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Ordoliberalism: A German oddity?

Edited by Thorsten Beck and Hans-Helmut Kotz

A VoxEU.org Book

CEPR Press

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Centre for Economic Policy Research
33 Great Sutton Street
London, EC1V 0DX
UK

Tel: +44 (0)20 7183 8801
Email: cepr@cepr.org
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Foreword

The typical approach towards economic policy in Germany follows order and rationality. Compared to the so-called Anglo-Saxon-Latin pragmatism, German policymakers appear to operate in a different intellectual sphere from other countries. Their unique approach was developed by Walter Eucken and colleagues at Freiburg University in the mid-20th century and was coined ‘ordoliberalism’. Following this principled approach should ensure that policy decisions are based on sound economic reasoning, which has so far proven generally successful for the German economy.

Every so often, however, policymakers deviate from this script. For instance, during the financial crisis, German policy took a leave of absence from its rules-based philosophy and embarked on large-scale bank bail-outs, along with countries across Europe and the North Atlantic. Advocates of ordoliberalism point towards the undeniable success of the ‘German Model’ over recent decades. Critics, however, hold this approach responsible for the poor macroeconomic performance of the Eurozone in the past decade, when compared to non-Eurozone European countries. This eBook compares the two policy approaches to understand where the differences lie and how they can potentially be bridged to underwrite European integration.

The authors come from a wide range of economic schools of thoughts, including both academics and policymakers. They look at the origins of ordoliberalism; its role in crisis resolution; how it fares with macro-management; the future of the European Monetary Union; and how ordoliberalism understands global current account imbalances.

CEPR is grateful to Professors Thorsten Beck and Hans-Helmut Kotz for their joint editorship of this eBook. Our thanks also go to Sophie Roughton and Simran Bola for their excellent and swift handling of its production. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this important topic. We would also like to thank the Center for European Studies, Havard, which hosted a workshop on the topic and from which some contributions to our eBook are taken.

TessaOgden
Chief Executive Officer, CEPR
November 2017

I What is ordoliberalism?

1 Introduction

Thorsten Beck and Hans-Helmut Kotz
Cass Business School, City, University of London, and CEPR; CES, Harvard University, and SAFE, Goethe University

German economics and, as a result (?), German economic policymaking, appear to be a land apart. Critics have even suggested German policymakers and academics live in a "parallel intellectual universe". The conflict, for example, with US economic policy pragmatism is a hardy perennial in international debates – dating back long before the most recent struggles in the G20 context. Interestingly enough, these engagements were often (even typically) about the persistent German current account surpluses and how to address them. It is also evident that discussions about Germany's role and position in international economic policy coordination predate the G5 meetings of the mid-1970s. They were, arguably, also a proximate cause for the unravelling of the Bretton-Woods-System of fixed-exchange rates half a decade before.

Clearly, international policy coordination becomes difficult when views about how the world works diverge. However, such discrepancies are particularly problematic when they exist *within* a monetary union. This appears to be precisely the case in Europe's monetary union: Forcefully insisting on a principled, rule-based approach, German views are, when push comes to shove, regularly opposed by more pragmatic orientations. The latter views often come with a qualifier: Anglo-Saxon. In EZ's case, however, the more discretionary approach is regularly defended by France and Italy. And, again, these differences in perspectives are long-standing.

However, German economic thinking has decisively shaped the design of Europe's policymaking institutions. (As it had before the Treaty of Rome, laying down the rules for the common market. Consider, for example, the philosophy underlying the prohibition of State Aid or the approach towards competition policy.) This orientation is deeply enshrined in the Treaty of Maastricht (from 1992) and more particularly in the Stability and Growth Pact (1997) with its insistence on rules for limiting deficits and debts.

At the time of its conception, numerous French commentators complained that there was much more stability than growth in the pact. Disagreements between Germany and (mainly) Southern European members of EMU also became apparent in the management of the sovereign debt crisis, in particular in the handling of the Greek problem.

Brunnermeier *et al.* (2016) have aptly described these controversies as a "Battle of ideas". In a way, this eBook is a sequel to their analysis, attempting to shed light on the pertinence of economic ideas and concepts for current policy debates. At the same time, it is also about the interpretation of these concepts. This involves pondering the mediating, or even determining, influences of the respective (national) publics as well as (national) interests: different views of the world often closely correlate with distinct differences of interests, for example between debtor or surplus countries.

Such divergences also show up in how European treaties are interpreted or understood in the respective constituencies – and ultimately implemented. An interesting case in point is an excellent report by the French Commissariat Général du Plan (Boyer 1999). After highlighting problems potentially arising from the lack of a macroeconomic stabilisation capacity at the Eurozone level (what is today called "fiscal space"), this report sketches four scenarios to deal with the issue going forward: (1) a reading *à la lettre* of Maastricht, (2) an insurance union, (3) fully developed fiscal federalism or (4) '*pragmatisme et apprentisage*', i.e., muddling through. Reflecting the French discourse, the report saw no chance for scenario (1), deemed (2) largely infeasible and held (3) as unacceptable in the French polity. At the time, scenario (1) was of course understood as a given by the German public (*pactae sunt servandae*). A vanguard group actually called for more pooling of sovereignty, hence held that scenario (3) – anathema to the French polity – had to be the *finalité* (Schäuble and Lamers 1994). Those cleavages between political discourses came with apparently national trappings: in the media (major newspapers), as well as between advisory bodies (the German *Sachverständigenrat* or the French *Conseil d'Analyse Économique*), it was difficult to find common ground on a number of crucial issues (Kotz and Kösters 2000).

In order to understand how ordoliberalism became an almost ineluctable point of reference in German economic policy debates and policymaking, this eBook will begin with an introductory chapter on the school's main lines of thought: its core arguments, its impact on the German as well as the European policy debate.

Then, in the following three parts, particularly contentious policy areas will be addressed. These are fields in which policy views regularly clash with US as well as Southern European approaches. One is the appropriate institutional design of Europe's monetary union. An ordo blueprint would call mainly for rules and a minimum of (arbitrary) discretion, if at all. Another area is the appropriate domain as well as conduct of monetary policy. Buying-up (sub-) sovereign debt, as the ECB does in its asset purchasing programmes, is deemed to be undermining the liability principle, inexorably laying the ground for ever larger distortions. A final topic, also a long-standing issue, again at the top of the G20 agenda, is that of global imbalances. The, seemingly uncontainable, German current-account surplus is read by many in Germany as an indicator of the high competitiveness of its export industries; whereas critics see a mercantilist strategy at work, with substantial negative spillovers onto Germany's trading partners, in particular in the Eurozone.

Ordoliberalism: whence it came

A distinctive trait – an idiosyncrasy – of German economics and the policy debate is its reference to 'ordo', an economic policy approach developed by Walter Eucken and colleagues at Freiburg University, in response to the malfunctioning, highly cartelised economy of the Weimar Republic as well as in opposition to the statist, authoritarian interventionism of the Nazi regime. Of chief concern was the protection of individual freedom. Competitive markets were seen as most effective in underwriting the conditions for individual liberty, including the reining in of private market power.

Harold James (Princeton) holds that the "basic elements of the contrasting philosophies [are]…(t)he German (or perhaps more accurately northern European) vision…about rules, rigor, and consistency, while the southern emphasis is on the need for flexibility, adaptability, and innovation. It is Kant versus Machiavelli." Obviously, this is the debate about rules versus discretion. The latter, inexorably, comes with the temptation to re-optimise or to postpone, i.e. kicking the can down the road. It thus undermines the "liability principle" and ultimately the competitive system itself. If rules don't rule, arbitrariness reigns supreme. Gaming the system becomes the default option. This argument holds *a fortiori* in a federal system, as James stresses: "The more federal a country is, the more it has to insist on rules." But, by necessity, rules cannot but remain incomplete.

Hence, as James argues (with reference to Aristotle's *Nicomachean Ethics* and Richard Wagner's *Meistersingers*), the real issue is to negotiate "sustainable flexibility" – "and a fundamental commonality of outlook", zooming-out towards a larger, European picture, beyond seeing "the world primarily in terms of national interest, national advantage, and national egotism".

In international debates, ordoliberalism is alluded to mainly with negative connotations, at times as an even more malicious version of the often decried neoliberalism. However, as Brigitte Young (Münster) demonstrates, ordoliberalism comes in a number of varieties. And, most puzzlingly, it calls for a *strong* state, mainly to contain market power which in a pure "*laissez-faire* [environment ends up] leads to distortions in the market mechanism by crippling the price mechanism." The market is cherished as a power-reducing tool, in particular to contain influential special interests, within the framework of a competitive order and the rule of law. This is in obvious contrast to the Chicago School liberalism which "celebrates the ascendancy of private market forces (and) strives for a lean state…). Traces of this ordo philosophy can be detected in EZ's "framework of rules aimed at ensuring a sound fiscal policy and sound money". But, then of course, those rules were honoured in the breach, beginning with Germany (in 2003). Hence, ordoliberals hold that their principles were, in fact, never fully applied – probably rightly so.

Freiburg School's basic philosophy is largely aligned with the "old Chicago school", according to Lars Feld, Ekkehard Köhler and Daniel Nientiedt (Eucken Institute and University of Freiburg). The emphasis on rules and a pervasive reluctance to use discretionary measures is meant to prevent distortions to the price mechanism, "the foundational – i.e. most important – principle in Eucken's system of constitutive principles". Post-Eucken, ordo-liberalism was about insisting on microeconomic foundations, a strong emphasis on the supply side and, similar to Buchanan-type constitutional economics, on conceiving rules for a resilient economy. The institutional design of EZ, being influenced by the rules versus discretion debate, has some ordoliberal touches (not the least since some German architects were imbued with ordoliberal ideas), but, of course, in reality, in particular in the wake of the crisis, they were not upheld. The German government's position was surely not unequivocally ordoliberal – only to the degree that such a view was in line with its interests.

Ordoliberal views, the authors conclude, have only a fading influence on German economics policy.

There is no *German* economics. Rather, the claim of specialness is, according to Michael Burda, based on three myths: First, a disregard of the Keynesian ideas about aggregate demand. In fact, already in the 1960s, the New Economics had found, following Karl Schiller, the minister for economics and finance, its German expression in the marriage between the Freiburg imperative and *Globalsteuerung* (management of aggregate demand). One could add that, since that time, students of economics have been raised on Samuelson (Nordhaus) or a similar diet. Second, while ordoliberals share strong policy preferences (in some cases "elevated to the status of a religion"), they rest their case on rigorous micro analysis and stress the pertinence of a long-term orientation. Thirdly, German policymakers stop obsessing about moral hazard when trouble is in their own backyard. In essence, the conflict between German and other economists is rooted in conflicting interests. The German Council of Experts (GCEE), based on rigorous analysis, often passes normative judgments – open to debate. Ordo takes a backseat when national self-interest calls for it: "*Teutonomik* trumps *Ordnungsökonomik*."

Christoph Schmidt (RWI-Institute and Council of Economic Experts) also holds that critique, portraying the 'representative' German economist or the GCEE as unequivocally preaching rule abeyance, as misplaced. The GCEE is not "wired differently" but perceives itself as "a critical, yet constructive voice in the economic policy arena". Its judgment is based on state of the art research and evidence based. This means, in particular, that policy evaluation relies on robust empirical research strategies. In this vein, careful identification strategies are deployed. In recent years, the GCEE has given the analysis of the Eurozone institutional landscape a particular priority. Its opposition to further risk-sharing in the Eurozone is based on the real experience with German federalism. To make the Eurozone viable and resilient, three principles have been defended: unity in diversity, subsidiarity and alignment of responsibility with control

Principled monetary and financial policy: Underwriting stability

The ECB pursues a monetary policy objective – a rate of increase of the harmonised consumer price index – of below, but close to, 2%. This is, as Peter Praet stresses, perfectly in line with Eucken's emphasis on the "primacy of monetary policy". The ECB's lexicographic ordering of its objectives – an unrivalled priority for price stability – also fits, hand in glove, with ordoliberalism's insistence on a rule-based policy with a narrow mandate. This is, importantly, reflected in the ECB's mandate (Art. 127(1) TFEU) and underwritten by its independence (Art 130 TFEU). Principles, however, do not suffice when it comes to developing instruments that allow for the achievement of the ultimate objective. And Eucken's proposals, as conceived against the background of the immediate post-War, obviously cannot address issues as they especially arose in the wake of the financial crisis. Central banks, in pursuing their objectives, were compelled to become innovative in their choice of instruments. Given that the control of short-term interest rates became largely ineffective, the structure as well as the size of the balance sheet became an instrumental substitute in contributing to achieving the ECB's objective. Unconventional, nonstandard measures were indispensable to underwrite price stability. From this angle, the ECB's policy is completely aligned with Eucken's principles.

For ten years now, ever since the crisis broke, German media, but for a rare exception, has treated its public to a highly sceptical assessment of ECB policy, according to Adalbert Winkler (Frankfurt School of Finance and Management). This critique was based "on opinions expressed by many ordoliberal German economists". Relentlessly predicting doomsday (hyper-inflation, vanishing foundations of wealth and political instability) this has sapped support for the ECB significantly. What matters for ordoliberals are principles – not the outcome. Within this view, asymmetric information or market imperfections have no place. Correspondingly, the GFC is explained as the upshot of a too-expansionary monetary policy and other ill-fated government interference in financial markets. Based on this "narrow view" the measures taken to contain the crisis "are seen as nothing else than massive violations of the Eucken principles". Most importantly, with its asset purchase programme the ECB is breaching its mandate.

The price for this scandalising approach is high: it "undermines public confidence in the most important European institutions".

Amongst policymakers (in Central Banks and Finance Ministries) it was conventional wisdom (long before the canonical economic models existed) that banks were special. According to Thorsten Beck (Cass Business School, London and CEPR) and Hans-Helmut Kotz (Center for European Studies, Harvard and SAFE, Goethe University Frankfurt), crises had taught this lesson. Banks needed backstops under dire circumstances, or else their failure could lead to an economic cataclysm. Given banks' "defining traits: …a purposeful mismatch between the average maturity of deposits (short, possibly very short – on demand) and their assets (regularly of a much longer tenor", banks are at the risk of bank runs (be they retail or, as during the GFC, wholesale). Banking markets are characterised by market imperfections (externalities, arising from interconnectedness and large scale, market power), calling for public sector intervention and backing. Inexorably, such insurance comes with moral hazard. German authorities always took a strong position on the necessity of aligning perimeters of liability and control. In the midst of the systemic crisis, however, quibbles about moral hazard and safety nets notwithstanding, German authorities came to the rescue. In practice, in other words, German banking politics was never unconditionally rule-abiding. When push came to shove, principles were honoured in the breach. Freiburg postulates, translated into modern language, are of course pertinent: to deal with moral hazard and time inconsistency, incentives have to be set right. But rules must be credible. Corner solutions do not help. Banking politics needs "both: rule with credible enforcement as well as, at times, discretion".

What's wrong with the Eurozone?

Whereas the Great Financial Crisis led to a similar hit to the Eurozone's economy as it did to that of the US, recovery in the case of the US was much swifter. That's the first observation from which Oliver Landmann (Freiburg) starts. Secondly, growth of domestic demand lagged significantly behind the increase in total output, that is, net exports were the major drivers of the Eurozone's mediocre performance – remarkable for such a big and rather closed economic area, and certainly not an approach which could be mimicked by everybody. Thirdly, this average performance hides very substantial regional divergences.

In fact, “new asymmetries” have been created and old are continuing to fester, challenging the Eurozone going forward. It is here that “conflicting narratives” about the appropriate design of policies come in. While “there is no compelling reason at all why a rule-based governance and a proper alignment of incentives should be fundamentally incompatible with a framework for effective macroeconomic demand management”, this is exactly what the two conflicting “belief systems”, the German one and the Latin one, have produced. Whereas the “two-handed approach” would suggest caring for supply as well as demand, the opposing views stress one or the other. In the case of ordoliberalism, Landmann diagnoses a “macroeconomic blind spot”, showing its roots in Walter Eucken’s adamant rejection of “full employment” or counter-cyclical demand management, which Eucken equated with Hitler’s job creating policy. And Landmann holds that this can be fatal for EZ since “no amount of ordoliberal virtue will sustain the common currency for long”.

Jeffrey Frankel (Harvard Kennedy School) assesses propositions made by German ordoliberals (ordos for short) and American pragmatists in light of the euro crisis, addressing a balance of what each got right – and wrong. First, he stresses that the danger of excessive deficits, potentially “exacerbated by moral hazard from the anticipated likelihood of bailouts”, was correctly acknowledged by ordos. This was also a reason for many “ordinary German citizens” to be wary of the common currency. But it did not even “appear on the long list of criteria” for why US economists deemed the Eurozone not to be an optimal currency area. Conversely, US economists’ concerns about the pertinence of asymmetric shocks and the difficulties of a one-size-fits-all monetary policy, was underappreciated by ordos. When the crisis hit however, “as American pragmatists had suspected”, the rules proved un-enforceable. To which ordos responded with an “escalation of language”. But “rules that are too stringent to be credible can be worse than no rules at all”. Everybody was too positive about “capital flowing downhill”, i.e. the benefits of deep integration of financial markets. Private overexpansion (think real estate or banking) can also produce macro havoc. Pragmatists are right when insisting on the unsustainability of Greek debt and hence calling for a restructuring. Ordos, on the other hand, rightly call for structural conditionality. A synthesis between both camps is feasible, and indeed advisable.

Although ordoliberalism (where it was known of at all in international circles) used to be seen as a "curious idiosyncrasy", the Eurozone crisis, as Charles Wyplosz argues, has documented the fateful power of these ideas. While ordoliberalism comes in many variants, in its crude version it stresses political failures and largely (almost completely) disregards market failures. Coordination issues are, however, in mainstream economics the reason why "eschewing demand management policies" is seen as flawed. Buttressed by its alleged better comparative performance, ordoliberalism nonetheless has had a decisive impact on the institutional structure of EZ. At the same time, for domestic purposes, Germany obviously never completely eschewed macro management. At the Eurozone level, however, it insisted on a rigorous set of rules. This resulted in an ECB akin to a Bundesbank writ large. It also led to fiscal policy rules in direct conflict with sovereign rights of member states which are not part of a federation. Possibly, as Wyplosz argues, another take on the issue is that the narrative is used to defend German interests. With a "partially flawed architecture" this amounts to an existential problem. While explicit rules of the game are important, the Eurozone's "management of discretion is a key weakness".

Jeromin Zettelmeyer, former Director General for Economic Policy at the German Ministry of Economics, narrates his *éducation idéologique*, when taking up his new role in 2014 – without having ever been exposed to ordoliberal thought before. Given that he was supposed to be one of the keepers of the flame, he read up on Eucken, finding that his views on preventing market abuse and "how the economic system should operate" were "thoroughly modern": a strong state underwrites and impartially implements the rules of the game and "the private sector is responsible for economic processes". Eucken, Zettelmeyer stresses, views the role of competition "not only as a condition for efficiency…but also ...[to prevent] inequality associated with economic rents". Where Eucken becomes old-fashioned, i.e. pre-Keynes, is in his rejection of any stabilising intervention of output or employment. While this position should be read in the light of its historical context, fixing ordo does not suffice. Conservative positions on Eurozone reform however, according to Zettelmeyer, have much less to do with a faithful exegesis of Eucken than with a narrow view of German interests, low trust in partners, an obsession with incentives for good policies and a disregard for international mainstream policy concepts. From this follows a suggestion: to out-Eucken German ordos, in terms of getting incentives right, but concurrently to allow for risk sharing and macro stabilisation at the Eurozone level.

Global imbalances – coordinating with different script books

For some, “the Germans are bad, really bad”; supposing any evidence for this is needed, just look at their quasi-permanent current account surplus. This is, as Philipp Steinberg (German Ministry of Economic Affairs and Energy) writes, not at all a popular assessment in Germany. There, the surplus is interpreted as the logical upshot of a competitive economy, firms producing goods and services in high demand worldwide. Moreover, this is not a policy issue, in as much as the surplus is driven by fundamentals (ageing society) or temporary factors (cheap domestic currency, low commodity prices). Almost half of the surplus, in accounting terms, can be explained by fundamentals. Inexpensive energy and an exchange value of the euro which favours net exports, has contributed strongly to the increase in the current account balance ever since 2008. Still, Steinberg holds, Germany should engage in policies which ultimately reduce the surplus: increase capital expenditures, allow for rising real wages, buoying domestic demand. This would complement attempts at achieving a more balanced intra-Eurozone landscape. But here, the main instruments have to do with a Eurozone level fiscal capacity, including a more flexible application of the Stability and Growth Pact.

Germany is not your typical “small open economy”, i.e. inconsequential in the aggregate. In fact, as Richard Cooper (Harvard) argues, it plays a role (a) in terms of the “discernible global impact” it generates, as well as (b) the guiding economic policy principles (the dogma). With reference to Henry Wallich, Cooper writes that exports, often equated with “competitiveness”, have for a long time been the “sacred cow” of German economic policy. Moreover, in terms of dogma and emphasising comparative performance, some Germans suggest that “the world would be better off” if more followed the German script-book. This is, as Cooper shows, arithmetically infeasible. Global net savings are (for reasons of accounting) exactly zero. Therefore, “competing over net exports is a zero-sum game”. For the same “reasons” of accounting, a current account surplus comes with net capital outflows. Within the Eurozone, this implies adjustment without the security valve of a change in nominal exchange rates. Instead, migration, fiscal transfers or adjustment of relative prices – in particular real wages – have to do the job. A more expansionary fiscal policy as well as a stronger growth of wages, however, was an anathema in Germany.

Instead, internal devaluation was asked from Germany's partners. A policy of competitiveness, i.e. playing non-cooperatively, is prone to create "serious problems for the world economy".

Gabriel Felbermayr, Clemens Fuest and Timo Wollmershäuser take the opposing view, and see the critique of Germany's current-account surplus, dominant in international circles as largely ill-advised. Germany's surplus of national savings over domestic investment is the upshot of reduced public sector deficits and less reliance on debt in the corporate sector, the latter also in response to a more equity-friendly tax system. Household savings and the financial sector balance, however, barely moved as a share of GDP over the last decade. On the other hand, declining oil prices and the low value of the euro have contributed significantly to the further increase in the balance since 2014. Given that there is no underinvestment as well as no inappropriate level of wages – with the share of wages actually growing again since 2007 – Germany has no immediate interest in reducing the surplus. However, protectionist threats, uncertainty about a too-large net creditor position as well as the Eurozone rules in the macroeconomic imbalances procedure should lead to Germany being more perceptive in terms of accepting calls for capping its surplus.

