Germany has changed: while in the past Germany was willing to subsume its national economic interest to the European integration process, this is no longer

[2] See also The Economist (2014).
[3] See e.g. Dullien and Guérot (2012).
[4] European Commission (2015), Stability and Growth Pact website.
[5] The Fiscal Compact is part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union signed on 2 March 2012, available at http://www.consilium.europa.eu/en/european-council/pdf/Treaty-on-Stability-Coordination-and-Governance-TSCG/.

the case. In this sense, Germany has become a normal country: it pursues its national interest, using the power at its disposal.[6]

But German hegemony does not describe EMU governance accurately. Despite the political and economic strength of Germany, no single country can dominate the EU, not least because the system has been designed to protect the smaller countries from domination by the bigger ones. EU policy-making is based on building coalitions rather than having a single country dominating. German influence is thus biggest when actions are taken outside the Community-method (such as the Fiscal Compact, which is an inter-governmental treaty), when new instruments are created that contain implicit or explicit veto powers for the countries providing the funding (e.g. the European Stability Mechanism[7]) or when countries are in such financial difficulty that they have to accept stringent conditions (economic reforms under support programmes, enforced through the Troika). Conversely, in the creation of new EU rules or in the 'normal' application of these rules, German influence is more limited, mainly constituting a quasi-veto power for new provisions or transfers of competence to the EU level.

4 Rules vs. reality

Even this quasi-veto power of Germany is either weak or not exercised consistently at EU level, as evidenced by a wide range of policies which have been introduced despite initial German resistance. The list of spurned German demands is rather long: no debt bail-out for countries in financial difficulties, no activism by the European Central Bank, no debt forgiveness, no flexibility for government deficits, no banking union with cross-border implications etc. All of these demands have, more or less, been rejected in recent years. While many (especially outside orthodox German economic circles) will contend that this was necessary and desirable, it flies in the face of the perceived power of Germany and the influence of Ordoliberalism which many have claimed.

There are many reasons why this might have been the case. Most importantly, there is an overarching need to take action to ensure systemic stability which provides a rationale for taking even unorthodox actions: preventing the collapse of the Euro or of Europe's banks, or

[6] See also Zuleeg (2015c).
[7] European Stability Mechanism website, http://www.esm.europa.eu/.

the political break-down of the EU, is worth almost any price. In the end, this kind of political consideration has always overridden the underlying economic principles.

Historically, the rules-based system has also been undermined by Germany itself, as clearly seen by the weakening of the Stability and Growth Pact by France and Germany in 2005.[8] A rules-based system can only be credible at EU level if applied to all Member States. The resistance of German politicians to the application of the Macroeconomic Imbalance Procedure to the German current account surplus is a more recent case in point.[9] Differences between key actors in Germany have also played a role: while Finance Minister Schäuble can be seen as broadly signing up to the main tenants of Ordoliberalism, it is far from clear whether this is shared by Chancellor Merkel.[10]

5 An economic governance under strain

But those in Germany who claim that there is something wrong in European governance also have a point. European economic governance cannot rely on rules alone but there is a level of trust which is necessary, between Member States and between the Member States and the institutions.[11] This level of trust has eroded to dangerously low levels on all sides. The problem of *ex post* opportunism continues to be present; in other words, once a country has received support and is no longer in an existential crisis, the incentive to carry out reforms and consolidate public finances is no longer present, especially where there is strong populist resistance.

In addition, the new economic governance mechanisms, and in particular the European Semester, are not changing countries' behaviours, especially not in terms of carrying out necessary economic reforms. In part, this can be explained by the unchanged political framework: decisions are still legitimised through national elections.[12] However, this does not help to make support for other countries more acceptable in countries like Germany, especially if there is a perception that there are no effective sanction regimes or even the ultimate consequence of exclusion from the Eurozone for persistent offenders.

[8] See also Reiermann and Wiegrefe (2012).
[9] See also Schneider, Zuleeg, and Emmanouilidis (2014).
[10] See also Schieritz (2015).
[11] See also Zuleeg (2015b).
[12] See also Zuleeg (2015a).

6 Implications for the future

What does this mean for the future? Undoubtedly, Germany has become politically stronger, with some elements of dominance, especially in relation to the Eurozone. This is unlikely to change and makes a stand-off like the one with the new Greek Government in the summer of 2015 more likely. At the same time, an isolated Germany or Germany in combination with a small number of countries cannot impose a policy on the rest of the Eurozone or even individual countries, unless they are in acute crisis. The result is a stalemate, with no significant further deepening of EMU possible unless a solution can be found that satisfies all sides.

What the EU is currently facing is not the prospect of a German Europe, with ordo-liberal and austerity policies being forced onto other Member States. Rather, the EU faces a period where effective decision-making is under severe strain. To make further progress, the European economic framework will have to contain both elements: support for economically weaker countries but also mechanisms to ensure countries carry out reforms; in European jargon, solidarity and responsibility. With this in mind, it could be worth revisiting the so-called contractual arrangements, i.e. commitments by member states to carry out reforms in return for support, as this could overcome the political blockage that is preventing the development of a fiscal capacity.[13] The existing fiscal rules should also be complemented by a Golden Rule which provides Member States with some flexibility to increase social and public investments.[14]

But in truth, the erosion in decision-making capacity goes far further than the EMU crisis, where at least some progress has been made. The refugee crisis is also posing similar questions of responsibility and solidarity, albeit with some countries being affected differently than in the Eurocrisis. So, paradoxically, what Europe needs is more Germany but a Germany that recognises that its relative hegemony implies that it needs to take the lead in constructing European compromises that can take the EU forward to overcome its poly-crisis. Without this recognition, there is a danger that the greatest experiment in creating a stability

[13] See also Zuleeg (2015c).
[14] See also Zuleeg and Schneider (2015).

mechanism and the rule of law across Europe is undermined over time, threatening the outcomes Ordoliberalism strives to achieve.

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