The almost exclusive focus on possible fiscal policy problems meant that other potential imbalances were not under the radar. Therefore, as Agnès Bénassy-Quréré writes, the lesson drawn from the crisis, to monitor those non-fiscal balances which are potentially troublesome, is correct. There was also a lack of policy coordination; therefore the European Semester is a substantial improvement on its precursor, the Broad Economic Guidelines. Nonetheless, the current set-up is not capable of cushioning shocks to aggregate demand at the Eurozone level. The Macroeconomic Imbalance Procedure – with its 14 indicators to be monitored – is too complex by far. It is also misguiding, insofar as it overlaps with the SGP, as the loadstar of fiscal policy and the long term growth-oriented Europe 2020 programme. This produces unclear signals and a lack of ownership. Hence, Bénassy-Quéré calls for a clarification of the surveillance process. This would also lead to more focused recommendations. What concerns the MIP, using the current account balance as the core indicator would be well-advised.

Theory, even if idiosyncratic, can be highly practical. Christopher Smart (Harvard Kennedy School), a former Deputy Assistant Secretary for Europe in the US Treasury (between 2009 and 2013) and Special Assistant to the President for International Economics (2013-2015) recounts his encounters with German officials and their "barely concealed supposition that debts and imbalances are *prima facie* evidence of political virtue and vice". While US officials felt confident that the Eurozone needed "a generous and determined reaction from monetary policy and fiscal authority", these suggestions fell on deaf ears in Germany. There, officials "remained intently focused on the post-crisis recovery of Germany with only a glancing eye on developments elsewhere". A comprehensive, encompassing Eurozone perspective was missing. German officials simply did not buy into the mainstream US perspective that a deep crisis called for a commensurately massive fiscal policy response. This was seen as "bastard Keynesianism". Moreover, increasing Germany's national debt "was a moral mistake as well". "Global imbalances", the G20 lingo for cajoling Beijing and Berlin to reduce their surpluses, were seen as a non-issue. Why should the government, even if it had the means to do so, call on firms to be less competitive, to export less? Those are not issues of merely historical interest. The increasing protectionist tide and the "much greater transatlantic misalignment" merit a rethinking of outdated views or even dogmas.

...where do we go from here?

In modern terms, the focus was on microeconomic issues. Macro (stabilisation) policies, other than the stabilisation of the value of money, were seen to be of little, if any, avail. In this regard, ordoliberalism shares a quite unconditional faith in the self-stabilising capacity of a market economy with the US freshwater schools of macroeconomics, regularly expounding a policy ineffectiveness proposition.

The ordo school was – is – highly influential in German economics as well as, possibly more important even, in politics and the public discourse. The post-WWII *Wirtschaftswunder* of the 1950s and 60s was understood as corroborating its analysis. Ordo philosophy also had a decisive impact on the institutional design of Europe's economic community as well as subsequently on its monetary union.

But in our second-(or third-)best world, markets are imperfect and fallible (as are public authorities, obviously). Contracts remain by necessity incomplete. Therefore, under certain circumstances, reasoned public intervention – discretionary judgment – is called for. This is, obviously, not a particularly German philosophy nor is it American pragmatism. More plausibly, the Greeks – cf. Aristotle's *Nicomachean Ethics* – can claim copyright to this.

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About the authors

Thorsten Beck is Professor of Banking and Finance at Cass Business School in London. He is also (Co-)Managing Editor of *Economic Policy* and Co-editor of the *Review of Finance*. He was Professor of Economics and founding Chair of the European Banking Center at Tilburg University from 2008 to 2013. Previously he worked in the research department of the World Bank and has also worked as a Consultant for – among others – the ECB, EIB, IMF, the European Commission, ADB, and the German Development Corporation.

His research and policy work has focused on international banking and corporate finance and has been published in *Journal of Finance*, *Journal of Financial Economics*, *Journal of Monetary Economics* and *Journal of Economic Growth*. His research and policy work has focused on Eastern, Central and Western Europe, Sub-Saharan Africa and Latin America. He is also Research Fellow in the Centre for Economic Policy Research (CEPR) in London and a Fellow in CESifo. He studied at Tübingen University, Universidad de Costa Rica, University of Kansas and University of Virginia

Hans-Helmut Kotz is a Resident Fellow, Center for European Studies as well as a Visiting Professor of Economics, both at Harvard University. At Goethe University, he is a Program Director of the SAFE Policy Center and Senior Fellow of the Center for Financial Studies. He is also on the economics faculty of Freiburg University. He was a Board Member of Deutsche Bundesbank (2002-2010), in charge of Financial Stability, Markets, and Statistics and as such a member of a number of committees and working groups of the Bank for International Settlements, the Financial Stability Board as well as the OECD, where he was Chair of the Financial Markets Committee. He was also the Central Bank Deputy for the G7 and the G20 process.

Before that, he was President of the Landeszentralbank in Bremen, Niedersachsen and Sachsen-Anhalt (1999-2002) and Chief Economist at Deutsche Girozentrale. Between 2002 and 2005 he served in a personal capacity as a member of the European Parliament's Expert Group on Financial Markets. He has published widely (*Zeitschrift für Betriebswirtschaft*, *Revue d'Economie Financière*, *Intereconomics* etc. as well as numerous edited books).

In addition to his academic positions, he is a senior advisor to McKinsey & Co. and serves on the Supervisory Board of Eurex Clearing AG, Frankfurt/Zurich. He is also a non-executive Member of the Board of Caixa General de Depósitos, Lisbon.

2 Rule Germania

Harold James
Princeton University

European integration is full of the same kinds of misunderstandings and misinterpretations that often characterise relationships between men and women. According to an American popular psychologist who wanted to provide a "practical guide for improving communication and getting what you want in your relationships", men and women are from different planets. This approach was adapted to international politics by Robert Kagan, who argued that Americans were from Mars and Europeans from Venus. "It is time," he said, "to stop pretending that Europeans and Americans share a common view of the world, or even that they occupy the same world." Europe now has discovered that it has its own version of mutual incomprehension. It needs a psychologist, or a marriage counsellor.

A recent attempt by Guiso *et al.* (2013) to understand the euro crisis tells of the incompatibility of national cultures, and in particular the incompatibilities of a culture obsessed with "cheating" (Greece) and a contrary culture obsessed with "punishment" (Germany). The authors then develop a model of the interactions of choices between these two cultures, and show that "interactions between Greeks and Germans result in excessive 'cheating' (by the Greeks) and excessive 'punishment' (by the Germans), with a generalised loss of welfare, which is increasing in the degree of cultural heterogeneity, and which cannot vanish rapidly given the inertia of cultural norms." They conclude that there may be only a choice of either break-up or of reaching a framework in which a common fiscal framework is a way of reaching a "superior steady state".

The basic elements of the contrasting philosophies can be delineated quite simply. The German (or perhaps, more accurately, northern European) vision is about rules, rigour, and consistency, while the southern emphasis is on the need for flexibility, adaptability, and innovation. It is Kant versus Machiavelli. Economists have long been familiar with this kind of debate, and refer to is as rules versus discretion.

Some more specific policy preferences follow from the general orientation: the rule-based approach worries a great deal about the destruction of value and insolvency, and about avoiding bailouts that will set a bad example and encourage inadequate behaviour among other actors (economists call this the moral hazard problem). In contrast, the discretionary approach sees many economic issues as temporary liquidity problems that can be solved easily with an injection of new lending – liquidity. From this point of view, the provision of liquidity is costless: there is no bailout, no incurred loss, and in fact the knock-on effects make everyone better off. There are, in this vision, multiple possible states of the world and multiple equilibria; the benign action of government and monetary authorities can shift the whole polity and economy from a bad situation into a good one. The European Central Bank should do more and more. In response to this, the long-faced adherents of the moral hazard view point out the costs that will pile up in the future from the bad example that has just been set: the ECB's activism is destroying Europe, generating an ephemeral and false prosperity while removing incentives to fix the underlying problems.

The German vision of order included both a system of general rules and a mechanism by which those rules define the liability (or responsibility) of individuals, and of economic agents. The system depended fundamentally on the accountability of market participants. Any measure limiting accountability or responsibility and promising some sort of contingent rescue would create destructive incentives producing an accumulation of unfulfillable expectations on behalf of the economic actors, and unfulfillable liabilities on the part of the government as the ultimate insurer.

As a consequence, the ordoliberal tradition worried greatly about moral hazard, a term taken from insurance (a well-insured person may not take sufficient care that his house does not burn down). On these grounds, the Freiburg school and its modern successors (such as the prominent German economist Hans Werner Sinn) even worry about the limited liability principle for corporations. "Unlimited liability is part of a competitive system,"

Walter Eucken wrote (Eucken 1992, 316). In his eyes, the problem was that the development of the legal system and the increased complexity of laws tend to subvert the liability principle: "its destruction by legal policy endangers the functioning of this system." So, too many, and too complicated, laws would breed moral hazard and give the economic agents incentives to game the system.

A persistent theme – indeed the *leitmotif* – of the discussion of the European monetary union has always been the insistence on the importance of rules. Rules rule. Is this just a question of a bizarre German fetishism, reflecting a deep lack of imagination or flair? Or is the German stance really needed in constructing a viable political community? Germany's position arises from the coincidence of two logics, one constitutional, and one historical.

The more federal a country is, the more it must insist on rules. Unless the responsibilities of the different layers of authority are clearly delimitated, there is a real danger that smaller units will try to pass the buck to higher levels of government, in order to get a free ride at the expense of the wider community. The thought that one part is exploiting the others inevitably leads to recriminations and resentments. So, federations need a legalistic approach.

Legalism helps in some aspects of policymaking. Historically there is also a strong correlation between successful federations and stable monetary policy, that depends on the consistent application of a rule. Switzerland, Germany, the US – all federal countries – were the pioneers in the late 20th century in applying a stability-oriented monetary policy. Unstable federations with a loose approach to monetary discipline – Yugoslavia in the late 1980s or the Soviet Union in the early 1990s – ended up by destroying themselves.

But it was really history that shaped the German perception. In Germany, thinking about the overall framework of political order was cast in a new way after WWII. The 'ordoliberal' tradition of thinking about economics pioneered by Walter Eucken and Wilhelm Röpke had developed initially as a response to the high degree of cartelisation and regulation in the Weimar Republic; but it became compelling as a response to the destructive arbitrariness of Nazi economic policy.

For similar reasons, the insistence on general rules, rather than arbitrary regulations that favoured one sector and distorted competition, is an important demand in many European countries where the aftermath of excessive and arbitrary state regulation has been pernicious: above all in post-communist societies, but also in many countries of southern Europe that have been the victim of bureaucratic overreach.

There is an old problem about constructing politics on the basis of rules, one that was already identified by Aristotle. In the *Nicomachean Ethics* (Chapter 5 section x), he set out the logic of looking for a malleable rule. He thought, as an analogy, of the flexible lead (rather than rigid iron) rule that sculptors on the island of Lesbos used to cut curved lines in stone. Sometimes, the legislator had made a statement that was over-simple, and that needed to be reinterpreted in the light of changing circumstances. The careful negotiation of sustainable flexibility – Aristotle's Lesbian rule - can offer a way out of traps that are constituted by rules that have become too rigid.

Some Germans realised the same point. Richard Wagner's *Mastersingers of Nuremberg* is a satire on a late medieval merchant community that took rules too seriously and consequently stifled innovation. His answer was that rules needed to be tested by popular consent.

Machiavelli saw a need for the appearance of consistency, and of virtues that would give a solid foundation to the principle of consistency. Those virtues, he thought, are in fact the basis for proper politics. In the most notorious chapter (Chapter XVIII) of *Il Principe*, he stated that "a prince ought to take care that he never lets anything slip from his lips that is not replete with the above-named five qualities, that he may appear to him who sees and hears him altogether merciful, faithful, humane, upright, and religious."

Yet the default mode of modern politics is to think of pragmatism, and to follow up with broken promises. Europe styles itself as being a postmodern construct, but one of the features of postmodernism is the reduction of political life to the playing out of cosmetically charged narratives, or to listening to constantly changing focus groups.

The malleable and changeable sense of reality within modern politics is a stark contrast with the Europe of Winston Churchill, Konrad Adenauer, Charles de Gaulle, Alcide de Gasperi or even Jacques Delors: they all believed something. They were also full of all kinds of political trickery: but it was the bedrock of an overall conviction that allowed

the trickery to be effective. Machiavelli should be correctly interpreted as calling for a politics of deep conviction: the opposite of postmodern political style. That approach means action as well as words. The only way of being consistently and deeply, rather than sporadically and shallowly, Machiavellian is to really do something that will make a new reputation.

Most of the German ordoliberal thinkers after 1945 believed that a rules-based order did not arise spontaneously, but required a fundamental commonality of outlook. Some dissidents – notably Friedrich von Hayek, who spent a great deal of his professional life in Britain and the US – insisted on the idea of spontaneous order. This issue continues to be divisive. There is a German Hayek Society that has, in the past years, been torn apart by a quarrel over exactly this point.

There is, in other words, need of a mechanism for seeing the big picture: for zooming out from the obsession with the national and onto the aggregate, to Europe considered as a whole. But how can Europeans get this larger picture, and how can they stop seeing the world primarily in terms of national interest, national advantage and national egotism? It may be that aggregating problems, rather than making them more intricate and less easy to solve, allows the negotiation of a grand bargain. Big crises – and even more the concatenation of big crises – prompt a rethinking, that may give birth to big solutions. Recent challenges, the Ukraine-Russia conflict of 2014, the humanitarian catastrophe in 2015 that followed from the disintegration of Libya and the civil war in Syria, and the Brexit and Trump victories in 2016, have increased the stakes.

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About the author

Harold James is Professor of History and International Affairs and the Claude and Lore Kelly Professor of European Studies at Princeton University, and a CIGI Senior Fellow. He was educated at Cambridge University and was a Fellow of Peterhouse for eight years before coming to Princeton University in 1986. His books include a study of the interwar depression in Germany, *The German Slump* (1986); an analysis of the changing character of national identity in Germany, *A German Identity* 1770-1990 (1989); and *International Monetary Cooperation Since Bretton Woods* (1996). He was also coauthor of a history of Deutsche Bank (1995), which won the Financial Times Global Business Book Award in 1996.

More recently he has written *The End of Globalization: Lessons from the Great Depression* (2001), and Europe Reborn: A History 1914-2000 (2003); *Family Capitalism* (2006); *The Roman Predicament: How the Rules of International Order Create the Politics of Empire* (2006); and *The Creation and Destruction of Value: The Globalization Cycle* (2009). His study *Making the European Monetary Union* has been published by Harvard University Press in the fall of 2012. In 2004 he was awarded the Helmut Schmidt Prize for Economic History, and in 2005 the Ludwig Erhard Prize for writing about economics. His current work is concerned with the history of European monetary union. He is Director of the Center for European Politics and Society at Princeton. He is also Marie Curie Visiting Professor at the European University Institute, and writes a monthly column for *Project Syndicate*.

3 Ordoliberalism as an 'irritating German idea'

Brigitte Young
University of Münster[1]

It is a puzzle how German ordoliberalism has been catapulted from being an internationally largely forgotten school of economic thought into the limelight over the Eurozone crisis management. Equally puzzling is that ordoliberalism is couched solely in negative terms and "has a bad reputation, especially outside Germany" (Brunnermeier *et al*. 2016: 63). It was Mark Blyth (2013), with his catchy book-title, *Austerity: The History of a Dangerous Idea*, who associated German ordoliberal ideas with austerity (Blyth 2013: 17). Equally harsh is the article in *Le Monde diplomatique*, entitled 'Germany's iron cage', suggesting that "Germany adopted the social market system of economic rules separated from political democracy, known as ordoliberalism, after 1945" (Denord *et al*. 2015). According to such interpretations, ordoliberalism is undemocratic and leads to an authoritarian European constitutionalism (Oberndorfer 2015).

Given that ordoliberalism is 'haunting Europe' (Hien 2016), this short review intends to interrogate the concept of ordoliberalism and its impact on the euro crisis management (Young 2014, 2017). This will entail a discussion of the various branches of ordoliberalism of which the Freiburg School is only one. The intent is to demonstrate that ordoliberalism is not reducible to one coherent *Weltanschauung* and that there are different branches with different goals. Much of the critical literature on ordoliberalism neglects the theoretical development and modernisation of ordoliberalism after WWII by Viktor Vanberg in cooperation with James Buchanan's modern constitutional economics.

1 Christian Joerges and Josef Hien organised a conference at the Hertie School of Governance in Berlin, May 13-14, 2016 with the title, *Ordoliberalism as an Irritating German idea*

This draws attention to the existence of two neoliberalisms which emerged at different historical junctures (1930s and 1970s) with diametrically opposed views about the functioning of political economies. Finally, the role of ordoliberalism in the management of the Eurozone crisis will be discussed along with questions of how far the image of ordoliberalism controls the euro crisis discourse and narrative.

The various branches of ordoliberalism

Historically, the German concept of neoliberalism originated in the 1930s, in opposition to the Anglo-Saxon *laissez-faire* liberalism of self-regulating markets and the totalitarian alternatives in the form of fascism and communism. According to the German economist Wilhelm Röpke, the term neoliberalism was coined at a symposium in honour of Walter Lippmann in Paris in 1938, the *Colloque Walter Lippmann*. The participants selected the term 'neoliberalism' to signal the start of a new liberal movement which rejected the *laissez-faire* liberalism of the 19th century. The spark that ignited a new neoliberal movement (which became ordoliberalism in the 1950s) was the turmoil of the 1920s and social malaise of the Great Depression. The *laissez-faire* orthodoxy of German Chancellor Brüning, who called for austerity measures at a time when the economy was in free-fall, exacerbated the economic and political malaise in Germany (Sally 1996). While not all members endorsed the term neoliberalism, it nevertheless became an umbrella term to designate different strands of liberalism. The exponents of this neoliberal circle united in rejecting the economic reductionism which they perceived as central to the ideas of 19th century *laissez-faire* liberalism. At the same time, they warned of an authoritarian shift to the right in the form of fascism and to the left in the form of communism (Sally 1996, Young 2011).

The best known of the ordoliberal branches is the Freiburg School which includes the economist Walter Eucken and the jurists Franz Böhm and Großmann-Doerthas as its most renowned representatives. The more sociological variant of German neoliberalism is found with Wilhelm Röpke, Alexander Rüstow, and Alfred Müller-Armack, who in fact coined the term social market economy, which developed from the earlier neoliberal circles and is still used today to describe some of the continental European (German) economic models.

Walter Eucken was most concerned with developing a conceptual foundation for a consciously formed and instituted 'ordo', which he called *Ordnung der Wirtschaft* (order of the economy), instead of a historically given order, a *Wirtschaftsordnung* (economic order). In this context, the resulting market order was a synthesis of legal and economic ordering. Eucken not only criticised private power in *laissez-faire,* which leads to distortions in the market mechanism by crippling the price mechanism, but he also warned of state power and the collusion of public and private power forming cartels to undermine the market. Private and public power concentration would constrain the freedom of individuals by subjugating them to centralised powers. The answer was not to delegate power to interest groups, so they can balance the various economic interests. Instead, Eucken saw the answer in decentralising power through a competitive market. Thus, Eucken envisioned an ordo to consist of a competitive order (*Wettbewerbsordnung*) regulated by a constitutional order (*Ordnungspolitik*), intimately linked and regulated by the rule of Law (*Rechtsstaat*) (Eucken 1952/1990, Sally 1996, Vanberg 2015, 2014, 1998)

While the Freiburg School is today the most prominent of the ordoliberal branches, there are also the other branches of historical sociology and cultural critique of Wilhelm Röpke, Alexander Rüstow, and Alfred Müller-Armack. Particularly Röpke and Rüstow are known for their conservative cultural critique of mass society associated with the transformation of small communities into giant industrial and urban areas mobilising the proletarian masses. More important than Röpke and Rüstow's conservative attack on modernity is Müller-Armack's focus on the "social". Müller-Armack's *Social Market Economy* played an important ideational role in German economic development after WWII.

The existence of various branches of ordoliberalism tends to refute the widely held belief, prevalent in much of the Anglo-Saxon world, that there is such a thing as a 'pure' ordoliberal school. Equally important is the fact that the ideas of the Freiburgers underwent significant transformations and further theoretical developments after WWII (Berghahn and Young 2013).

Further theoretical developments of the Freiburg School

Throughout the post-war German period, the dominant Freiburg School of Eucken and Böhm underwent fundamental transformations. Viktor Vanberg, a sociologist, who joined the Walter Eucken Institut, Freiburg, in 1995, was one of the foremost thinkers to advance the concept of 'constitutional economics', in close cooperation with James M. Buchanan, as an alternative macro-societal approach for creating a 'desirable social order'. The new perspective drew on Public Choice Theories and Constitutional Economics. Accordingly, the constitutional dimension of the liberal paradigm not only has to encompass an economic constitution (*Ordnungspolitik*), but also to establish and maintain an appropriate political constitution (*Ordnungstheorie*). Politics should be constrained by rules rather than follow discretionary authority to respond to particular governance problems, since the latter rests on expediency at the expense of long-term considerations. In explaining why rules are preferable to discretionary authority, Vanberg cites three reasons. The first reason is the existing *knowledge problem*, which Hayek had problematised as "the incurable limits of our knowledge and powers of reason", making rules essential in a world of complex reality (Vanberg 2015: 14). Two additional rules are subsumed under the incentive and reputational categories. "Incentive problems" refer to psychological concerns, in that humans are tempted to over-weight current needs and short-term effects. In such circumstances, rules force or guide individuals to consider long-term consequences. The advantage of rules is equally demonstrated in cases where *personal reputation* and predictability in social interactions are of primary concern. Rules in such circumstances would constrain opportunistic behaviour which is more apt to occur where discretionary choices prevail.

Hence, the *rules of the game* provide the basis for any stable economic system. Since economic activities are the result of evolving historical and institutional frameworks, economic orders include not only the formal-institutional framework but also the informal conventions and traditions that govern economic activities in the respective communities. In this respect, it is often forgotten that the rules of the game are not written for all times, but have to be acceptable in terms of distributional outcomes. As Vanberg notes there is, *a priori*, no reason why these rules should not be chosen or changed, where feasible, with the intention of bringing the expected pattern of outcomes closer to normative standards that are important to the participants in the game (Vanberg 2015, Young 2015).

Contrasting German neoliberalism with Anglo-Saxon neoliberalism

It remains a puzzle why critics of market fundamentalism selected the term *neoliberalism* to castigate the liberalisation, privatisation, deregulation, and austerity measures of the Thatcher and Reagan governments, despite the fact that the new neoliberalism has a different meaning from that of the 1930s. It is true that the ordoliberals used the term neoliberalism to signify that they rejected the *laissez-faire* liberalism of the day. The ordoliberal intellectuals of the 1930s favoured a third way and, despite differences among various branches of German neoliberalism, central to their endeavour were questions of order, institutions, law and ethics. In contrast to the utilitarian approach of *laissez-faire* economists, neoliberals emphasised a normative-ethical foundation of economics, delineating an important role for the state in setting the constitutional framework for economic competition in order to serve the larger interests of society. Thus, the intellectual proponents of German neoliberalism combined economic efficiency with human decency to achieve a just and stable social order. In rejecting *laissez-faire* liberalism, the proponents of neoliberalism challenged the separation between the political and economic spheres. They envisioned the state as providing a constitutional economic framework to enhance positive freedom for citizens while at the same time constraining the private and public monopoly powers that hinder citizens' autonomy (Young 2011, Young 2017).

In contrast, Anglo-Saxon neoliberalism celebrates the ascendancy of private market forces and strives for a lean state through budget consolidation with austerity measures. Intellectuals most closely identified with the norms of the radical market fundamentalism are found in the so-called Chicago School, but they have their antecedents in Austrian economics of Ludwig von Mises and Friedrich August von Hayek. The *laissez-faire* economists developed the theoretical foundation for claiming the superiority of economic freedom over public intervention. Characteristic of *laissez-faire* liberalism, as practiced in the early 20th century, was a market system based on competitive labour markets, the automatic gold standard, and free trade. Economists postulated that unfettered economic competition was superior to any form of state guidance in coordinating human efforts (Young 2011, Young 2015a).

Seen from this historical perspective, the later re-emergence of neoliberalism has more in common with the belief system of *laissez-faire* liberalism of the 19th/20th century, both emphasising the negative liberty of ridding the economy of regulatory constraints. Twenty-five years later, there is still no shared consensus on the meanings of neoliberalism as it emerged at the end of the 1970s, except for its negative connotation. The term has become synonymous with human and natural resource exploitation, the dismantling of the welfare state, increasing global inequality, and even oppression in the name of freedom (Müller 2007). It is these negative effects, resulting from a belief in unrestrained and self-regulating market forces, that ordoliberal economists and lawyers of the 1930s tried to mitigate.

Image of ordoliberalism dominates the EU-crisis discourse and narrative

If we analyse the impact of ordoliberalism on the management of the Eurozone crisis, the question to be asked is whether a link exists between the rule-based economic and monetary union (EMU), and the German rejection of joint liability (*Haftung und Kontrolle*). In terms of the EMU, the rule-based union reflects an attempt to create a framework of rules aimed at ensuring a sound fiscal policy and sound money. In creating the euro as a de-nationalised currency with no links to the individual Member States, meaning that Member States had to pay their debt in a currency which they could not create, the rules of the Maastricht Treaty and the Stability and Growth Pact served to prevent fiscal profligacy by the Member States. Setting standards for fiscal discipline (which turned out to be insufficient) was an attempt to ensure sound fiscal policy and sound money. With the introduction of the single currency, the Member States of the Eurozone entered a regime of irrevocably fixed exchange rates. This meant that countries could not devalue in order to improve their competitiveness, as countries can do with national currencies. Since the nominal exchange rate is fixed, all they can do, to become more competitive, is to adjust wages and prices accordingly.

It is here that the critique sets in against the supposedly ordoliberal logic of the monetary union. However, as Feld *et al.* (2015) point out, the design of the monetary union owes more to the New Institutional Economics (NIE), than to any particular ordoliberal principles.

Monetary economists suggest that effects of devaluations are short-lived, since it does not address the underlying causes of the prevailing economic conditions. To wit, so long as devaluations are ruled out as a policy option, the relative competitiveness of a country can only be adjusted through wages and prices, as is presently demanded of the indebted countries in the Eurozone. "Notably, the need for such adjustment cannot be attributed to any specific type of ordoliberal heritage or anything else specifically 'German'." (Feld *et al*. p. 57)

Undoubtedly, there are grounds to criticise Germany for not showing more solidarity in the management of the Eurozone crisis. However, this position can also be explained by referring to national egoism, in that Germany was unwilling to support Eurobonds, since this would have increased its interest rates and thus reduced its competitiveness. What is most important for our argument, is that neither the distinct set-up of the EMU, nor the logic of the monetary union, are the outcome of specifically ordoliberal principles.

Conclusion

This short chapter should not be understood as a defence of ordoliberalism, nor as uncritically supportive of German management of the Eurozone crisis. My intent is more academic. If ordoliberalism dominates the EZ-crisis discourse and narrative, then critics should at least explain which ordoliberals they are referring to, and what is specifically ordoliberal about them. Secondly, critics should demonstrate that the policies they are referring to as ordoliberal are, in fact, ordoliberal. In other words, if critics talk about an 'ordoliberalisation of Europe' which supposedly rests on the assumption of a specific German approach to monetary policy combined with its implications for fiscal discipline, then these assumptions require further explanation.

As I have tried to argue, there is no such thing as a *pure ordoliberal* theory or school. Instead there are different branches of ordoliberalism which have been further developed and influenced by Critical Choice, Constitutional Economics, and New Institutional Economics. The claim that German macroeconomic policy corresponds to ordoliberal thinking neglects the heterogeneity and evolution of this school of thought.

Secondly, Germany has followed ordoliberal principles far less than its critics seem to hold, first in the setting up of the *Bundesbank*, later in transferring supposedly ordoliberal constitutional principles to the European Central Bank, and in creating the EZ. The same can be said for austerity, which did not originate with German government policy. It first reared its head under Margaret Thatcher and Ronald Reagan, both eager to break the Keynesian class compromise which emerged during the 1960/1970s. Critics are right to take Germany to task for its handling of the Eurozone crisis, but this has more to do with Germany following its national interests at the expense of European solidarity.

Finally, Anglo-Saxon neoliberalism of the 1970s is not synonymous with the neoliberalism of the 1930s. They emerged at different historical junctures with diametrically opposing views about the functioning of the political economy. This is all the more important considering that Anglo-Saxon neoliberalism, based on the self-regulating market and anti-state rhetoric, has ushered in an era of ‘turbo-capitalism’, ending in the biggest financial crash since the Great Depression. Even die-hard free-marketeers have come to realise that free-markets are not natural and self-regulating. Rather, in the language of ordoliberals, free markets are a political-cultural product based on a constitutional order that requires ‘cultivation’ for its maintenance and proper functioning (Vanberg 2015, Young 2015, 2015a).

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About the author

Brigitte Young is Professor Emeritus of International political economy at the Institute of Political Science, University of Münster, Germany. Her research areas include economic globalization, global governance, feminist economics, international trade, global financial market governance and monetary policy. She has worked on EU-US financial regulatory frameworks, European economic and monetary integration and heterodox economic theories. She is the author of many journal articles and books in English and German on the Global financial crisis of 2008–2009, the US Subprime mortgage crisis, the European sovereign-debt crisis, and the role of Germany and France in resolving the euro crisis.

She received the Käthe Leichter-State Prize of Austria for 2016 for her work on finance and gender equality.

4 The "Dark Ages of German macroeconomics" and other alleged shortfalls in German economic thought

Lars P. Feld, Ekkehard A. Köhler and Daniel Nientiedt[1]
University of Freiburg and Walter Eucken Institute

1 Introduction

The German approach to macroeconomics has recently been subject to debates. The first is the least controversial and concludes that German macroeconomics is in a good state regarding the quality of research.[2] .The second debate is devoted to the "ill-reputed" 'German approach' to macroeconomic policy.[3] This debate is far-ranging, rich in hyperbolism and poor in historical differentiation: Keynesian economists hold German ordoliberalism responsible for leading us into these "dark ages in German macroeconomics", denouncing this peculiar school of thought as "the wacky economics of Germany's parallel universe".[4]

What is true about such statements is that ordoliberalism originates from the Freiburg School of Economics, founded by Walter Eucken during the 1930s at the University of Freiburg, which is in fact in Germany. It is neither true that 'ordoliberal' thought prevails

1 We thank the participants of the Roundtable Discussion on 'Rules vs. Discretion: A Roundtable Dialogue on the Macro and Financial Economics of the Eurozone', September 12 – 13, 2016 at King's College, University of Cambridge (UK) and of the Workshop on 'Incompatible Economic Philosophies: German Ordo vs. U.S. Pragmatism', Center for European Studies, Harvard University (USA), April 24, 2017 for their comments and suggestions.

2 See https://www.socialpolitik.de/De/there-german-macroeconomics

3 See http://www.epc.eu/pub_details.php?cat_id=17&pub_id=6497

4 See https://next.ft.com/content/e257ed96-6b2c-11e4-be68-00144feabdc0

in German macroeconomic policy today nor that it is responsible for Germany's policy stance during the crisis in the Eurozone. In this chapter, we argue that the notion that Eucken's work holds the key to explaining the German position in the Eurozone crisis is not tenable.[5]

We first outline Eucken's approach and its embeddedness in the thinking of his time (Section 2). In Section 3, we emphasise the relation of ordoliberalism to the "Rules vs. Discretion" debate and to Constitutional Economics. An analysis of the role of ordoliberalism for the design of EZ as well as for the German policy stance during the Eurozone crisis in Section 4 is followed by some concluding remarks in Section 5.

2 The origins of the Freiburg School in the thinking of its time

At the centre of the debate is the question of to what extent Eucken was aware of the Keynesian paradigm. Eucken did not discuss Keynes and Keynesian thinking in detail. The General Theory was published in 1936, three years after the Nazis seized power. At this point, Germany was relatively isolated from the outside world. It was difficult for Eucken to follow international scientific debates and continue, e.g. his exchange of letters with Simons at the University of Chicago. This exchange influenced Eucken's rule-oriented thinking considerably (Köhler and Kolev 2013). The course of events eventually prohibited such contacts. Thus, some developments in economics since the mid-1930s simply passed Eucken by.

In the early 1940s, Eucken was occupied with other concerns, as he was in contact with the German resistance movement and questioned by the Gestapo after the failure of the plot of 20th July 1944 (Maier 2014). During the short time Eucken lived following the war, reconstruction had first priority. A main concern was the establishment of a free market economy – an effort that stood in contrast to both the war economy and the central planning of the Soviet-occupied zone. Eucken was in direct contact with Erhard; moreover, his student Leonhard Miksch drafted the *Leitsätzegesetz*, which abolished price controls and proved crucial for the German economic miracle (Feld and Köhler 2015). It was only after Eucken's death that Keynesian ideas became influential in Germany.

5 By doing this, we draw on previous work (Feld *et al*. 2015, Feld 2016, 2017).

Aside from historical considerations, Eucken was not generally opposed to expansionary fiscal policy. For example, he supported the ideas of German (Proto-)Keynesians during the Great Depression, as the discussion about the so-called Lautenbach plan illustrates (Lautenbach 1952, Borchardt and Schötz 1991). Lautenbach was a German Keynesian who advocated expansive fiscal policy financed by debt in order to overcome Germany's dire economic situation. Miksch noted in his diary that Eucken suggested that one should try the Lautenbach plan after all.

Eucken is sometimes mentioned in current discussions about macroeconomic policy because he was quite critical of full-employment policy as discussed after WWII (Eucken 1951). Eucken was afraid that such a policy would lead to a distortion of price signals (Eucken, 1952/2004, pp. 140-144). The functioning of the price system is the foundational – i.e. most important – principle in Eucken's system of constitutive principles of a competitive market economy (Eucken, 1952/2004, pp. 254-255).

Apart from the functioning of the price system, Eucken's constitutive principles also include open markets, private property, freedom of contract, the constancy of economic policy and particularly the "primacy of currency policy" and the principle of liability. The primacy of currency policy refers to the objective of maintaining price stability – not least because of Germany's experience with inflation and deflation. The principle of liability says that liability and control should be aligned: those who stand to profit from a particular action should also bear potential costs and risks. Both the primacy of currency policy and the principle of liability play an important part in today's discussion about the Eurozone crisis (Weidmann 2013). Still, it should be noted that Eucken himself opposed the concept of an independent German central bank. He supported the Chicago Plan and, thus, a 100% reserve currency system (Feld *et al*. 2015).

3 The development of ordoliberalism after Eucken's decease

German economists caught up with the international development of the discipline quickly after WWII. In the field of macroeconomics, German economists have both initiated new developments and influenced them (Issing and Wieland 2013).

Starting in the 1950s, Keynesian thinking was adopted very quickly in Germany. The year 1963 saw the creation of the German Council of Economic Experts (GCEE) as a child of Keynesianism (Sievert 2003). The GCEE Law contains price stability, a high level of employment, and steady and adequate growth, as well as external equilibrium, as four policy goals. This law was the first formal step in the direction of Keynesian economic policy, before Schiller tested countercyclical fiscal policy in 1966. Despite this Keynesian background, the work of the GCEE was influenced by ordoliberalism. It has aimed at finding rule-based policy solutions and arriving at explanations that provide for a microeconomic foundation of macroeconomic analysis (Sievert 2003).

The further adoption of international developments was often reminiscent of ordoliberalism, but it has mainly been the normal way that scientific progress moves across the world. This applies, for instance, to Monetarism or the theory of rational expectations. German speaking economists ensured the speedy reception of these ideas. It also applies to the so-called supply-side economics. In the mid-1970s, before the expression was coined in the US, this concept was introduced and elaborated upon by the GCEE (Sievert 1979). Still today, the concept plays an important role in its work.

It is interesting to note that Eucken's rule-oriented approach can be described by using the term "rules versus discretion". As was mentioned before, Simons (1934/1948, 1936) argued in favour of rule-based monetary policy. Rules help to contain time-inconsistent behaviour by decision makers. To date, this idea – associated with the works of Kydland and Prescott (1977), Barro and Gordon (1983) or Taylor (1993) – is well-established in macroeconomics. Buchanan's constitutional economics is another case in point. Thus, rule-orientation is not specifically German; also, the underlying idea of ordoliberal policy does not appear to be outdated.

4 Ordoliberalism and the European Monetary Union

The architecture of EZ, as laid out initially in the Maastricht Treaty, was much influenced by the rules versus discretion debate. EZ should provide a framework of rules that ensure time-consistent decisions by policymakers. The Maastricht criteria do not necessarily provide for an important element of that framework. The framework rather consists of the ban on monetary financing of fiscal policy and the no-bailout rule.

Both elements should ensure that each member state would be responsible for its own fiscal and economic policy. This also holds despite the Stability and Growth Pact (SGP), as member states have preserved their control over fiscal policy even in the excessive deficit procedure. The weakening of the SGP in 2003 and 2005 shows that member states could organise a silent majority that would not want to trigger the next step of the procedure proposed by the European Commission.

These elements of EZ are open to the interpretation that they are consistent with ordoliberal thought (Weidmann 2013). An independent central bank for which the mandate of price stability is dominant, and the no-bailout requirements that supposedly ensure an alignment of liability and control, are examples of how two of Eucken’s constitutive principles, the primacy of currency policy and the liability principle, are implemented.

Sievert (1993) was the most dedicated proponent of EZ following ordoliberal arguments. In EZ, monetary policy is denationalised in the sense that EZ member countries would have to pay their public debt by a currency they could not create individually. In essence, EZ offered the possibility of disciplining member states’ fiscal and economic policy. Member states need to converge to sound fiscal and economic policies supporting ECB’s monetary policy, as in other international monetary arrangements like the Gold standard or the Bretton Woods system. Financial markets provide for the disciplining device.

Interpreting EZ from an ordoliberal perspective neglects, however, the fact that other member countries of EZ had quite different objectives (James 2012, Brunnermeier *et al.* 2016). Moreover, the theory of optimum currency areas (OCA) could similarly well provide the insight as to how adjustment in a monetary union should take place (Mundell 1961).

That ordoliberalism plays a role for German policy during the Eurozone crisis holds at best in singular policy dimensions. Particularly regarding banking union, the liability principle guided German positions. Schäfer (2016) demonstrates this by digging deeply into documents, protocols and press releases. The German government adopted this position, however, only after it had bailed out German banks during the financial crisis.

In other respects, pragmatism and national interests characterise German policy during the Eurozone crisis more strongly. Evidence for pragmatism are the Greek rescue packages and the acceptance of the ECB's monetary policy. Regarding Greece, the German government not only endorsed three different programmes, although the discussions in public were extremely critical (Sinn 2014). It also even remained engaged after the Greek government reneged on the agreed adjustment programme (GCEE 2015). Regarding monetary policy of the ECB, it defended the Outright Monetary Transactions (OMT) at the Federal Constitutional Court against several complaints, although this programme interferes with the fiscal policies of member states (Kronberger Kreis 2016). The German government still supports the monetary policy of the ECB and respects its decisions about Quantitative Easing (QE), although monetary conduct is too expansionary for Germany and induces misallocations.

Evidence that German national interests play a role exists mainly in the area of fiscal policy. German governments have consistently rejected any proposal for mutualisation of government debt. The government obviously fears that it will finally be liable for public debt of other member states. In the discussions about the creation of a fiscal capacity at the EU level, the government has rejected everything to date. It is still reluctant to accept proposals for a fiscal backstop to the Single Resolution Fund (SRF). In these cases, the liability principle might provide an argument for the German government, but it certainly aims at sheltering its national financial position.

5 What can we expect?

Overall, government policy during the Great Recession and the Eurozone crisis in Germany is not dominated by ordoliberalism. During the Great Recession, e.g. the German government bailed out its banks in order to avoid a meltdown of the financial system, just like other countries, in particular the United States did. Similarly, Germany conducted expansionary fiscal policy during the years 2008 and 2009, e.g. a cash-for-clunkers scheme, in addition to the automatic stabilisers that are much higher than in the US. During the Eurozone crisis, Germany showed its pragmatism in several respects, mainly regarding monetary policy or the Greek rescue packages, but also the ESM. Even in the case of banking union, most closely related to ordoliberal thinking, Germany finally accepted several pragmatic compromises (Schäfer 2016).

Against this background, it can be expected that the responsibility for fiscal and economic policy in the Eurozone will largely remain in the autonomy and responsibility of member states. German governments will continue to be reluctant to accept any mutualisation of government debt or any notable fiscal capacity at the EU level. Recent German proposals to develop the ESM to a European Monetary Fund mainly aim at ensuring a stronger compliance with fiscal rules and establishing a restructuring mechanism (Andritzky *et al*. 2016). Moreover, the doom loop between banks and sovereigns should be weakened by de-privileging government debt. Government bonds and other loans to governments should be risk-weighted and there should be large exposure limits to sovereigns. This would certainly have effects on German banks and jurisdictions as well, but it would enhance the credibility of the no-bailout clause (Feld *et al*. 2016).

Ordoliberalism influences German macroeconomists very little. It may have played a stronger role in previous times, but these times are long gone. Perhaps economic policy in Germany emphasises rules more strongly in the rules versus discretion debate than that of other countries would (Brunnermeier *et al*. 2016). However, as economic policy in the past illustrates, Germany easily deviates from such rule-guided behaviour whenever national interests or particular political considerations become dominant. Wasn't it Germany that did not comply with the SGP? Finally, German economic policy is as pragmatic as US economic policy.

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About the authors

Lars P. Feld has held a Chair of Economics, in particular Economic Policy, at Albert-Ludwigs-University of Freiburg since 2010 and is the current Director of the Walter Eucken Institute. After his studies in Economics Lars P. Feld graduated from University of St. Gallen in 1999 and qualified for a professorship in 2002. From 2002 to 2006, he worked as a Professor of Economics, with a focus on public finance, at Philipps-University Marburg, and from 2006 to 2010 at the Ruprecht-Karls-University Heidelberg. He is a permanent Guest Professor at the Center for European Economic Research (ZEW) in Mannheim, as well as a member of Leopoldina (the German National Academy of Sciences), the Kronberger Kreis - scientific council of the think tank Stiftung Marktwirtschaft -, and the Mont Pelerin Society. Since 2003, Lars P. Feld has been a member of the Scientific Advisory Council to the Federal Ministry of Finance and, since 2011, a member of the German Council of Economic Experts (GCEE). He currently represents the GCEE in the Independent Advisory Council of the Stability Council, Germany's construction of a fiscal council. His research interests and publications are in several fields of public economics, economic policy, political economics and law and economics.

Ekkehard A. Köhler is Executive Research Assistant at the Walter Eucken Institute, Freiburg. He is currently on leave, visiting the University of Southern California Marshall School of Business, Finance and Economics Department. His work is at the intersection of finance and political economy, focusing on how interventions and policy reforms affect decision making and markets. Ekkehard received is PhD from the University of Freiburg, spending part of his doctoral studies visiting the Paris School of Economics. He is a Postdoc of the University of Freiburg.

Daniel Nientiedt is Research Assistant, Walter Eucken Institute and University of FreiburgDaniel Nientiedt is a Ph.D. candidate in economics at the University of Freiburg (Germany). He is currently working as a research assistant at the Walter Eucken Institute and as a lecturer at the Institute for the International Education of Students, both in Freiburg. His research interests include public choice, constitutional economics and the history of economic thought.

5 Ordnungsökonomik or Teutonomik?

Michael C. Burda
Humboldt-Universität zu Berlin[1]

1 Introduction

Recent events inside and outside Europe are once again raising questions about economics and economists in Germany. Public discussion has focused on *Ordnungsökonomik* – literally, "the economics of order" – almost as a caricature of German economic thought.[2] Do German economists really live in a different universe, harping on non-existent problems, endorsing austerity at the wrong time, and committing the fallacy of composition at every opportunity? In this essay, I argue that their positions – especially those criticised in the European debate – are more a reflection of national interests in a very crowded and polarised continent than some obscure economic religion or sect. In particular, there is nothing special about German economics, and there is certainly nothing special about *Ordnungökonomik*. German economics is nothing more than a reflection of German national interests, for better or worse.

1 This essay contains ideas from my "Letter from Germany" in the Royal Economic Society Newsletter, July 2015 and "German macroeconomics or German macroeconomists?" in Bratsiotis and Cobham (2017). I am grateful to Wolfgang Franz, Christoph Schmidt, Lars Feld, Volker Wieland, and Charles Wyplosz for discussions.

2 Without implication: "Of Rules and Order" in the *Economist* 9 May 2015. 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 putatively deranged Teutonic world views. For an overview of "German macroeconomics" see Bratsiotis and Cobham (2017)

2 Debunking three myths

Myth #1: German economists fundamentally reject Keynesian ideas

This is nonsense. The importance of aggregate demand for short-run output determination is standard, not only in courses taught by me in Berlin, but in those taught by all colleagues I know who teach macro. Keynesian ideas have been around in Germany for a long time – even before Keynes, if one considers the imaginative policy responses considered in the late Weimar Republic. The Nazis were out front implementing Keynesian policy in the years before WWII – see Keynes's ignominious preface to the first German edition of the *General Theory*. During the post-war reconstruction, Economics Minister Karl Schiller considered *Globalsteuerung* (aggregate demand management) crucial for managing trade-offs between growth, inflation, unemployment and the current-account balance. The *Stabilitätsgesetz* of 1967 explicitly authorises those demand policies that Germany employed to react to the Great Recession, in coordination with its EU partners.

Resistance to expansive aggregate demand policies is better explained by national interests than by ordoliberalism. The Anglo-Saxon view of Germany's role in the global economy is highly exaggerated. An all-out Keynesian pump-priming binge in Germany – at 4.9% of world GDP and 22% of EU Europe – would surely reduce its own current account surplus, but hardly influence global or EU aggregate demand. Furthermore, Germany is an open economy – the sum of exports and imports is about 90% of GDP compared with 55-65% for Italy, Spain, France and the UK. For those who can still remember, the old-fashioned multiplier is inversely related to the marginal propensity to import and standard Keynesian analysis suggests little domestic benefit from aggregate demand policy. It is hardly reasonable to expect any country to engage in aggregate demand policy for the benefit of others, if domestic voters are not convinced of their own welfare gains. Modern macroeconomists reject hydraulic Keynesian views of the world in which prices are constant and consumers mechanically spend a constant fraction of their income. A more nuanced perspective sees income-constrained households as critical for the multiplier – it is implausible that all, or even half, of highly banked German households consume disposable income hand-to-mouth.

While our profession is in unusual agreement that fiscal policy is effective at the zero lower bound, this applies only to closed economies and only as long as the good faith and credit of borrowing countries remains intact.

Myth #2: German economists are priests of 'ordoliberalism' and supply-side policies

Many articles I cite in the introduction disparage 'ordoliberalism'. ordoliberalism is "a liberal (i.e. free market) regime with relatively stable rules to control the excesses of unbridled capitalism" (Wikipedia). Allegedly, it stems from the rejection of national socialism and embodies ideas of Hayek, in particular a strong preference for decentralised market outcomes over state planning; rule of law provides a stable backdrop for competition to develop its positive effects. Going after antitrust 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 wonderful, it hardly represents science based on mainstream methods of our field. *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 could be described as a strong policy preference, perhaps even elevated to the status of religion. I have yet, however, to see a serious analysis of welfare effects of an ordoliberal regime.

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 shows 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 following unification, Germany suffered enormous losses of competitiveness and was the sick man of Europe; inflation had raised nominal wages while European integration had reduced prices of foreign goods. Paying for unification using the back door of social security contributions led to elevated payroll taxes and distorted labour markets. Germany's labour market reforms, now touted as a model for other European countries,

took at least half a decade to work. It is easy to see why Germans have little patience for short-term views of the world and tend to think in terms of chains of Keynesian short runs, which eventually need to find consistency with long-run policy objectives. It is interesting to observe a lively discussion currently underway in Germany, led by Carl Christian von Weizsäcker and Marcel Fratzscher, who endorse taking advantage of low interest rates and investing in infrastructure, with both short-run Keynesian and long-term supply-side gains.

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

There is no doubt that German economists tend to harp on moral hazard and austerity when discussing European fiscal policy and fiscal union, and German interests are certainly aligned with finding sustainable solutions to southern European fiscal problems. Sometimes the judgments are lopsided, however. Moral hazard implicates not only profligate borrowing by periphery countries, but also poor due diligence by northern European creditors (German banks). In principle, governments should practise austerity in good times, not bad, and austerity is needed not only to service the debt, but also to accelerate internal depreciation and restoration of competitiveness. Both France and Germany famously failed to impose stability rules and sanctions on themselves in 2003, after insisting, in the Maastricht Treaty, on tough membership criteria for monetary union as well as "no bailout". A Germany that fails to pursue austerity risks losing all credibility on fiscal discipline in the monetary union.

Given the history of Greece and other countries, German scepticism also originates in fundamental mistrust. To the extent that policymaking is the product of the interactions of hard-nosed politicians and policymakers, positive analyses of economic policy yield high returns. For this reason, German economists certainly take a much more cynical view of policy and political economy than those in the Anglo-Saxon sphere. When I first came to Berlin in the early 1990s, the discussion surrounding the Eurozone project was uniformly sceptical. In contrast to the discussion in the US and the UK, the predominant view was that politicians respond to short-term national and political incentives, not to what our models predict for policy in a vacuum. In view of current events, the sceptics turned out to be right.

Germans have intimate understanding of the political economy of moral hazard, based on first-hand experience. Unlike their US counterparts, the German states (*Bundesländer*) are jointly and severally liable for each other's debt; predictably, smaller states have allowed their debt to soar since the 1980s in the aftermath of structural decline and in spite of countless promises to balance budgets. Bremen's debt per capita rose from about €5000 in 1980 to €30000 in 2015; in Saarland, it leapt from €1600 per capita to almost €14000 (for Germany in the same period, debt per capita increased by 'only' 200%). Twenty-five years after reunification, East Germany is still on the subsidy drip. While it appears plausible and perhaps unavoidable to bail out Bremen, Saarland (or Berlin), doing the same for 10 million Greeks is another question – and which country is next? Under such circumstances, moral hazard becomes a categorical imperative.

3 The Sachverständigenrat, positive economics and normative recommendations

The debate regarding German economics arose over a number of tussles with the international community, led, but not exclusively represented, by the country's Council of Economic Advisors or *Sachverständigenrat*. Members of the Council are serious economists who publish in academic journals, are members of respectable international scholarly associations, and use the same tools as other economists around the world. These 'wise men' provide independent and sometimes unwanted advice to the government in the form of an annual report. While they are not partisan advocates of government policy, they base their recommendations on national interests. Members of the council are nominated by sitting governments after consulting with corporatist entities – labour unions, employers' associations, finance. 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 might deny it, it is improbable that a member appointed on a 'trade union ticket' would criticise the minimum wage, just as it would be improbable if a member endorsed by the employers came out in favour of a wealth tax.

For better or for worse, Council members are more likely to be nominated for their normative leanings than their positive economic prowess.[3]

Here lies the problem. Lionel Robbins' famously enjoined economists 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 ironic that the original law that created the *Sachverständigenrat* in 1963 tasked its members with impartial economic assessment and analysis, rather than specific policy proposals or recommendations.[4] In practice, the Council frequently issues normative judgments that often contradict government positions, not to speak of those 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 recommendations to reflect a national perspective, especially when national taxpayers are on the hook.

3 In the Council's enabling legislation (*Gesetz über die Bildung eines Sachverständigenrates zur Begutachtung der gesamtwirtschaftlichen Entwicklung* 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.

4 "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, *should nevertheless make no recommendations for particular economic and social policy measures*.") *Gesetz über die Bildung eines Sachverständigenrates zur Begutachtung der Gesamtwirtschaftlichen Entwicklung* (1963) §2 (my emphasis).

Rather than shills or lobbyists for government policies, the Council of Economic Experts is supposed to assess the state of the economy and make recommendations in the interest of the nation's economic well-being. Living in Germany for 25 years, I have observed an increasing tendency for the Council to issue policy recommendations and even criticise sitting governments. Increasingly, they perceive their job as the promotion of national economic interests, rather than a pure positivistic evaluation of where the economy is going and what particular policies might accomplish. I suspect that this alone would be uninteresting and significantly less glamorous, and it is not surprising that the Council has moved beyond its narrow writ, landing in the trenches of politics.[5]

4 Conclusion: Ordnungsökonomik or Teutonomik?

Some see national economic policy, to paraphrase Clausewitz, as war by other means. Public statements of German economists, especially those in the Council of Economic Experts, represent projections of national interests and may contribute to this impression. Because some German academics find it difficult to separate the normative from the positive, patriotism can look like bad economics from an external perspective. Yet it is wrong, and possibly disingenuous to implicate the belief system of a country's economists when one disagrees with their government's policies. This applies in particular to *Ordnungsökonomik*, which never really took off as a field but finds support in the writings of Hayek, von Mises, and Friedman as well as Barro, Gordon, Phelps, Kydland and Prescott.

While the importance of rule of law, economic dynamism, competition, and rules-over-discretion are well-established, their pre-eminence in German policy is greatly exaggerated. *Ordnungsökonomik* was surely vital for the establishment of free markets after the WWII and correctly stresses the central role of law and order for the capitalist system, but it has hardly found its way into the economic mainstream. National self-interest and healthy mistrust informed by experience rather than ordo-liberal religion are more likely to explain the behaviour of Germany and its prominent economists. *Teutonomik* trumps *Ordnungsökonomik*.

5 In 2003, I declined an invitation to serve on the Council on the 'industry ticket' when it became clear to me that expectations might compromise my independence and my own personal research objectives. Although I turned down a considerable amount of professional prestige, I never regretted that decision.

Germany, like the UK, it is part of a mosaic of self-interested sovereign nations that is Europe, each with its own history of "long-standing animosities based on history, nationality, and religion" (Feldstein 1997). In the end, German economists will tend to endorse economic views that serve Germany's own self-interests, just as some UK economists have come to think less negatively (!) about Brexit, or Irish and Dutch economists might rationalise low tax corporate rates, or the US economists judge an interest rate rise by the Fed in the future. If it is to succeed, the European project needs to redouble its efforts in those areas where national interests are aligned, and leave the difficult rest for future generations to sort out.

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About the author

Michael Burda is Professor of Economics at Humboldt University of Berlin. He previously taught at INSEAD and Berkeley. His research centers on macroeconomics, labour economics and the economics of European integration. With Charles Wyplosz, he is the author of the textbook Macroeconomics: A European Text (Oxford University Press), which is now in sixth edition and has been translated into twelve other languages. He has published papers on the economic origins and impacts of labour market institutions, economic integration, employment and wages, and globalisation, as well as the transformation of Central and Eastern Europe and the former German Democratic Republic. In 1998, he received the Gossen Prize of the Verein für Socialpolitik. He received his BA, MA and PhD (1987) at Harvard. From 2011-2014 he served as President of the Verein für Socialpolitik, the professional association of economists in Germany, Austria, and Switzerland.

6 Don't shoot the messenger: About the diversity of economic policy conclusions in the face of severe identification issues

Christoph M. Schmidt
RWI – Leibniz-Institute for Economic Research, German Council of Economic Experts (GCEE), Ruhr-University Bochum (RUB), and CEPR[1]

Views on how to pursue the process of European integration widely diverge. The disagreements over the necessity of an alignment of liability and control, the importance of adherence to fiscal rules, and the priorities to be set in crisis management have all become highly transparent since the Eurozone slid into an existential crisis, starting with the Greek debt crisis of 2010. The dispute manifests itself most prominently in the conflicting positions taken by the member states of the Eurozone, with the German government being an important and, at the same time, perhaps the most intensely criticised protagonist. While crisis management required them to act pragmatically, German officials are notorious for their insistence on compliance to rules.

The adamant positions taken by the German government have even led to the narrative that the institutionalised economic policy advice in Germany might be to blame. It is often alleged to operate out of synch with the development of the field of economics, being non-empirical and wed to the ideas of the orthodox school of thought of ordoliberalism. The focus of this harsh criticism often lies on Germany's most important institution for providing economic policy advice, the German Council of Economic Experts (GCEE). This narrative, however, goes completely astray. Empirical evidence and an intense discourse over conflicting arguments raised in the current economic literature lie at the heart of its work, not an ideological blueprint.

1 I'm grateful to Sebastian Breuer, Wim Kösters, and Benjamin Weigert for their constructive comments.

1 The controversy: Are German economists wired differently?

Throughout its existence as Germany's most important advisory body for economic policy advice, the German Council of Economic Experts (GCEE) has become used to receiving a lot of partisan criticism. By frankly voicing the conclusions of its analyses and ensuing reform proposals in the public arena, irrespective of the current political mood and sometimes to the detriment of massive economic or ideological interests, the GCEE frequently enrages powerful political and economic actors. To be such a critical, constructive and independent voice, though, is nothing less than its statutory mandate, which stipulates that the GCEE should be a critical economic policy companion to every German federal government, and not a direct government advisor.

The relevant criterion for judging whether this mission has been accomplished has never been its congruence with current government policy or with a particular economic school of thought. Rather, its statutory mandate implies that the GCEE should provide a balanced expert opinion of current macroeconomic developments based on economic reasoning, reflecting the inherent uncertainty regarding these matters wherever this is appropriate. While expert knowledge certainly needs to rest on a thorough understanding of the current state of the art in economics, this mandate also recognises that, despite a common academic and informational basis, there typically cannot be an unequivocal perspective on matters of economic policy.

In recent years, the GCEE's annual reports have placed increasing emphasis on the discussion of issues pertaining to the European realm. It regularly comments on the monetary policy conducted by the European Central Bank (ECB), it contributed extensively to discussions of rescue policy measures throughout the crisis of the Eurozone, and it provided concepts for fortifying the architecture of the Eurozone and the European Union. While it was, in many respects, in agreement with the German government on these matters, other arguments fell on less fertile ground in the political realm, such as the European Redemption Pact (Schmidt and Weigert 2013) or the suggestion to integrate domestic climate policy more deeply in a joint European approach.

Quite interestingly, and obviously feeding on a deep frustration with the decisions of the German government on European issues, new critics of the GCEE's work have emerged on the European level. Even such a renowned newspaper as the *Economist* has alleged that economic orthodoxy in the GCEE has to be blamed for misguided German policymaking (*Economist* 2013, 2015). It is true that academic economics in Germany was for a long time essentially non-empirical, although this was never a uniform affair.[2] Today though, the situation has changed drastically. German economists contribute to the academic literature and participate in learned societies to quite a similar extent as their international peers.

Insinuations that the GCEE is adamantly and irrespective of the circumstances opposed to debt of any kind, expansionary monetary policy or any Keynesian argument whatsoever (*Economist* 2015), are simply misguided. Nor do members of the GCEE sit at a round table, wearing black gowns and reading in awe from first editions of Hayek's works. Instead, the GCEE rather relies on advances in the economic literature and on the results of empirical research in a quest to balance all the relevant arguments, regarding, for instance, appropriate debt ratios or the ideal stance of monetary policy. That this search might lead to conclusions which differ from those favoured by "hydraulic" Keynesian economists, should hardly be taken as evidence for a decoupling from state-of-the-art economic research (Burda 2015).

2 The GCEE: A very special beast

The way in which economic policy advice is organised differs starkly between countries. The United States' Council of Economic Advisors (CEA) marks one polar approach, with a tight relationship to the current federal administration. Its task has traditionally been the design of economic policy as well as its communication, and it typically leaves office as the current President is ending his term. The other pole is occupied by the GCEE which is a group of economic researchers acting independently of the current government, with a mandate to provide Germany's policymakers and the general public with advice on a wide range of questions of economic policy (Schmidt 2016b).

2 The domestic controversy about the role of empirical analysis in the social sciences even reaches back to the 19th century (aus dem Moore and Schmidt 2013).

To fulfil this mandate, the GCEE has the legal obligation to submit an annual report on macroeconomic development, “to assist all authorities responsible for economic policy as well as the general public in forming a sound opinion”. Thus, the GCEE comments on the design and implementation of economic policy but does not actively design or conduct economic policy itself. Rather, its annual report has been serving as an anchor for the budgetary planning and forecasting of administrations and enterprises, as a principal source of information regarding the state of the economy and the effects of policy interventions, and, more generally, as an inspiration for the public discourse on economic policy in Germany and at the European level.

Being a critical, yet constructive voice in the economic policy arena is enshrined in the GCEE’s legal mandate and process. The law stipulates that four macroeconomic objectives – stability of the price level, a high rate of employment and equilibrium in foreign trade and payments, together with steady and adequate economic growth – should serve as a guideline for its work. Yet, the GCEE is free in determining how to weigh these objectives, in identifying undesirable developments, and in considering possible improvements to economic policy. It is “only bound by the mandate set forth in this law; it is independent in the performance of its work”, and its members remain in office for their respective turn, irrespective of any changes in the government.

Several mechanisms ascertain the scientific underpinning of the GCEE’s analyses. The law stipulates that its members should “possess a specialised knowledge of economic science and be experienced in matters of economic policy”. As the GCEE’s reputation rests on the academic standing of its members, they should have published extensively in refereed international journals. Schmidt *et al*. (2013) document, for instance, that their publication record beats that of their most vocal domestic critics in the academic realm hands down. Moreover, appointment to the GCEE is only ever a temporary affair, which typically ends after two five-year spells. Throughout, GCEE members retain their full-time position at universities or research institutes and, thus, remain embedded in the academic community.

The GCEE draws on the latest economic literature when preparing the annual report, and also conducts its own empirical analyses, based on macroeconomic data or individual-level survey data. Quite frequently, it commissions additional empirical analyses in collaboration with external economists who are particularly knowledgeable in a specialised field of application. Finally, all reports and background papers written

by the GCEE are published at the same time as they are handed over to the government, opening up all arguments for public scrutiny. All tables and graphs in these reports are published together with the underlying data, allowing fellow academics and the general public to probe the accuracy of the GCEE’s statements.

3 Different modes of policy advice, one unified science

While the different modes of organisation of economic policy advice might all have their advantages and disadvantages, this heterogeneity is nevertheless remarkable. After all, academic research in economics is conducted in an integrated world market. Although, in the past, many German economists tended to be hesitant to embrace empirical economic research, it would be incorrect to presume that different modes of organisation reflect different awareness of the state of modern economics. In fact, supported by its institutionalised independence, the GCEE is adamantly providing evidence-based policy advice. That is, respect for empirical evidence and careful reasoning regarding its specific applicability are at the heart of its work.

Anything else would be quite disconcerting, especially since the potential of economic research has grown considerably, facilitating the accurate assessment of economic policy and the provision of policy advice which is substantiated by empirical evidence (Schmidt 2007). Among the most important advances in the field of economics during the last few decades have been the emergence of systematic policy evaluation and – in close correspondence with this progress – a growing awareness of the pitfalls associated with inadequate empirical research strategies. The focus of these methodological advances has fallen on the establishment of causality – and the root of good economic policy is a solid understanding of causal mechanisms.

When it comes to establishing the causal effects of policy interventions, researchers need to isolate the effects of the policy intervention under study, to the best extent possible, from the impact of all other aspects of the economic environment. Applied research in economics has made tremendous progress in dealing with this problem of identification (Manski 1995). Yet, this objective must be pursued in a real-life context, outside of the perfectly controlled laboratory environment which natural scientists have grown accustomed to.

Most importantly, the objects of scientific interest to economists typically exert influence on their treatment status under the policy to be evaluated, and on their own economic outcomes.

Consequently, while one might be able to devise an appropriate study design to emulate the analytically desired but practically impossible randomised controlled trial, there will be insurmountable limits to observability which prevent us from ever learning causal mechanisms with certainty. In particular, it will be inherently impossible to observe economic actors in different states of the world, with and without the intervention under study, a problem which arises irrespective of sample size. Therefore, researchers need to formulate identification assumptions which facilitate treating observations as comparable to one another for analytical purposes. Naturally, there is always a danger that such assumptions are incorrect.

This problem tends to be less relevant when analysing a relatively small intervention in an otherwise undisturbed environment. It is highly virulent, though, when analysing large-scale interventions or when addressing the economic development of whole economies. Thus, macroeconomic analysis tends to require particularly strict identification assumptions. Typically, these assumptions are embedded within highly stylised quantitative models. Conclusions drawn from them are therefore subject to two distinct margins of error: the residual uncertainty due to limited sample size within the confines of the model, and a possible inadequacy of the model specification.

4 General implications for economic policy advice

Genuine evidence-based policy advice should therefore breathe a spirit of modesty. Humility should prevail, for instance, when using a cross-section sample of economies to analyse the effects of institutional arrangements. Linear regression models are powerful descriptive devices which highlight the association of outcome variables with other factors. This is a far cry from establishing a causal link, though. It might be tempting to use the estimated model as a basis for counterfactual simulations, but one should think carefully about deriving any causal statements from this. For the illustrative case of the inequality-growth nexus, the associated pitfalls were documented in GCEE (2015b: 237-238).

Another case in point is the distinction of cyclical fluctuations from the underlying trend. For macroeconomic policy, this distinction is far from innocuous. After all, if an observed decline in economic activity reflects a temporary disturbance, leaving the genuine capacity to produce economic output intact, policymakers might ponder measures to stabilise the economy. If, instead, the economy’s growth path is impaired, the appropriate reaction would be to conduct structural reforms to rectify these impairments. Stabilisation measures might even be counterproductive. Yet, any dissection of observed economic activity in a trend and a cyclical component necessitates strong identification assumptions, particularly when using real-time data.

The analysis of real-time data is exactly the task of advisory bodies such as the CEA or the GCEE. These institutions should, therefore, not only know how to use empirical research to gain insights on adequate empirical analogies to the situation at hand. They should also be aware of the limits to the conclusions which could be confidently drawn from the available data. Severe identification problems specifically plague the analysis of recent economic developments in the Eurozone. The more one doubts that pre-crisis trends provide a reliable guideline for the genuine growth potential of member states such as Greece, the less convincing are calls for the exclusive stabilisation of aggregate demand and the more structural reforms move into focus (Schmidt 2016a).

Furthermore, any statement about the presumed effects of austerity policy on member states’ economic outcomes during and after the crisis needs to rely on an identification assumption regarding the counterfactual development under a different set of policies. A simple extrapolation of pre-crisis trends will certainly be an inadequate approach, yet this seems to be employed implicitly by many commentators. Instead of displaying indignation about a different interpretation of the data, the debate should be about the identification assumptions generating this deviation. In the example of the Greek economy, it seems difficult to argue that its pre-crisis trend could serve as a reliable anchor for analysing the effects of adjustment programmes.

5 Implications for policy advice on the Eurozone

Evidence-based policy advice is tantamount to a confession of imperfect knowledge. This does not at all imply that economic policy advice should renounce the use of empirical research. To the contrary, it is the awareness of the limits and pitfalls of modern-day empirical tools which enables policy advisors to provide solid advice. Since one must abandon the hope of finding the ultimate model which would give a reliable answer to all questions, and since often a direct precedent is lacking, the best approach is to search for empirical evidence which facilitates conclusions by analogy, and to carefully consider which identification assumptions will be required to sustain these conclusions. This is exactly how the GCEE approaches the discussion of the future of the Eurozone.

There is certainly no direct precedent for a monetary union under crisis in the modern era of dominant financial markets, where responsibility for fiscal policy rests with individual member states and where conflicting visions for the future path of European integration prevail. Nevertheless, one might derive important insights, for instance, on the possible effects of fiscal risk-sharing, by observing the development of the indebtedness of the German Länder. This experience cautions us that risk-sharing covenants might be mutating into arrangements of organised irresponsibility. Yet, it would be difficult to argue that risk sharing will always tend to lead to dismal outcomes, quite obviously, the precise conditions for failure need to be understood.

To rest its assessments of such matters on a broad empirical basis, the GCEE draws, for instance, on estimates of equilibrium real interest rates (Beyer and Wieland 2017, GCEE 2016: 204-206), on descriptive analyses of the sovereign-bank nexus (Schnabel and Schüwer 2016; GCEE, 2016: 267-270), or on evaluation studies regarding the effectiveness of EU structural funding on regional development and convergence (Breidenbach *et al*. 2016, GCEE 2016: 169-170) As a general tendency, though, the more deeply the questions asked penetrate unchartered territory, the less one might be able to rely on empirical evidence to draw conclusions by analogy, and the more one has to resort to economic reasoning based on first principles.

Along these lines, throughout the Eurozone crisis the GCEE has consistently advocated a perspective which combines short-term crisis relief with fostering long-term stability.

This consideration lies behind its insistence on compliance with the terms of the rescue packages for Greece and its refusal to consider further haircuts for Greek debt (Feld *et al*. 2015a, Schmidt 2015). It also provides the background for its emphasis on the urgency of structural reforms in Eurozone member states (Constâncio *et al*. 2015, Schmidt 2015). In its discussions of possible routes which could be taken to ascertain the sustainability of the Eurozone, the GCEE consistently emphasises three principles:

- Unity in diversity: the central strength of the European project is that it unites its member states in pursuit of peace and prosperity. However, this requires a rich reservoir of ideas, not a single, unified approach.
- Subsidiarity: decision-making should be decentralised whenever possible, to ensure that local and regional preferences are considered alongside the effects of Eurozone-wide harmonisation and economies of scale.
- Alignment of responsibility and control: ensuring that decision-makers are accountable for the outcomes of their decisions, prohibiting shared liability so long as fiscal sovereignty is retained at the national level.

Relying on such principles in its reasoning, the GCEE devised the concept of Maastricht 2.0 as a coherent concept for a sustainable Eurozone (GCEE 2015a, Feld *et al*. 2015b, 2016a, 2016b, and 2016c).

An important element of this overarching concept is the implementation of a mechanism to restructure sovereign debt (Andritzky *et al*. 2016a). This proposal can serve as an illustrative example for the GCEE’s careful considerations regarding the question of how transition to the new architecture could be organised, in the face of severe legacy problems, by a well-defined phasing-in of the new elements. Finally, under the impression of the Brexit vote, the GCEE suggested a way forward for European integration, adhering to the same first principles (Andritzky *et al*. 2016b, Schmidt 2017). Instead of weaving a fruitless narrative about their ordoliberal roots, commentators should rather grapple with the arguments provided in these contributions.

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About the author

Christoph M. Schmidt, born in 1962, studied economics at the University of Mannheim, Germany, where he received his degree as Diplom-Volkswirt in 1987, at Princeton University, where he received his M.A. in 1989 and his Ph.D. in 1991, and at the University of Munich, where he received the degree of Dr. rer. pol. habil. in 1995. From 1995 to 2002 he taught Econometrics and Labour Economics as a Full Professor at the University of Heidelberg. Since 2002 he has been President of the RWI – Leibniz Institute for Economic Research, Essen and Professor at Ruhr–Universität Bochum. Since 2009 he has been member of the German Council of Economic Experts (GCEE), since 2013 its Chairman. From 2011 to 2013 he was a member of the Enquete–Commission "Wachstum, Wohlstand, Lebensqualität" ("Growth, Welfare, Quality of Live") of the German Bundestag, since June 2011 he has been member of acatech – Deutsche Akademie der Technikwissenschaften, and since 2014 a member of its executive board.

Schmidt was awarded a Princeton University Fellowship, 1987-1990, the Alfred P. Sloan Doctoral Dissertation Fellowship, 1990-1991, and was a Fellow of the Deutsche Forschungsgemeinschaft (DFG) 1992-1995. Since 1992, he has been a Research Affiliate of the Centre for Economic Policy Research (CEPR), London, since 1996 a CEPR Research Fellow, and since 1998 he is also a Research Fellow at the Institute for the Study of Labor (IZA), Bonn.

He served as an Editor of the *German Economic Review* and of the *Journal of Population Economics*. He has published articles in journals such as the *Review of Economics and Statistics*, the *Journal of Public Economics*, and the *European Economic Review*.

I Ordoliberalism and crisis resolution

7 Unconventional measures – a case of realpolitik?

Peter Praet
Member of the Executive Board of the ECB[1]

Introduction

In the wake of the economic fallout from the global financial crisis, the ECB, like other central banks, has deployed novel policy instruments on a grand scale. By extending credit to banks and purchasing assets (in the sovereign space, in particular) it has expanded its balance sheet to an unprecedented size, and it has also introduced negative interest rates on reserves.

Over the years, the effectiveness of these measures in supporting financial conditions and boosting credit, in pursuit of price stability in the face of dire economic and financial circumstances, has been consistently praised by a succession of academic observers and international agencies, such as the IMF and the OECD.[2] However, as was to be expected, these unconventional measures also sparked some criticism. Concerns about the ECB overreaching its mandate[3] were, in some quarters, accentuated by concrete fears that monetary policy would end up supporting weak fiscal positions, propping up failing banks or undermining market discipline. Specifically, central bank purchases of sovereign bonds were seen as forsaking central bank independence and ultimately paving the way for inflation (Issing 2016a, 2016b, Uhlig 2013).

1 I would like to thank Claus Brand for his support in the preparation of this article.

2 See the IMF Staff Reports for the annual Article IV consultations and the OECD's regular economic surveys of the Eurozone

3 See Buiter (2016), Haan and Eijffinger (2017)

Other observers have characterised the ECB's policies as pragmatic *realpolitik*, whereby policy choices traded off principles against pragmatism, or rules against discretion. One such *realpolitik* narrative has it that events forced the hand of the ECB, as it was the only institution capable of acting; a doubtful choice perhaps, but better than the alternative of potentially allowing the Economic and Monetary Union (EMU) to collapse.

The legacy of German ordoliberalism appears to have strongly influenced the critique of ECB measures among German economists. The Ordo School rightly places great emphasis on the need for a central bank's mandate to be as narrow as possible and for policy to be principles and rules-based – if not rule-constrained. However, a departure from the use of conventional policy instruments does not mean that principles have been sacrificed. Nor does it seem helpful to conceive of the ECB's policy choices as having involved a trade-off between conflicting objectives or between principles and pragmatism. The objectives and safeguards (i.e. principles) of the novel measures do not lend themselves to such simple assessment.

This contribution argues that the principles governing the ECB's novel policy instruments are built on a clear hierarchy, in which monetary policy objectives take precedence over other public policy objectives, pretty much in line with ordoliberal doctrine. I shall begin with a critical assessment of the principles laid down by ordoliberalism.

The role of monetary policy

The influence of ordo economics on Germany's post-war economic order, its social market economy and monetary stability, can hardly be exaggerated. In his work *Grundsätze der Wirtschaftspolitik* (Principles of Economic Policy), published posthumously in 1952, Walter Eucken laid the basis for a consensus on the role of monetary policy, which crystallised only decades later, after Milton Friedman had popularised the quantity theory of money. Eucken's central ideas are fully consistent with the foundations of modern central banking.

First, in what he called "the primacy of monetary policy", he stressed the utmost importance for a functioning market economy of price stability, through its support for correct market signals, its contribution to an efficient use of economic resources and its furtherance of public welfare.[4] Eucken was emphatic that these propositions are not just abstract theory, lucidly exposing the harmful impact of the three episodes of monetary disorder that had been etched so indelibly onto Germany's collective memory: what he called the "open" inflation of 1914 to 1923, which ultimately culminated in hyperinflation; the deflation of 1929-1932; and, finally, what he coined "pent-up inflation", created between 1936 and 1948.[5]

Second, Eucken stressed that, to safeguard monetary stability, monetary policy needed to be confined exclusively to the pursuit of price stability and to be shielded from the influence of vested interests or other public policies.[6]

The foundations of EMU embraced these fundamental tenets more explicitly than had ever been the case in Germany's post-war monetary history. First, Article 127(1) of the Treaty on the Functioning of the European Union set price stability as the primary objective of the Eurosystem. Second, the principle of central bank independence is enshrined in Article 130 of the Treaty, which prohibits the ECB from taking instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body.

In designing unconventional policy measures, the ECB has adhered to these principles. All of its unconventional measures were deployed to achieve price stability and all relevant decisions were taken fully independently of governments.

4 Eucken went so far as to say that, without price stability, any attempts to reap the benefits of a free market economy are futile: "*Alle Bemühungen, eine Wettbewerbsordnung zu verwirklichen, sind umsonst, solange eine gewisse Stabilität des Geldwertes nicht gesichert ist.*" (All attempts to create a competitive system are in vain as long as a certain degree of monetary stability is not guaranteed.) (Eucken 1952, p. 256).

5 See Eucken (1952), pp. 256-257.

6 See Eucken (1952), pp. 255-264.

Instruments and indicators of monetary policy

Price stability cannot be preserved simply on the basis of institutional principles. Eucken also had to confront the question of how to define monetary stability and which instruments to use in its pursuit. Eucken was aware of the gold standard's limited success in ensuring lasting monetary stability: in large parts of the world where the gold standard had been adopted and faithfully observed, secular changes in the supply of and demand for gold had caused measurable divergences from what we today would regard as price stability.[7] Moreover, it was not universally understood how to operate the gold standard successfully in the event of banking panics (Eichengreen 1992). With these shortcomings in mind, Eucken considered combining two proposals. The first proposal, the 'Chicago Plan', stipulated that bank deposits be covered fully (i.e. 100%) by central bank reserves.[8] The aim of the plan was to make bank deposits as safe as banknotes and to strip the banking sector of its ability to create inside money – an ability that was seen as being the root cause of financial excess. The second proposal, a broad commodity-reserve-currency standard, would ensure full automaticity in the supply of money necessary to stabilise the price of a basket of underlying commodities (Graham 1944, Hayek 1943). The built-in automaticity would shield monetary affairs from vested interests and political influence. The proposal sought to marry financial and monetary stability in one coherent, simple, automatic and transparent way. However, although a 100% reserve coverage ratio would forestall any bank runs, it might well engender excessive macroeconomic instability. It would establish nothing less than a state monopoly on the creation of money, and banks would merely intermediate between savers and borrowers. Combining the Chicago Plan with automaticity in the supply of money – through a commodity-reserve currency – would render money and credit creation insufficiently elastic in response to cyclical conditions, thereby propagating instability in output and employment (given that prices and wages are sticky).

7 See, for example, Friedman, (1992) pp. 104-125. Friedman describes how, owing to rising demand for gold (from countries adopting the gold standard), prices nearly halved in the United States and fell by more than 20% in the United Kingdom over the period 1865-95, and subsequently, in the period up until 1920, rose by similar proportions, owing to gold discoveries in South Africa, the development of the cyanide process and various countries suspending the gold standard.

8 See Eucken (1952 p. 258), which draws on the following: Fisher (1935), Lutz (1936), Simons (1933).

Both in its original[9] and in more flexible forms, the Chicago Plan has recently been picked up again. In a flexible form, the plan has resurfaced in former Bank of England Governor Mervyn King's idea of the central bank as a "pawnbroker for all seasons" (PFAS)(King 2016 pp 269-281): bank balance sheets would be constrained by the requirement to pre-position collateral and reserves in order to acquire a central bank borrowing entitlement, and by stipulating that a bank's liquid assets must not fall below its liquid liabilities. This proposal has multiple aims. It seeks to link the idea of the Chicago Plan with the central bank's role as lender of last resort, to replace complex regulation, while still enforcing requirements for higher equity and higher holdings of liquid assets and, finally, to ease bank resolution. The proposal covers some important goals of bank-level and system-wide rules currently being phased in under Basel III and also elements of how central banks, and the ECB in particular, have provided funding liquidity – against eligible collateral – during the most acute phase of the banking crisis. Ultimately, it recognises that leverage and liquidity play a pivotal role in forestalling and tackling financial imbalances.

We recognise the clarity of Eucken's proposition that monetary policy must be vested with sufficient independence and with the right instruments to make the achievement of its goal feasible. Yet his practical proposals for monetary reform (combining the Chicago Plan with a commodity standard), including a strict use of quantitative targets as instruments, were never implemented.[10] Throughout most of the post-war era, including in Germany, and notwithstanding the Deutsche Bundesbank's monetary targeting strategy (Bernanke and Mihov 1996), monetary policy was predominantly implemented through an elastic supply of high-powered money, steering interest rates in interbank money markets, thereby enabling central banks to influence broader conditions in capital and loan markets. These conditions, in turn, influence the investment and spending decisions of households and firms, and, ultimately, price developments.

9 See, for example, Benes and Kumhof (2012), Mayer (2013)

10 The only exception to date was the nonborrowed reserves targeting procedure that the Federal Reserve System sought to implement from October 1979 to October 1982, under Chairman Paul Volcker. The episode was short-lived and the quantitative targets were complemented by an explicit corridor for the federal funds rate. For a critical appraisal, see Bindseil (2004), pp. 29-31, and the references therein.

Novel policy instruments: principles and safeguards

The relationship between short-term interest rates, financing conditions and developments in activity and prices, on which central banks had relied throughout the post-war era, was fundamentally upended during the global financial crisis. Moreover, disinflationary developments eventually proved so strong as to exhaust the central bank's room for manoeuvre on short-term interest rates. This unprecedented situation has forced central banks to resort to more complex and partly untested instruments in order to discharge their mandates.

A thorough exposition of the design and transmission of the novel measures deployed by the ECB across various phases of the crisis is beyond the scope of this contribution,[11] but a number of salient features are worth mentioning.

The ECB's balance sheet has taken on a central role as a stabilising instrument in several ways.

First, in the aftermath of the bank funding freeze precipitated by the demise of Lehman Brothers in September 2008, the ECB provided essential funding liquidity to banks with a view to forestalling a collapse in money and credit. Liquidity was made available in virtually unlimited amounts – against eligible collateral – and at increasingly long tenors, in particular through the longer-term refinancing operations (LTROs).

Second, in response to the sovereign debt crisis, triggered in 2010, in part, by weak fiscal positions, and reinforced by government solvency support to weak banking systems, the ECB initially launched the Securities Markets Programme (SMP) and in 2012 announced Outright Monetary Transactions (OMTs), to eliminate the excessive risk premia in sovereign bond markets produced by fear of a Eurozone break-up.

Third, while the announcement of OMTs was effective in removing tail risks from sovereign credit spreads, in 2014 further credit easing was required to address the persistent disconnect between the ECB's accommodative monetary policy stance and lending conditions for households and firms. These measures comprised targeted

11 For overviews, see Praet (2017a), Praet (2017b).

longer-term refinancing operations (TLTROs) and purchases of covered bonds and asset-backed securities. Unlike LTROs, TLTROs were *targeted* through a built-in incentive mechanism, ensuring that the funding-cost benefit of longer-term refinancing with the central bank was passed on to lending conditions for households and firms. Under these operations, banks were able to borrow at an interest rate that could be as low as the Eurosystem's deposit facility (as applicable at the time of allotment), but only on condition that the borrower could demonstrate strong loan origination activity.

Fourth, as of 2015 the ECB expanded its asset purchases into the sovereign space to reverse a continued shortfall of inflation relative to price stability[12] and a downward drift in inflation expectations in a situation in which the deposit facility rate had already been reduced to below zero. While previous measures chiefly aimed to support monetary policy transmission, asset purchases provided necessary monetary accommodation, when the ECB's classical interest rate instrument had become increasingly constrained by its lower bound. In scope and size, the ECB's asset purchases resembled the quantitative easing programmes adopted by other major central banks in order to ease monetary conditions once their key interest rates had reached their lower bound.

These measures have complemented each other and have proved to be effective. Asset purchases have kept financing conditions in capital markets at sufficiently accommodative levels. This effect was strengthened by the introduction of negative interest rates on bank reserves. Together with forward guidance on the future path of asset purchases, on short-term interest rates, and on the sequencing of different instruments, negative interest rates have ensured that the term structure of interest rates is sufficiently supportive of the economic recovery and, indirectly, of price pressures. TLTROs, in turn, have been pivotal in easing financing conditions by compressing the spread between interest rates in capital markets and on bank loans. Policy action has checked and reversed the decline in bank loans. As a consequence of the unprecedented scale of the liquidity injections into the financial system, the ECB's balance sheet has more than tripled since 2007.

12 In 1998, the Governing Council defined price stability "as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the Eurozone of below 2%". In 2003 the Governing Council clarified that it aims at small, positives rates of inflation stating "that in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term."

However, broad monetary developments have been far from excessive. After an annual increase of only around 1% in early 2014, M3 growth has been running at around 4½-5% over the past two years.

All these measures have been designed to safeguard the effectiveness of monetary policy – to support its transmission in the face of severe market dislocation and balance sheet retrenchment and to provide necessary accommodation once the central bank's room for manoeuvre on the conventional interest rate instrument appeared exhausted – in the pursuit of price stability, and to ensure that monetary policy objectives are given clear priority over other public policy objectives. Non-standard measures have not been designed at the behest of governments or to finance government deficits.

In order to ensure its non-standard measures stay within the limits of monetary policy, the ECB has established a number of important safeguards. These safeguards ensure that any central bank instrument is used only to the extent that, first, it is able to attain the central bank's narrow price stability objective, second, the central bank lacks standard instruments, which could achieve the same result, and third, the expected benefits of the measures outweigh their expected costs. With regard to OMTs, the Governing Council specified that they can be activated only if price stability is under threat and only subject to strict conditionality: a country would first have to commit to a macroeconomic adjustment programme under the European Stability Mechanism (ESM). A number of safeguards also apply to public sector bond purchases under the public sector purchase programme (PSPP). The modalities for their activation are exclusively governed by the primary objective of price stability, and decisions are taken by the Governing Council entirely independently of developments in other policy areas. Moreover, several provisions are in place to minimise, in particular, potential distortive effects on market functioning and price formation. Finally, asset purchases have played a vital role in supporting the ECB's policy stance of bringing inflation back into line with its medium-term objective in a situation in which key interest rates could scarcely be reduced much further.

Conclusions

The ECB's non-standard measures have been deployed in order to fulfil its narrowly defined objective of price stability, designed entirely independently of other public policy goals and without breaching the limits of its primary mandate. In particular, they cannot be used to compensate for failures in other policy areas. Moreover, when novel policy tools have been implemented, based on a careful assessment of the merits of all possible policy choices in the light of the ECB's mandate, the choice has not been between discretion and rules or between realpolitik and principles. On the contrary, the design of the ECB's measures has ensured the effectiveness of monetary policy, in pursuit of its primary goal of price stability. Finally, it is important to stress that the principles of ordoliberalism extend far beyond monetary policy. Eucken stressed the need for these principles to be observed by other policy areas to ensure a functioning market economy and economic stability (see Euken 1952, pp. 291-324).

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About the author

Peter Praet joined the European Central Bank as Member of the Executive Board in 2011. He is responsible for the Directorate General Economics.

Mr Praet gained a PhD. in economics from the Université libre de Bruxelles in 1980. He was an Economist at the International Monetary Fund from 1978 to 1980, Professor of Economics at the Université libre de Bruxelles from 1980 to 1987, Chief Economist of Générale de Banque and Fortis Bank from 1988 to 1999 and Chef de cabinet for the Belgian Minister of Finance from 1999 to 2000. Before joining the ECB, he was Executive Director of the Nationale Bank van België/Banque Nationale de Belgique from 2000 to 2011. Here, he was responsible for International Cooperation, Financial Stability and Oversight of Financial Infrastructures and Payments Systems. Between 2002 and 2011 he was also a member of the Management Committee of the Belgian Banking, Financial and Insurance Commission, where he was responsible for prudential policy for banking and insurance.

Mr Praet has served on several high-level international bodies, including the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System and the European Banking Authority. He was First Alternate of the Board of Directors of the Bank for International Settlements from 2000 to 2011.

8 Ordoliberalism, post-crisis monetary policy and the German 'Angst'

Adalbert Winkler
Frankfurt School of Finance & Management

1 Introduction

It was business as usual. A couple of days before the meeting of the ECB Governing Council on 7 September 2017, the German press started reporting on its potential outcome, i.e. whether and to what extent the ECB would exit its "ultra-loose monetary policy", in particular, reducing the monthly volume of asset purchases. As always, the vast majority of commentators called for a more restrictive policy stance, stressing the dangers of the "money flood" – illustrated by a tsunami wave with the power to destroy everything which it hits (*Handelsblatt* 2017).

This has been the general tone on ECB reporting in Germany since the global financial crisis. Of course, there have been exceptions, providing a more sober analysis, which concluded that there is no reason to believe that a tsunami is building up. Overall, however, for about the last ten years, the German public has been regularly alerted to the risks it is exposed to due to the conduct of monetary policy: inflation and hyperinflation, the "TARGET trap", the transformation of the euro into a "soft currency", moral hazard behaviour by banks and governments in the southern Eurozone periphery that take advantage of the German taxpayers and savers, asset price bubbles that will burst and lead to massive destruction of German wealth, and the expropriation of German savers via zero interest rates.

The media is known for portraying issues as more drastic than they really are. Fear sells better on the news market than reporting that puts things into perspective. Thus, one could argue that the ECB reporting just reflects the unwritten laws of the media business. However, this is not the case, as press reporting is largely based on opinions expressed by many ordoliberal German economists (Fratzscher 2016)[1]. According to them, the ECB undermines the basic foundations of our economic order by transforming the market economy into a planned economy:

> *"by pouring more and more cheap money into the system, the ECB prevents fragile states and banks from defaulting. Zombie banks, completely dependent on access to central bank funding, prolong loans to no longer viable businesses. The very foundations of our wealth are vanishing. Productivity gains and growth approach zero. Thus, a growing part of the population is unable to benefit from higher wages and more generous social security. At the same time, the money flood of the central banks increases the wealth of the few which leads to a rise in inequality. Thus, it is no surprise that public support for our economic order dwindles. Economic instability will be followed by political instability, if policies do not return to [ordoliberal principles set by] Walter Eucken." Schnabl (2017)*[2]

At the press conference following the 7 September ECB Council meeting, President Draghi addressed these concerns. He asked for concrete evidence that could support

1 It must be stressed that not all ordoliberal economists share the views expressed by the ECB critics. This also suggests that ordoliberalism can be interpreted differently with regard to the actual conduct of monetary policy in mature economies over the last ten years (Paqué 2015). At the same time, the sharp criticism of monetary policy, as it is expressed in the German media, overwhelmingly refers to ordoliberalism, i.e. Eucken and/or Hayek, as the theoretical foundations the criticism is based upon. This includes editorials by many journalists strongly influenced by the ordoliberal tradition as a result of their academic training (Jacoby 2014)

2 "*Immer mehr billiges Geld der EZB hält wackelige Staaten und Banken am Leben. 'Zombie-Banken', die am Tropf der Zentralbank hängen, verlängern Kredite an Unternehmen, die eigentlich nicht mehr lebensfähig sind. Die Grundlage unseres Wohlstandes schwindet. Produktivitätsgewinne und Wachstum tendieren gegen null. Immer größere Teile der Bevölkerung profitieren deshalb nicht mehr von hohen Löhnen und großzügiger sozialer Sicherung. Gleichzeitig macht die Geldschwemme der Zentralbanken nur einige wenige reich, was zu wachsender Ungleichheit führt. Kein Wunder, dass die Akzeptanz für unsere Wirtschaftsordnung schwindet. Der wirtschaftlichen Instabilität wird politische Instabilität folgen, wenn sich die Politik nicht bald auf Walter Eucken zurückbesinnt.*"

the doomsday predictions: "this anxiety should be also based on facts because so far, everybody has benefited greatly from this monetary policy, all countries have benefited greatly. So, this angst so far has no evidence that could justify it." (Draghi 2017).

Draghi's call for evidence will go unheard, as the underlying ordoliberal theory which these anxieties are based upon relies on an unbreakable circular reasoning which cannot be shattered by evidence. Thus, the German angst will continue. This does not bode well for raising confidence in European monetary policy in the largest and economically dominant Eurozone country (Winkler 2014, Hayo and Neuenkirch 2014, Fratzscher 2016).

2 Ordoliberal principles: Order matters, not outcomes

Ordoliberalism is defined by its focus on order, concretely the order established by economic policies. The order should reflect seven constitutive principles laid down by Walter Eucken (1990). With regard to monetary policy (Weidmann 2013) the key principles are the liability principle (*Haftungsprinzip*) and the principle of the primacy of the monetary order (*Primat der Währungspolitik*). Ordoliberalism, as depicted in the German public debate, postulates that, when policymakers follow these principles, growth, employment and economic development will reflect the optimal that can be achieved.[3] Thus, there is no need, and it is even counterproductive, for governments or central banks to focus on economic outcomes, such as employment or growth.[4]

This conclusion is not derived from any model specifying conditions that reveal the underlying assumptions the conclusion is based upon. Ordoliberalism is not microeconomics. The latter has demonstrated that, under certain conditions, i.e. asymmetric information among market participants, markets can fail to achieve an optimum solution and might even collapse without governments violating Eucken's principles (e.g. Akerlof 1970, Diamond and Dybvig 1983). Moreover, optimising agents might settle for sticky prices and/or wages which provide room for activist monetary and fiscal policies that can improve on economic outcomes (Williamson 2017).

3 These outcomes might be rather poor, as creative destruction sets in, causing unemployment and a drop in growth. But this must be accepted in order to pave the path for a strong recovery (Sinn 2016b).

4 This is often equated with the rejection of activist (Keynesian) policies

Ordoliberalism does not account for these possibilities. This has a strong implication, with regard to the interpretation of economic and financial crises, i.e. situations where it seems obvious that the private sector does not achieve an optimal outcome: crises are solely due to government policies and interventions violating the Eucken principles.

The ordoliberal narrative of the global financial crisis illustrates this. It has been solely triggered by the failures of central banks and governments to enforce the primacy of the monetary order and the liability principles. The former reflects a too expansionary monetary policy before 2007 (Belke and Schnabl 2010), the latter ill-designed government interference in financial markets, notably the mortgage market (Schüller 2009, Schäfer 2009). Of course, these arguments are shared by many economists (see e.g. Calomiris 2008). However, they do not agree with the monocausal explanation of the ordoliberals but also acknowledge that crises reflect an inherent instability of the private sector. For example, financial crises were regular features of monetary economies at a time when there were no central banks – as in the US until 1913 (the establisment of the Federal Reserve) – and the patterns of the subprime mortgage crisis had much in common with those crises (Gorton 2008). Thus, it is highly unlikely that crises are only triggered by central banks and governments violating Eucken's principles but rather they also reflect information problems in financial markets triggering contagion and runs (Gorton 2012).

The ordoliberal narrative on the euro crisis is very similar. It also focuses on regulatory failures, with regard to banking sectors in Spain and Ireland, as well as failures in enforcing the liability principle and/or the rules laid down in the Stability and Growth Pact (SGP). Thus, again, the crisis is only caused by violations of ordoliberal principles (Feld *et al.* 2016) Other narratives accounting for the facts that SGP violations have neither been a necessary nor sufficient condition for turmoil and stressing the importance of private-sector-driven sudden stops and capital flow reversals (Baldwin and Giavazzi 2016) are downplayed or ignored. The same holds for the presence of contagion effects which do not play a role in the ordoliberal concept (Feld *et al.* 2015). The latter has severe implications for the analysis of crisis triggers and crisis management: if contagion effects are ruled out, crises only reflect massive insolvencies and have nothing to do with illiquidity.

Consequently, crisis management should only focus on solvency issues – which explains the repeated calls of ordoliberal economists for an insolvency mechanism for sovereigns (Feld *et al*. 2016) – while measures aimed at fighting a liquidity crisis are counterproductive. In short, ordoliberal economics has no room for a crisis of confidence and a lender of last resort addressing it (Winkler 2013).

Stressing the narrow view of the ordoliberal crisis explanation is important in order to understand that measures taken by governments and central banks to mitigate panic and to maintain price stability are seen as nothing other than massive violations of the Eucken principles. As these principles are at the origin of Germany's economic success, euro crisis management is a threat to the wealth and well-being of the German people. Given this threat, economists must ring alarm bells far beyond the academic community. In addition to the editorials and comments published in the media, this has been done by directly addressing the German public via open letters which warn against "fatal long term effects" (*Plenum der Ökonomen* 2011, 2012) if ordoliberal principles are not adhered to, supporting a lawsuit against the OMT programme at the German Supreme Court (Sinn 2013, Fuest 2013, Konrad 2013), and the founding of a new political party, the *Alternative for Germany* – it was (and still is) all needed to protect fellow citizens from disastrous economic consequences.

3 Price stability – the irrelevance of monetary policy mandates

The most immediate negative impact of euro crisis management was expected to be seen in a quick and rapid rise of inflation. With the liability principle hollowed out and a central bank giving up the primacy of monetary order principle and engaging in fiscal policy – a key narrative of ordo-liberal economists, with regard to ECB post-crisis monetary policies – inflation should rise quickly. Thus, in 2010 - 2013 the German public was regularly confronted with inflation projections (they are documented in Winkler 2014) substantially above the ECB definition of price stability. Some even alluded to the possibility of hyperinflation.

Inflation, however, did not rise but instead fell. Indeed, it reached levels that increased the danger of deflation. In 2015, the ECB – already operating at the zero lower bound (ZLB) - opted for quantitative easing, mainly in the form of purchasing

Eurozone government bonds. Mersch (2016) defends this measure as being consistent with ordoliberal principles, referring to Eucken who argued that deflation leads to a distortion of prices and hence a misallocation of resources in the same way as inflation. However, confronted with the fact that inflation fell substantially below 2%, ordoliberal economists started rejecting the view that the absence of inflation is proof of the fact that the ECB adheres to the primacy of the monetary order principle.[5] Moreover, they silently reversed the former German position of price stability as the primary monetary target by playing down the importance of meeting the target (Kooths 2017) or by simply ignoring inflation developments when discussing the conduct of monetary policy (Fuest 2016).[6]

The mandate has become inferior to the instruments and means used to achieve it. Instruments which are inconsistent with the Eucken principles should not be used even if they are a) legal and b) appropriate in fulfilling the price stability mandate of monetary policy. This implies that zero or even negative interest rates as well as asset purchases cannot be accepted as monetary policy instruments as they violate ordoliberal principles. They must be avoided even if it means that the inflation target is undershot. A (temporary) undershooting of the inflation rate is less dangerous than the long-term disastrous economic consequences of violating the principles. This is the "cultural revolution" (Sinn 2016b) which is needed for the conduct of monetary policy.

4 Asset purchases at the zero lower bound: The age of fear continues

The predicted disastrous consequences of ECB monetary policy have not been seen. By contrast, since 2015 the Eurozone has enjoyed falling unemployment and rising growth. Risks to the outlook are mainly linked to political events, outside as well as inside the Eurozone. Ordoliberal economists square the contradiction between reality and prediction by claiming that the recovery led by expansionary monetary policy is unsustainable because interest rates have been kept "artificially" low.

5 In doing so, they contradict a long-standing interpretation of the principle which has been commonly identified with price stability (Weidmann 2014).

6 Others argue that inflation has taken a new form, as it no longer shows up in a rise in prices of goods and services, but in rising asset prices (Schnabl 2017).

This distortion triggers a series of medium- to long-term risks that might severely undermine economic performance as a) the allocation function of the (capital) market is distorted, b) moral hazard risks, with regard to banks and governments, loom large and c) asset price bubbles are created and supported. Thus, the recovery hides the fact that the German economy operates in a "fragile environment" (IfW 2016). Given this analysis, with each day that the ECB does not exit unconventional monetary policies, a backlash becomes more likely and more severe.

The narrative is by now familiar: violations of ordoliberal principles, even if triggered by policies that aim at maintaining price stability, lead to economic decline and thus must be rejected.[7] However, the financial repression type of argument on which these predictions are based faces several challenges, including from an ordoliberal perspective. First, Eucken's primacy of monetary order principle includes the call for a 100% reserve requirement for banks (Van Suntum *et al*. 2011). Thus, strictly following Eucken would imply that interest rates on bank deposits would be under complete control of the central bank and would always be remunerated at the interest rate which the central bank offers banks for their reserve holdings. As a result, nominal interest rates on bank accounts would be even lower than they are today. Second, the golden years of German *Ordnungspolitik*, the 1950s and early 1960s featured interest rates on bank deposits which were directly tied to the Bundesbank's monetary policy rates (*Zinsbindung*). Thus, the degree of financial repression was substantial, also because monetary policy had more administrative elements than it has today which implies that in the 50s and 60s interest rates were much less market driven, and hence more "artificial", than they are today. Third, it is unclear why today's interest rates are artificially low while this was not the case five, ten, or twenty years ago.

7 Some ordoliberal economists, e.g. Sinn (2016a), completely reject the notion that the ECBs asset purchase programme has been motivated by the undershooting of the inflation target and the ZLB. They claim that it represents fiscal policy geared towards bailing out the (insolvent) Eurozone periphery countries. The argument takes on fears the German public has been confronted with since the early days of European Monetary Union and thus falls on fertile soil. However, it completely ignores the fact that most central banks in mature economies have opted for quantitative easing policies in recent years even though – by being nation states – the central bank had no reason to bailout insolvent parts or even the central government of the respective currency areas. Ordoliberal economists making use of the moral hazard argument offer no explanation as to why they arrive at the conclusion that the ECB engages in QE as part of a bailout policy while Sweden and the US engage in QE to maintain price stability after having hit the ZLB.

Monetary policy, via the transmission mechanism, always influences interest rates and thus makes them "artificial" compared to a pure market solution. Moreover, it has been consensus since the early 1980s that central banks should "artificially" raise interest rates when inflation rises and "artificially" lower interest rates when inflation falls (Goodfriend 2007). Thus, making use of the term "artificial" when analysing interest rate developments, given the ECB's monetary policy, makes sense only by noting that this time the ECB has lowered interest rates even more than in the past.[8] There is a heated debate on this question within academia, within the central bank community and between both (see, for example, the debate between Wieland and Williams on whether the neutral interest rate has declined (SIEPR 2017)). But it is a debate on the conduct of monetary policy and not a debate on whether the ECB (or any other central bank) violates the primacy of monetary order or any other ordoliberal principle. Indeed, it is a debate which takes place regularly at the end of a monetary policy cycle, i.e. when central bankers change course because interest rates have become either too high (at the end of a period of tightening) or too low (at the end of a period of loosening) monetary policy.

This line of reasoning – and the experience with incorrect inflation projections in the years 2010-2013 – might explain why the more recent warnings about the negative consequences of ECB monetary policy do not contain any date or period over which they can be expected to occur. Moreover, while the warnings use strong language when describing the negative side effects of monetary policy, most of them are conditional, i.e. they "might" occur or the ECB "takes the risk that" – in other words, it may be that the negative scenario will never occur. Thus, the gloomy predictions represent statements like "when the cock crows on the dungheap, the weather changes or it stays the same (German proverb, author's translation) This, however, implies that the ordoliberal position cannot be put to an empirical test which allows the theory to be falsified.

8 Clearly, interest rates on Eurozone government bonds have declined substantially. Moreover, in terms of levels, they have significantly decoupled from US interest rates, even though most of the decoupling took place in 2014, i.e. before the start of the asset purchase programme, also reflecting the decline in inflation and slow growth in the Eurozone at that time. Moreover, since lowering bond yields was an explicit goal of the programme, it makes it difficult to argue, as some ordoliberal economists do, that it had no effect. However, developments of US and Eurozone interest rates over time, i.e. ups and downs, are still highly correlated. For example, after the election of Donald Trump, bond yields shot up in the US and the Eurozone. Thus, despite massive ECB purchases,Eurozone interest rates respond to changing demand and supply conditions, indicating that ECB purchases do not prevent the capital market from performing its allocation function.

It can only be confirmed, namely by the next crisis. As market economies have been subject to crises and turmoil since they have evolved, a new crisis will almost certainly occur in the future. Since – from an ordoliberal perspective – crises are, by definition, not created by the private sector, violations of ordoliberal principles, as they allegedly now massively occur, will provide for an easy explanation that can be introduced by saying: "We always told you …."

5 Conclusions

Ordoliberal economists have been severely critical of the monetary policy stance taken by the ECB over the last ten years. This criticism is driven by the view that the instruments the ECB has employed to fulfil its mandate, to maintain price stability, violate ordoliberal principles. As violations of these principles have been major triggers of the global financial crisis as well as the euro crisis, they do more harm than good.

However, up to now there has been no evidence for this position: inflation has continued to be low, GDP is growing at a healthy pace and unemployment falling. Moreover, government deficits and debt levels have declined.[9] However, the contradiction between prediction and reality does not lead to a reconsideration of the theoretical grounding which predictions have been based upon. Rather it is solved by arguing that the recovery is unsustainable and the bad end is still to come, and will be even more severe the longer expansionary monetary policy continues. Thus, it is impossible to reject ordoliberal claims about the disastrous consequences of violations of the Eucken principles by referring to the fact that these consequences have not been seen. Indeed, the very fact that they have not yet materialised is an additional argument for claiming that they will be even more severe in the future.

Does this mean that ordoliberal concepts should not be used when analysing economic developments and economic policies? The answer is a clear no. It is very useful to establish an economic order as laid down in Eucken's principles and to analyse how policymakers (and market participants) live up to them.

9 While this does not mean that moral hazard issues are not important, it suggests that moral hazard is not everywhere and that it does not represent at all times a major consideration (Goodhart 1999).

However, living up to the principles does not guarantee good outcomes. The balancing act which needs to be performed can be illustrated by an analogy put forward by Schmieding (2014), one of the few economists in the ordoliberal tradition who defended the ECBs OMT programme: it is a good idea for a house to have measures in place for fire prevention. If people follow these measures, it is much less likely that a fire will break out. However, there may still be fires that do not start in houses but do spread to them and possibly to the city as a whole. In such a case, the measures do not help. People call the fire brigade, even though this might create moral hazard (why should anyone bother with fire prevention measures if the fire brigade can deal with a fire anyway), and this itself might have negative side effects, i.e. the flooding of apartments that have not been (so severely) damaged by the fire yet.

Performing this balancing act also does not mean that monetary policymakers, at the ECB or any other central bank, cannot be criticised. Central bankers can and do make mistakes. The same applies to the fire chiefs (for example flooding an apartment when there was only smoke but no fire). But we do not use the fact that people make mistakes to call for a "cultural revolution", namely to abolish fire brigades and their mandate to fight fires. Rather, we analyse why wrong decisions have been made and what we can learn in order to minimise the risk of similar mistakes being made again. The same applies to central bankers and their mandate to maintain price stability.[10]

To conclude, the mainstream German ordoliberal criticism of ECB monetary policy is not misguided because the Eucken principles do not hold. The critics are wrong because they argue that following these principles is always all it takes and that every deviation from these principles is bound to end in economic and financial chaos. Unfortunately, this is the way ordoliberalism has presented itself in the German media over the last ten years, most recently by transforming a rather normal monetary policy issue, namely when and how to end a period of monetary expansion, into an issue that has fundamental implications for economic outcomes.

10 Indeed, this approach has guided monetary policy in mature economies over the last ten years since it can be interpreted as the implication of the lesson learnt from the Great Depression when monetary policy utterly failed to maintain price stability (Friedman and Schwartz 1965).

It has pursued "scandalising the unspectacular"[11] instead of providing the German public with a sober analysis highlighting the pros and cons of monetary policy decisions in a challenging economic and financial environment.

There is a high price to be paid for this decade of scandalising. The first thing is obvious: it severely undermined public confidence in one of the most important European institutions, the European Central Bank, by creating an atmosphere of angst. The second is more subtle: ordoliberal views might become increasingly discredited, which could imply that, at the very moment when ordoliberal principles really are at risk, the public will not listen to economists calling on governments and authorities to stick to them. Given the rise in populism and economic nationalism, this moment is in danger of coming sooner rather than later.

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11 The term was coined by the members of the German Council of Economic Experts, namely Lars Feld and Christoph Schmidt

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About the author

Adalbert Winkler, born in 1962, studied economics at the University of Trier and at Clark University, Worcester, Mass. He holds a Ph.D. from Trier University and a post-doc ("Habilitation") from the Bayerische Julius-Maximilians University of Würzburg. Before joining Frankfurt School of Finance & Management, Adalbert pursued a career in development finance and central banking. From 1994 to 2001, he headed the Economics Department at Internationale Projekt Consult (IPC GmbH), Frankfurt. In 2001 he joined the European Central Bank's Directorate General International and European Relations. From 2004 to 2007 he was in charge of monitoring and analysing economic developments in the countries neighboring the EU. In the first half of 2008 he served as an Adviser at the International Department of Deutsche Bundesbank. Adalbert's research interests and publications have been focusing on development finance and microfinance as well as the global monetary and financial system.

9 Banking union: Rules versus discretion?

Thorsten Beck and Hans-Helmut Kotz
Cass Business School, City, University of London, and CEPR; CES,Harvard University, and SAFE, Goethe University, Frankfurt

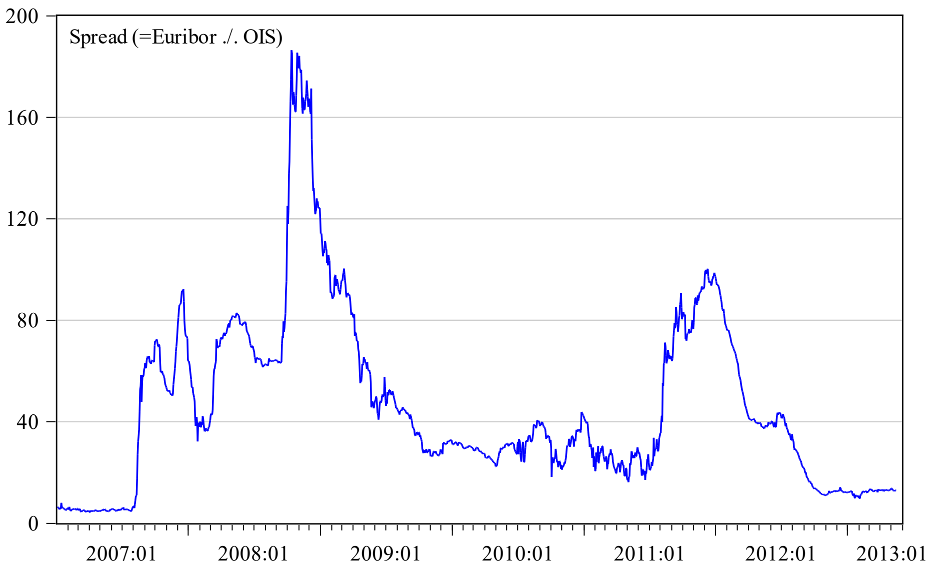
1 Introduction: Competition policy vs financial stability

In the spring of 2009, a conflict between the EU Commission and German authorities, which had been simmering for a while, became public. Axel Weber, then President of Deutsche Bundesbank, reproached Neelie Kroes, then EU Commissioner for Competition, arguing that, in a financial crisis environment, her insistence on pricing capital injections into a large German bank at market prices did not make sense. The Commissioner, however, held that her role as Guardian of the Treaty was to prevent competitive distortions in the European Union. In fact, at the time, markets were heavily distorted, some almost completely missing: think of the uncollateralised interbank market (see Figure 1) or the *Pfandbriefe* segment where issuance of new bonds (backed by high quality bank assets) had quite literally stopped. Letting nature run its course was not seen as an acceptable option, barely six months after Lehman and AIG, and the G20 declaration of October 2008 that no big bank would be allowed to fail.

The case in point was Commerzbank, Germany's second largest private-sector banking institution, whose failure would obviously have been systemic. The deposit guarantee mechanism of German private banks was not capable of facing up to the challenge. It had already needed support in managing the case of IKB, a midsized bank, over-exposed to structured products (via a Dublin outlet), in August of 2007.

Thus, for convincing reasons, Weber called for a flexible or balanced reading of rules, in light of the existing context and plausible consequences. A rigorous, quasi-automatic application of rules would have run the risk of prohibitive opportunity losses.

Figure 1. Eurozone interbank money market



Source: ECB

Striking a balance, in this case, trading-off distortions to competition (especially in German banking) against underwriting systemic financial stability, is a demanding task. Any bailout comes with signalling effects. Going forward, incentives to run institutions cautiously will be reduced. But then, social opportunity costs, as the North Atlantic Financial Crisis has again amply shown, can be dramatic – and linger for a long while.

To be fair, this took place under Europe's incomplete infrastructure of banking (and financial market) supervision at the time, i.e. before the Banking Union. Thus, DG Competition was in a very challenging position. Effectively, it had to substitute for the (deliberate) absence of restructuring or resolution authority at the EU level (see Beck *et al.* 2010). And it did that remarkably well, given its constraints.

Many economic, legal and political analyses of Europe's Banking Union have been written, both on the process of getting there and on its actual structure.

As in many other areas, the fault line fell between Germany (together with the Netherlands, Finland and some smaller Central European countries) and the crisis periphery countries, plus France and Italy. This has often been interpreted as a conflict between creditor and debtor countries. In this chapter, we will rather understand it from the perspective of a rule-based versus a discretionary approach.

2 Banks are special, even German banks

Banks are special…

Backstopping banks (or their functional equivalents) necessarily impacts on incentives. A put option, written by the public sector, changes incentives and thus the behaviour of bank managers and shareholders. In crisis times, such an option comes into the money, enticing behaviour on the side of managers detrimental to debtors and the taxpayer at large.

Banks are special. Long before that phrase became a hardy perennial of banking literature, it was acknowledged in politics. These were lessons learned from crises. See, in particular, but not only, the Great Depression and the rash of banking laws ushered in by it, in basically all nations hit by the fallout. Banks needed public backing, not only in dire times. Such backing came, by necessity, with restrictions, especially entry restrictions (licensing etc.) and activity limits. It also meant less competition. But that was accepted, given banking's defining traits: banks' business is characterised by a (purposeful) mismatch between the average maturity of deposits (short, possibly very short – on demand) and their assets (regularly of a much longer tenor).

This makes banks vulnerable – not only individually, but as a group – to rapid, large-scale withdrawals. If runs happen, it implies collateral damage to bystanders, not party to the initial contract.

To be brief, externalities (as they arise from large-scale, interconnectedness or a high degree of similarity) mean that banking markets are not perfect but are prone to fail at times. Market power, arising from differential access to (or capacity to) process information or economies of scale and scope, is another indicator of imperfectness.

This implies a wedge between private and social costs. And it is a reason for public sector intervention with rules and penalties (Freixas and Rochet 2008).

…as are German banks

With the structure of its financial safety net, Germany was an outlier in the Eurozone, as deposit insurance schemes were sector-based, with no government involvement (see Beck, 2002, for a discussion) or lender of last resort outside the Bundesbank. Membership in the deposit insurance scheme of the privately-owned banks is voluntary and, although completely privately funded and managed (by the bank association), there was always a close cooperation between regulators and the three different, sector-based (private, public and cooperative) banking associations in terms of licensing and auditing banks.

Similarly, pre-2008 bank resolution was also sector-based, with no taxpayers' money involved as a bank ran into trouble; but, again, a close cooperation between banks and regulators. In the very rare cases where insolvency threatened, regulators corralled the leading creditors (mostly other banks) and the banking association for late night meetings, in which the resolution was hashed out. While this club-based structure of the financial safety net worked well into the early years of the 21st century, it came increasingly under pressure from foreign competitors entering the markets, as well as critique directed at the three-pillar structure of the German banking system. Following the EU directive on deposit insurance schemes, Germany had to introduce publicly managed schemes that covered all banks, including the private banks that were not members of the private deposit insurance scheme.

The 2008 crisis was a turning point for the financial safety net, as in many other countries. autumn 2008 saw the extension of a blanket guarantee for all deposits in the German banking system extended by the grand-coalition Merkel government. As already mentioned, bailouts of Commerzbank as well as some smaller banks followed. Several public-sector owned Landesbanken, also heavily exposed to the US subprime market, had to be recapitalised; some of them were ultimately closed.

At the same time, the lack of a resolution framework impeded crisis resolution, as rather stringent German property right protection was used by shareholders of banks, not officially declared as insolvent, to sue against regulators.

In the midst of the crisis (17 October 2008), quibbles about moral hazard and safety nets notwithstanding, German authorities launched SoFFin, a special fund (*Sondervermögen*) to manage the fallout, with the help of two bad banks. In order to mitigate concerns about wrong incentives, this fund was deemed to be temporary – but, of course, later on morphed into the permanent resolution framework.

3 Tying Ulysses to one of the sirens?

When the European banking restructuring and resolution directive was discussed, Germany was at the forefront of pushing for more stringent rules. More specifically, it insisted on a paradigmatic shift: moving from a bailout to a bail-in regime. Concurrently, however, Germany was very reluctant to accept higher capital requirements (in the Basel rules or the Capital Adequacy Directive), to a degree probably reflecting the pressure emanating from its banks, a view shared across sectors.

Germany took a strong position in the negotiations on the banking union – an idea pondered long before in academia, becoming respectable however only in the summer of 2012, when talk of redenomination risk (i.e. the breakup of the Eurozone) was rife. Germany pushed for rules and quasi-automaticity in their enforcement. It also insisted on a sequenced implementation approach – first, common supervision and resolution before, eventually (if at all), moving on to joint funding of resolution and a mutualised deposit insurance system. While the quite successful history of sector-based deposit insurance might have informed this reluctance against a Eurozone-wide deposit insurance scheme, more important were concerns about legacy issues: Germany (and there are many Germanys in Northern Europe) did not want to be made liable for past losses, incurred by others.

The philosophy referred to, especially in *inner*-German debates, was ordo: policies had to be assessed as appropriate from this perspective (*ordnungspolitisch korrekt*).

Ordo – governance by rules, only?

However, backstopping banks (or their functional equivalents) necessarily impacts on incentives. For unwavering adherents of the Freiburg School, such support is therefore inappropriate. Any insurance of this type for bank managers and shareholders will, by necessity, be detrimental for debtors and the taxpayer at large.

What is so dear to ordoliberals, the *Haftungsprinzip* (liability principle) is weakened.[1] With the link between decision-making and responsibility severed, bank managers run risks beyond a societally optimal level. Whilst they can pocket profits when things pan out, when push comes to shove, they do not have to bear the consequences. Losses will be socialised.[2]

Applying the *Haftungsprinzip* in the last crisis (still somehow lingering) *à la lettre* would thus have meant bailing-in (or wiping-out) not only shareholders but also junior as well as senior debtors. Given that some of those junior debtors would have been other banks, it would not have been at all clear where this process would stop.

This is precisely the reason why bailing-in is not a convincing proposition in a systemic crisis (Goodhart and Avgouleas 2014). Banking crises are often not idiosyncratic. Expected costs risk being prohibitive. Under such circumstances all big banks are, *de facto*, Landesbanks (Kotz 2014).

And here's a further argument why banking is different: bailing-out a bank is, obviously, about underwriting claims registered as liabilities on a bank's ledger. Those are often assets of other banks. And it is these creditors which are ultimately bailed-out. On the receiving end of this positive externality are thus a bank's competitors (e.g. Beck *et al*. 2010).

1 Ordoliberalism comes in a number of distinct variants (see Young 2017 and Feld 2017 in this eBook or Vanberg 2015). Here we refer exclusively to the Freiburg School (in particular, Eucken 1952). The *Haftungsprinzip* is one of Eucken's eight "constitutive principles" (pp. 254-289). To be fair, in *Grundsätze,* Eucken did not have much to say on money and banking.

2 This is exactly the reason why some adherents of this school would do away with limited liability (see for example Sinn 2010). In a related vein, pursuing this logic to its end could also mean the end of inside money, created by banks (by the stroke of a key, as it were).

In reality, German banking regulation, although strongly influenced by the ordo school, was also heeding the lessons of the banking crisis of 1931, and was, therefore, much less radical. German law explicitly acknowledged the specialness of banks (Liepmann 1980): in the law on the Bundesbank, the law on credit institutions as well as in its competition law, defining banking for a long time as a *wettbewerblicher Ausnahmebereich* (a sector, exempted from standard rules of competition).

German banking rules were never unconditionally tied to Scylla.

Rules and systemic crises

For a long time, the North Atlantic did not experience a *systemic* crisis. To be sure, there were a host of problematic incidents (secondary banking crisis in the UK in the early 1970s, the Spanish real estate trouble in the mid-1980s, the US Savings and Loans Crisis in the 1980s, the Nordics in the early 1990s etc.). But not an encompassing, a generalised and definitely systemic one.

Germany was even more boring, as a result of its boring banking. Banks' individual problems were dealt with through mergers. And smaller accidents in the private sector (the Herstatt crisis of 1974, SMH-bank's liquidity travails in 1983) ultimately posed no real problem, politically or otherwise.[3]

Boredom might have spelled complacency.

Establishing a robust framework, allegedly *à la* Freiburg, was apparently working. Unconditionally abiding by the rules also meant that the power to distribute favours – which comes with discretion – was very limited (Vanberg 2015). And this is not a small danger, in particular in finance, where capturing – including mental – is almost inevitable. In any case, discretion, like pragmatism, has a somewhat negative connotation in the German debate, unlike in France, where a *volontariste* politics does not ring of short-term expediency but of a reasoned (*raisonnée*) assessment.

3 Herstatt was influential in launching the process ultimately leading to the Basel Accord. The SMH accident was handled by a cooperative effort organised by the Liquiditätskonsortial-Bank. Incidentally, this institution, given its by far too small scale, was not even mentioned in the last crisis. (Truth in advertising: during the crisis, one of the authors was deputy chairman of its supervisory board.)

It is important to note again, however, that this quiet boredom came partly at the expense of competition and innovation in the German banking system.

But, of course, in 2008/2009 this German approach was put to a severe test, and it was honoured in the breach. While the IKB and Sachsen LB incidents could be handled without immediate involvement of taxpayer's money, this was not possible anymore in the wake of Lehman – i.e. after Hypo Real Estate (involving the Pfandbrief market) *et al*.

4 One money, many banking politics

The North Atlantic Crisis hit the Eurozone's member states differently, and spread out over time.[4] Responses were accordingly differentiated – mediated by the respective national background conditions.

Different background conditions

In the first round, it was especially German banks which took a hit. To be precise, German banks with a defining business orientation: a strong focus on structured products, be they privately owned or held by public sector entities (*nota bene*, not the state). This also held true for some Swiss, UK or US banks, the latter actually dominating (in terms both of number and, in particular, of size of losses) the write-down league established by Bloomberg during the crisis.

The majority of German banks, mainly boring public-sector savings banks or cooperative-sector credit institutions, however, was not involved (Kotz and Schmidt 2017). Unlike their large competitors, enjoying some market power in their regional markets, they were less compelled to go for structured products. The latter have been aptly called in German "*Ersatzkreditgeschäft*" (no need of translation). In a highly contested domestic market, large German institutions (be they private or public), faced with demanding (unachievable) RoE expectations, took highly leveraged positions in structured (derivatives) products, in particular since the mid-2000s (Shin 2013).

4 Greece, Cyprus or Spain, for that matter, were below the market's radar until the end of 2009.

Again, they have not been, by a long way, the only offenders (as they were judged *ex post*, but not at the time).

Italian and French banks were also, initially, less exposed since their supervisors were less inclined to allow booking *typical* bank business (for reasons of "capital-efficiency") off balance sheet. They also enjoyed markets with higher margins in traditional banking.[5]

…and nationally differentiated policy responses

As a quasi-physical corollary, this meant essentially different national policy reactions within the Eurozone.

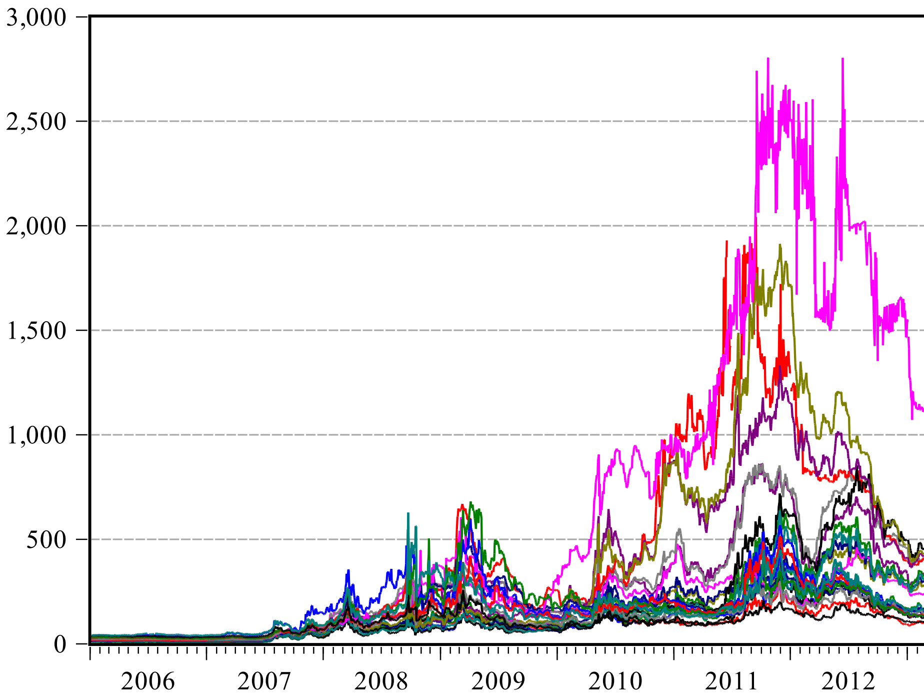
In fact, this was not seen as a problem, insofar as externalities, spilling across borders, were duly taking account of. At the time, Europe – with largely similar rulebooks as well as its colleges of supervisors, memoranda of understanding, the EU Commission, the Council, and, not to forget, its supranational ECB – deemed itself to have a resilient and performing structure in place. The cases of Fortis, Dexia etc. however made undeniably clear that this was not the case.

The important first attempt at mending this institutional flaw, the *de Larosière Report*, judged as ambitious at the time, led to a new structure of European Supervisory Authorities. Still, the dominating principle was coordination amongst Eurozone member states. Incidentally, very much in line with the Freiburg liability principle – if it's ultimately national taxpayers who are on the hook, mutualisation is difficult to justify.

Markets responded in kind. Sovereign spreads and premia to be paid in order to insure against bank defaults correlated strongly along the national dimension (see figure 2). The singleness of the currency – bank-created "inside" euro money – was endangered. It took President Draghi's "Whatever it takes, within the mandate" (i.e. the outright monetary transactions programme, with its conditionality) to stop the rut.

5 As did Canadian or Australian banks, both from markets with higher concentration ratios.

Figure 2. CDS premia European banks



In other words, another existential crisis was again needed to get what we now have, a (still) incomplete banking union. Europe went beyond coordination towards more centralisation in banking supervision (SSM), in restructuring and resolving troubled banks (SRM). It is also about to harmonise deposit insurance. While this is the maximum achievable under current political-economic circumstances, one can rightfully doubt whether this set-up could weather a major financial dislocation.

5 Rules cum discretion

Tying banking politics to Scylla (pure discretion) would make it rudderless, difficult to account and democratically illegitimate. Much of what ordo suggests thus also shows in contemporary economics, though in a different vernacular.

In particular, two concepts – moral hazard and time inconsistency – are almost explicitly part of the Freiburg programme.[6] Setting incentives right (creating robust institutions) is of the essence. Robust rules, giving not too much discretionary leeway, also means that technocrats have a protective shield against special interests.

However, rules have to be credible. Insisting, unconditionally, on enforcement, disregarding consequences (opportunity costs) is exactly not that: credible. Rules will remain incomplete. And the bluff is regularly called. Just recall the blanket deposit guarantees promised – including in Germany on a famous Sunday afternoon in early October 2008. Charybdis is another corner solution, prone to fail.

However, reasonable people can disagree on the trade-offs (the balance of opportunity costs) implied.

Banks (as well as nonbank banks, i.e. their, not yet appropriately accounted for, functional substitutes) are special: opaque (difficult to assess), generators of externalities, at times systemic (too similar to tell a difference). Therefore, they can be the source of very serious fiscal problems.

They require both: rules with credible enforcement as well as, at times, discretion.

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6 Though, ordo has no regard for macro stabilisation, see Landmann (2017) and Zettelmeyer (2017), both in this eBook. Interestingly, Alfred Müller-Armack, *spiritus rector* of ordos's Catholic-Cologne version, could imagine a positive macro-stabilisation role.

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About the authors

Thorsten Beck is Professor of Banking and Finance at Cass Business School in London. He is also (Co)-Managing Editor of *Economic Policy* and Co-editor of the *Review of Finance*. He was Professor of Economics and founding Chair of the European Banking Center at Tilburg University from 2008 to 2013. Previously he worked in the research department of the World Bank and has also worked as a Consultant for – among others - the ECB, EIB, IMF, the European Commission, ADB, and the German Development Corporation.

His research and policy work has focused on international banking and corporate finance and has been published in *Journal of Finance*, *Journal of Financial Economics*, *Journal of Monetary Economics* and *Journal of Economic Growth*. His research and policy work has focused on Eastern, Central and Western Europe, Sub-Saharan Africa and Latin America. He is also Research Fellow in the Centre for Economic Policy Research (CEPR) in London and a Fellow in CESifo. He studied at Tübingen University, Universidad de Costa Rica, University of Kansas and University of Virginia

Hans-Helmut Kotz is a Resident Fellow, Center for European Studies as well as a Visiting Professor of Economics, both at Harvard University. At Goethe University, he is a Program Director of the SAFE Policy Center and Senior Fellow of the Center for Financial Studies. He is also on the economics faculty of Freiburg University. He was a Board Member of Deutsche Bundesbank (2002-2010), in charge of Financial Stability, Markets, and Statistics and as such a member of a number of committees and working groups of the Bank for International Settlements, the Financial Stability Board as well as the OECD, where he was Chair of the Financial Markets Committee. He was also the Central Bank Deputy for the G7 and the G20 process.

Before that, he was President of the Landeszentralbank in Bremen, Niedersachsen and Sachsen-Anhalt (1999-2002) and Chief Economist at Deutsche Girozentrale. Between 2002 and 2005 he served in a personal capacity as a member of the European Parliament's Expert Group on Financial Markets. He has published widely (*Zeitschrift für Betriebswirtschaft*, *Revue d'Economie Financière*, *Intereconomics* etc. as well as numerous edited books).

In addition to his academic positions, he is a senior advisor to McKinsey & Co. and serves on the Supervisory Board of Eurex Clearing AG, Frankfurt/Zurich. He is also a non-executive Member of the Board of Caixa General de Depósitos, Lisbon.

I Ordoliberalism and macro-management

10 What's wrong with EZ: Conflicting narratives

Oliver Landmann
University of Freiburg, Germany

1 Introduction: "The Battle of Ideas"

On the occasion of the tenth anniversary of EZ, the European Commission (2008) was in a jubilant mood, declaring: "Ten years into its existence, the euro is a resounding success". No one would share this assessment today. But what went wrong, and why? By which criteria do we judge success and failure? Without a broadly shared view on these questions, there is little hope that the Eurozone will ever develop into the prosperous, resilient economic area its founding fathers had hoped to create. As one crisis was followed by the next, divisions between the members of the currency union deepened. The bitter disagreements and tough negotiations between governments may often appear to reflect narrow pecuniary conflicts of interest. But much more is at stake than who pays the bills. As Markus Brunnermeier, Harold James and Jean-Pierre Landau (2016) forcefully argue in their recent book, Northern and Southern members of the EMU ("Germany" and "France") are divided by fundamental differences over the appropriate economic philosophy that should guide the governance of the Eurozone. Not surprisingly then, narratives of what went wrong with the euro and what should be done about it reflect these conflicting philosophies and lead to sharply conflicting conclusions.

Brunnermeier, James and Landau's "Battle of Ideas" is related to the antagonism between German ordoliberalism and Anglo-Saxon pragmatism which forms the topic of the present eBook. The German insistence on the enforcement of existing rules borrows from the doctrine of ordoliberalism the idea that economic policy should be strictly rule-based and refrain from any discretionary meddling with the economic process.

The French *penchant* for discretionary flexibility, which puts the judgment of policymakers above predetermined rules, in turn, shares a lot with Anglo-Saxon pragmatism. To be sure, the French and Anglo-American economic cultures differ in many ways. But, when it comes to economic policy and to the question of whether government can be trusted to act in the interest of the common good, they may both be inclined to grant authorities the benefit of the doubt, whereas ordoliberalism is preoccupied with keeping the power of government in check.

Problems within EZ are often attributed to policy mistakes and structural weaknesses in individual member states. However, this approach risks obfuscating the larger point of what it takes to make a currency union work. Any assessment of what's wrong with EZ must be conducted with a view to the Eurozone as a whole and with a focus on indicators of its macroeconomic performance. It is on this level that the choice of a monetary arrangement and its institutional underpinnings matter most. The salient macroeconomic symptoms of what went wrong in the Eurozone are reviewed in Section 2.

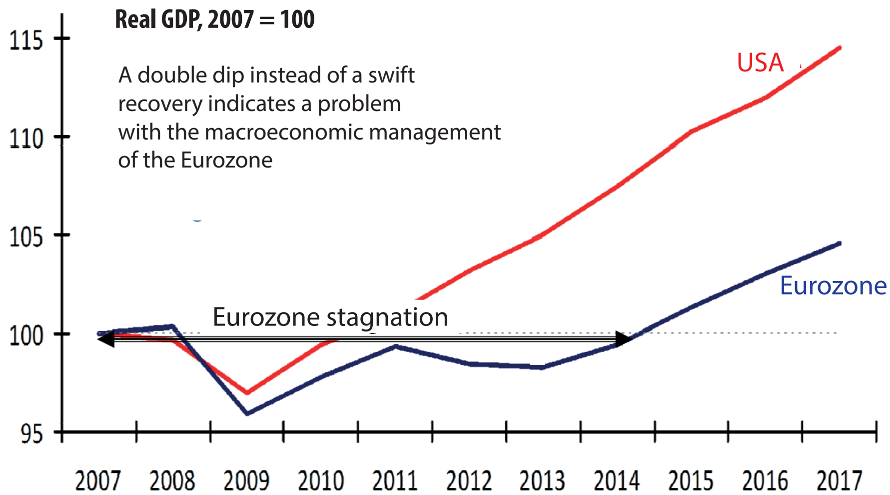
Next, this chapter addresses the economic philosophy from which the policy response to the failings of the Eurozone is derived. Unquestionably, nothing much happens without Germany's blessing. German economic philosophy, in turn, is in line with, if not directly informed by, ordoliberal thought along several dimensions (Feld *et al*. 2015). Although ordoliberalism has few insights to offer on macroeconomic issues, Section 3 explores its general approach towards macroeconomic policy and finds the doctrine wanting in this regard.

2 What went wrong in the Eurozone: Three observations

The EZ and the USA are economies of comparable size and living standards. Both were hit by the Global Financial Crisis of 2009 with comparable force. Both experienced a fall in output to a comparable extent. But their recoveries from that recession could not have been more different (Figure 1). The US economy swiftly recovered from its trough and surpassed its pre-recession level of GDP as early as 2011. Though branded as "disappointing" by American analysts (e.g. Fernald *et al*. 2017), the recovery has continued without interruption ever since. By way of contrast, the Eurozone, after a short-lived and weak recovery, fell back into a 'double dip recession' by 2011.

Is it a mere coincidence, that in 2011, the European Central Bank raised its policy rate twice and Eurozone fiscal policies reverted to drastic procyclical austerity across the board? Clearly, the EZ has a serious problem with its macroeconomic management.

Figure 1. Recovery from the Great Recession – the EZ and the US compared



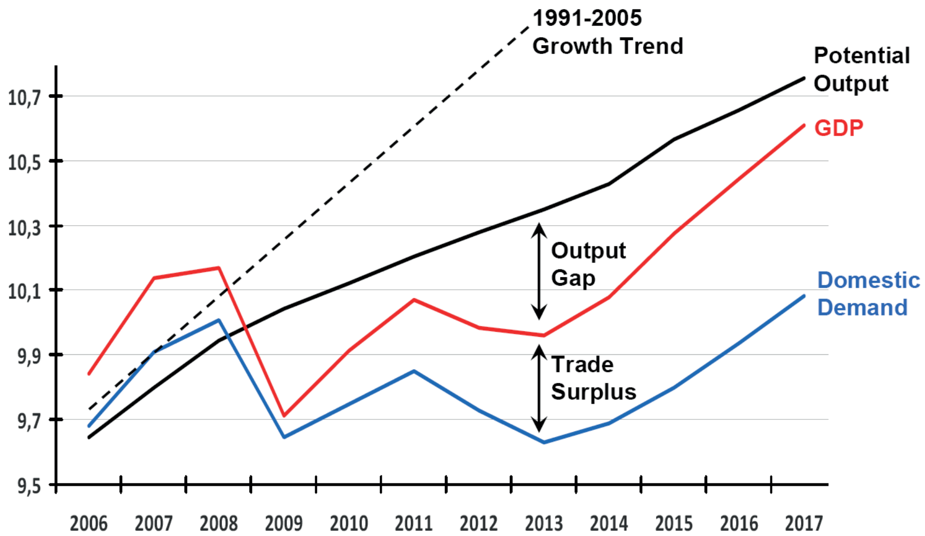
Data Source: OECD Economic Outlook Database (Figures for 2016 and 2017 are OECD projections)

The second observation refers to what is known in international macroeconomics as internal and external equilibrium. Figure 2 plots the real GDP of the aggregate Eurozone both against an OECD estimate of potential output and against real domestic demand.[1] The Eurozone is currently approaching internal equilibrium as real GDP has almost caught up with potential output by 2017. Whether this means that the level of aggregate demand in the Eurozone is back where it should be may be dubious. If the substantial drop of potential Eurozone output below the pre-2005 trend is in part due to hysteresis, i.e. a delayed consequence of the prolonged stagnation of actual output, as recent research suggests it is, there might be some scope for more vigorous demand growth to reverse the slowdown of potential output growth at least partially (Ball 2014).

1 Here, real domestic demand refers to domestic demand, expressed in units of domestic output.

Whereas the output gap of the Eurozone is shrinking, its external trade surplus has been growing relentlessly since the Great Recession of 2009. As Figure 2 reveals, domestic demand lags far behind GDP growth. Total domestic demand in the aggregate Eurozone has barely grown above its pre-crisis level by 2017, which indicates that the modest output growth the Eurozone has achieved during this period was not of its own making. Rather, the Eurozone has been sailing on the coat-tails of a respectable recovery of the world economy. Had the rest of the world tried to follow the same formula, it would still be mired in the depths of the Great Recession.

Figure 2. Real GDP and real domestic demand, aggregate Eurozone, 2006-2017



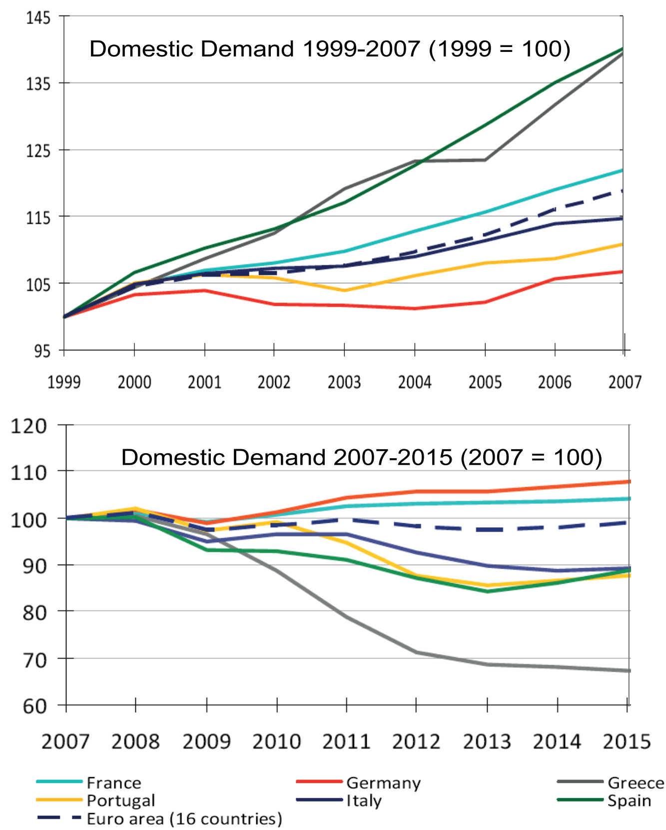
Real values, expressed in billions of 2014 euros

Data Source: OECD Economic Outlook Database (Figures for 2016 and 2017 are OECD projections)

A third observation refers to the macroeconomic tensions within the Eurozone. From its very beginning, the EZ experienced pronounced macroeconomic disparities across its member states (Landmann 2011, 2012). At first, domestic spending soared in much of Southern Europe whereas the German economy, in particular, hardly grew at all. The resulting divergence of cyclical conditions is illustrated in the upper panel of Figure 3. The European Central Bank was powerless to do anything about this situation. Inevitably, its monetary policy stance was too tight for Germany and too loose for the periphery, at the same time.

Later, when the Great Recession hit the Eurozone, it created new asymmetries. As shown in the lower panel of Figure 3, Germany's aggregate spending fell only slightly and returned to moderate growth soon thereafter whereas domestic demand in a number of other Eurozone countries literally collapsed and remained depressed for many years. As much as circumstances differed before and after the crisis, Figure 3 makes it abundantly clear that the EZ lacks the means to address major internal disparities.

Figure 3. Domestic demand divergence, 1999-2015



Data *Source*: OECD Economic Outlook Database

All has not gone wrong with EZ. The euro, widely feared to become a soft currency initially, proved to be the opposite: stable and well-accepted worldwide. Also, the European Central Bank proved to have the capacity to ensure reasonable macroeconomic stability for the aggregate Eurozone economy, provided it has traction. However, it has also become clear that monetary policy cannot run the show alone.

If a currency union is hit by asymmetric shocks, as the EZ was, and if it lacks effective built-in adjustment mechanisms, as the EZ does, severe macroeconomic imbalances are bound to arise and persist. Moreover, if a currency union suffers an adverse demand shock of a magnitude that even zero nominal interest rates cannot offset, the union must have other policy tools ready to assist its central bank in the task of managing aggregate demand. All of this was well known at the time the architecture of the common currency was designed. And yet, when these risks materialised, EZ was caught off guard and failed to address them adequately. That, in a nutshell, is what went wrong.

3 Macroeconomic stability: the blind spot of ordoliberalism

The failures of demand management and the lack of precautions against imbalances within EZ do not play a prominent part in the narrative which forms the Conventional Wisdom in Germany. German accounts of what needs to be corrected tend to highlight economic and fiscal discipline, the avoidance of moral hazard, the strict observation of rules, and the rejection of fiscal transfers (Feld *et al.* 2016). This narrative regards the large disparities across the Eurozone as proof that appropriate domestic policies are the key to a successful economic performance under a common currency. Structural reforms are seen as the primary responsibility of individual member states where governments have the democratic legitimacy to implement them. Labour market reforms, debt brakes, opening markets, improving corporate and public governance may be painful, they may require patience, we are told, but they pay off. Isn't Germany's transformation from being Europe's 'sick man' in the early 2000s into its strongest economy largely the result of its own rigorous reform efforts? And doesn't the long-term success of these reforms prove the point? While this narrative maintains that the German model and its results can and should be emulated by anyone, it also warns that structural reforms will hardly ever be implemented if governments succumb to the sweet temptation of demand stimulus.

Brunnermeier *et al*. (2016) contrast this way of thinking with the French (or Latin) economic philosophy, according to which the German model is not the solution, but the problem. From this point of view, it is the rigidity of the rules which has prevented a speedier recovery from the 2009 recession, not the failure to enforce them.

An economic paradigm which relies on massive trade surpluses to support growth is rejected as a role model for the entire Eurozone, let alone the world economy. The French economic tradition suggests a different way out of the crisis, therefore: a flexible fiscal response, a central bank committed to economic growth as much as to price stability, and a symmetric adjustment to international imbalances, eschewing mercantilist zero-sum games such as wage reductions to bolster competitiveness.

There is no compelling reason at all why a rule-based governance and a proper alignment of incentives should be fundamentally incompatible with a framework for effective macroeconomic demand management. But it appears that the economic philosophies associated with the conflicting narratives have manoeuvred policymakers into sort of a Catch-22 situation. If the German belief system views any demand stimulus as killing off incentives to start structural reforms and the Latin belief system views structural reforms as ineffective in a demand-constrained economy, it is hard to break out of the paralysis that prevails on either front. The solution, quite obviously, is what Blanchard *et al.* (1986) had long ago dubbed a "two handed approach": supply-side and demand-side policies must be implemented in tandem if they are to yield the desired results.

The way the German narrative downplays cyclical stability as a central concern for economic policy or for the institutional design of a currency union is widely regarded as puzzling. It is puzzling not only to the French and other Latin Europeans, but also to Anglo-American economists who look upon the Eurozone from the outside in bewilderment. Not all of them would go as far as Paul Krugman who criticised Germany as "both self-satisfied with its situation and living in its own intellectual universe" (in his NYT Blog on August 20, 2016). But many would agree that the German narrative does not offer a convincing explanation for the macroeconomic weaknesses of the Eurozone. As a case in point, how would more vigorous structural reforms or a better alignment of liability and control have helped overcome the persistent stagnation of the Eurozone in the wake of the 2009 recession?

There is some debate as to whether German macroeconomics has its own life, as a school of thought separate from the Anglo-American-dominated mainstream (Burda 2016), or whether standard macroeconomic analysis is superseded by ordoliberal doctrine as a policy framework of German decision-making in euro matters (Bofinger 2016).

One should tread carefully here. The mere observation that top German government officials routinely genuflect to ordoliberalism at festive occasions such as an Eucken anniversary (Merkel 2016) should not be mistaken as an indicator of the factual influence of ordoliberalism on German policymaking. Undeniably, however, the German narrative neatly fits into the ordoliberal mould; and so does the spirit of the Maastricht Treaty which bears the unmistakable signature of Germany. The belief in the virtue of rules, the high priority attached to price stability and the insistence on the liability principle, as enshrined in the no-bailout clause for example, are the very principles that form the backbone of ordoliberalism.

When Walter Eucken (1952) wrote up his ordoliberal rulebook for a market economy, macroeconomic concerns other than price stability were not at the centre of his thought. Although he did reflect on lessons to be learned from the Great Depression, he concluded that major disturbances of the type of the Great Depression could be all but ruled out if only the ordoliberal rulebook was faithfully observed. He was adamant in his rejection of any systematic Keynesian countercyclical demand management. He was convinced that any such policy was bound to destroy the operation of the price system and to pave the way to a system of central administrative control. He felt vindicated by the experience of the "epoch of full employment policy" in Germany, by which he referred to Hitler's job-creating agenda of the 1930s and which indeed ended in a system of central control.

It is here, in the interpretation of the years of the Great Depression, that ordoliberal and Anglo-American thinking differ most sharply. As many shades of Anglo-American economics as there may be, they are virtually all in agreement that the Great Depression demonstrated the effectiveness of macroeconomic demand policy as well as its compatibility with a decentralised allocation mechanism relying on price signals. Joan Robinson (1972, p. 8) famously refused to regard the Keynesian revolution as a great intellectual triumph because it came too late: "Hitler had already found how to cure unemployment before Keynes had finished explaining why it occurred." Paul Samuelson (1955) introduced the concept of the "neoclassical synthesis" to express the idea that macroeconomic stabilisation policy, far from destroying the market economy, rescues capitalism from the throes of depression and deflation and thereby makes a decentralised price system workable in the first place.

As a foundation for a unified economic research paradigm, the neoclassical synthesis may not have lived up to its promise (Blanchard 1991). But as a general vision of the complementarity of demand management for the sake of macroeconomic stabilisation and a supply-side framework for the sake of microeconomic efficiency, it has stood the test of time very well. If any further proof had been required that Eucken's dismissal of countercyclical demand policy was premature, it was provided by the comparative experience of the UK, the US and the Eurozone since 2009. Neither of the Anglo-Saxon economies can be said to resemble a centrally controlled system even remotely, but both of them have responded to the Great Recession with significantly more vigorous demand stimulus than the Eurozone, and they have enjoyed significantly quicker and stronger recoveries as a result.

4 Conclusion

The promise of "One Market, One Money" was not just the promise of a convenient and reasonably stable medium of exchange. It was a promise of "microeconomic efficiency", "macroeconomic stability", and "equity as between countries and regions" (European Commission 1990, p. 9). Quite obviously, EZ has thoroughly failed to deliver on this promise, thereby feeding widespread disillusionment with European integration more broadly. The key failure, both in the institutional design of EZ and in policy choices made in times of crisis, was a lack of attention to macroeconomic stability, be it on the level of EZ as a whole or in individual member states.

EZ was built on the premise that the Eurozone economy would be self-stabilising if only a policy framework was put in place to ensure the stability of the aggregate price level and the efficient operation of markets. This very same belief in the self-stabilising capacity of a market economy is a cornerstone of the ordoliberal school of thought. A long history of financial and economic crises in market economies lends precious little support to this belief. Many great minds in economics have explained why, none more compellingly than John Maynard Keynes (1936). A vast literature on the economics of currency unions has shown what it takes to maintain macroeconomic stability once the equilibrating mechanism of exchange rate adjustment is no longer available – most of which was serenely ignored by the Panglossian spirit of the Maastricht Treaty. The principles of ordoliberalism may provide valuable guidance on many fronts. But unless macroeconomic stabilisation takes centre stage in EZ's policy framework, no amount of ordoliberal virtue will sustain the common currency for long.

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About the author

Oliver Landmann is Professor of Economics at the University of Freiburg, Germany. He holds a doctorate from the University of Basel, Switzerland. He has previously worked for the Swiss National Bank and as a Program Director for the Swiss Science Foundation. Also, he has been a consultant to the International Labour Organization (ILO), a member of the Federal Commission for Business Cycle Issues at the Ministry of Economics, Switzerland, and a visiting professor at the Universities of Basel, Switzerland, and Nagoya, Japan. He has published widely on macroeconomics, employment theory, and international monetary economics and contributed columns to German and Swiss print media. His most recent research deals with the macroeconomics of the European Monetary Union and with international economic policy coordination. His publications can be accessed under http://www.macro.uni-freiburg.de/publications.

11 German ordoliberals vs American pragmatists: What did they get right or wrong in the euro crisis?

Jeffrey Frankel
Harvard University

I leave it to other contributors to elucidate the concepts of German ordoliberalism and "American pragmatism" (or Anglo-Saxon pragmatism).[1] I will assume that we have a general idea to what each of these terms refers and I will focus, rather, on what the two approaches had to say about the euro crisis, including the policy issues that led up to it and the measures taken after the crisis arose. Neither party had it all figured out. What did they get right and what did they get wrong? We begin with the origins of the euro and the roots of the crisis, before turning to attempts to deal with it in 2010 and thereafter.

What German ordoliberalism got right at the birth of the euro

German ordoliberals got some things right when the terms of European Economic Monetary Union were agreed at Maastricht in December 1991. They recognised that the danger of excessive national budget deficits – to which they are by nature always acutely sensitive – would be exacerbated by moral hazard from the anticipated likelihood of bailouts in the event of difficulty. Ordinary German citizens were wary of monetary union, on the grounds that they

1 But, briefly: German ordoliberals believe in classical liberalism, supported by a democratic constitution, including (i) emphasis on the rules under which economic agents play the game; (ii) government intervention to enforce the rules, including to enforce competition; (iii) an aversion to counter-cyclical macroeconomic policies, and especially discretionary fiscal or monetary policies, as inconsistent with rules.

would eventually be asked to bail out some profligate Mediterranean country. The leaders sought explicitly to address these concerns with a set of rules to bind euro members, which were agreed at the level of the European Union. These rules included:

- The Maastricht fiscal criteria, which specified that among the pre-conditions for a country to join the euro, it had first to achieve a budget deficit under 3% of GDP and a public debt under 60% of GDP or at least a path approaching that level.
- The Stability and Growth Pact of 1997 (SGP), which took the fiscal criteria required to join the euro and extended them as requirements for members thereafter, supposedly to be enforced by fines.
- The feature of the 1991 Maastricht treaty (reaffirmed in the 2007 Lisbon Treaty) that is popularly known as the "No bail-out clause", which prevents member governments from being responsible for the debts of other member governments.

The importance of fiscal moral hazard in a monetary union was not as obvious as it may seem in retrospect. North American economists had long kept a list of criteria that were thought to qualify nations to join in an "optimum currency area" but fiscal constraints did not even appear on their list.[2] If anything, the loss of independent monetary tools at the national level suggested the need for an *increase* in the counter-cyclical use of the fiscal policy tool.[3] This would have meant allowing more fiscal latitude at the national levels or, as in the US, creating fiscal buffers at the federal level. Or both. But the German 'ordo' view was correct to identify the fiscal problem, as subsequent experience has borne out.

Versus what US 'pragmatism' had right

American economists tended to be sceptical of the euro project from the beginning.[4] Many of their concerns have been borne out, particularly concerns that European countries did not constitute an optimum currency area, certainly not to the extent that American states do.[5]

2 The optimum currency area literature began with Mundell (1961), a Canadian.

3 E.g. Buiter *et al*. (1993).

4 As catalogued in the ill-timed paper by Jonung and Drea (2009),

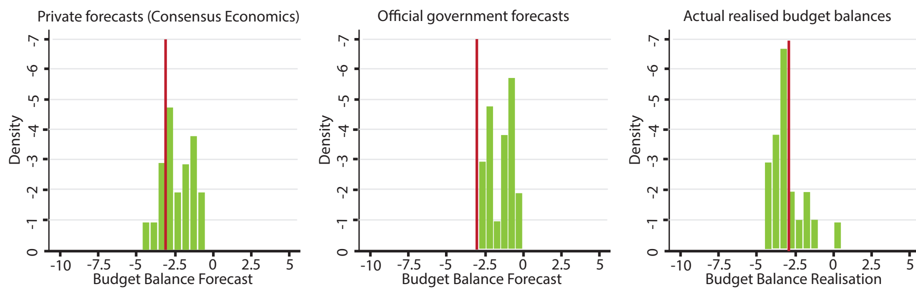
5 Eichengreen (1992).

They correctly predicted the importance of asymmetric or asynchronous shocks and the difficulty of dealing with them once countries had lost monetary independence. Ireland, for example, in 2004-2006, needed a tighter monetary policy than the ECB (European Central Bank) was prepared to set, because it was experiencing a housing bubble and economic overheating; during 2009-2013 it needed an easier monetary policy than the ECB was prepared to set because it was in steep recession.

What German ordo got wrong, when fiscal rules were violated

Although the architects of the euro had correctly identified the problem of fiscal moral hazard and tried to address it in advance by fiscal rules, these rules did not work in practice. As American pragmatists had suspected, the SGP fiscal rules were unenforceable. Virtually all euro members except Luxembourg soon violated the 3% budget deficit rule, including Germany.

Figure 1. Forecasts of budget balances and actual realisations, as % of GDP, among Eurozone countries, pre-2008



Source Frankel & Schreger, 2016, “Bias in Official Fiscal Forecasts: Can Private Forecats Help?”, NBER WP 22349.

Note: In the euro countries which are subject to SGP rules, the optimism bias was reflected in the practice of never officially forecasting next year’s budget defecit > 3% of GDP, even though such defecits recurred, as seen by private forecasters.

The response of the ordoliberals was continuation and escalation of language insisting on rules and the sanctity of debt, with little reason to think that the rules could be enforced. This included:

- Repeated unrealistic assertions that fiscal targets would be met in the future, assertions that could only be maintained via consistently over-optimistic forecasts. Governments never forecast that they would have a budget deficit in excess of 3% 1999-2008, even though they did, often in successive years.[6] Rules that are too stringent to be credible can be worse than no rules at all.[7]
- Refusal to write-down Greek debt in 2010, despite Debt Sustainability Analysis that showed the debt/GDP path to be explosive even with stringent fiscal austerity.
- Other forms of head-in-the-sand procrastination, notably a series of European summits that tended to 'kick the can down the road'.
- Vast underestimation by the troika (ECB, EU Commission and the IMF) in 2010 and thereafter of the fall in income that would follow from austerity in the periphery countries.[8] Even leaving aside the economic cost of the recession and the political cost of associated populist anger, fiscal austerity did not achieve its financial goal of putting Greece and other periphery countries onto sustainable debt paths. To the contrary, the fall in GDP was greater than any fall in debt, with the result that debt/GDP ratios rose at accelerated rates.[9]
- Successive attempts to revise the SGP rules (such as the "Fiscal Compact" of 2012).

6 Frankel and Schreger (2013). See Figures 1 and 2.

7 Greek indiscipline and ordo discipline interacted in such a way as to produce the worst of both worlds: When Greece joined the euro, it began to run one of the world's most pro-cyclical fiscal policies. Figure 3 shows by country the correlation of the cyclical components of spending and GDP. (The cyclical components of each were computed using a HP filter with $\lambda = 6.25$ and expressed as percentage deviations from the trend. For each country, the HP filter was applied exclusively to the common sample of spending and GDP (i.e. considering only the years for which data for both were available) so that any start-/end-of-sample bias of the HP filter would apply symmetrically to both variables. In addition, forecasts in the out-years until 2022 were included in both series before applying the HP filter.)

8 Blanchard and Leigh (2013) argue convincingly that the underestimation of the severity of the recessions took the form of underestimation of fiscal multipliers. See Figure 4.

9 See Figure 5. Fatás and Summers (2017) argue that fiscal austerity may have exacerbated debt/GDP paths not just in the short run but even in the long run.

Figure 2. Official Greek forecasts of budget balance, 1, 2 & 3 years ahead

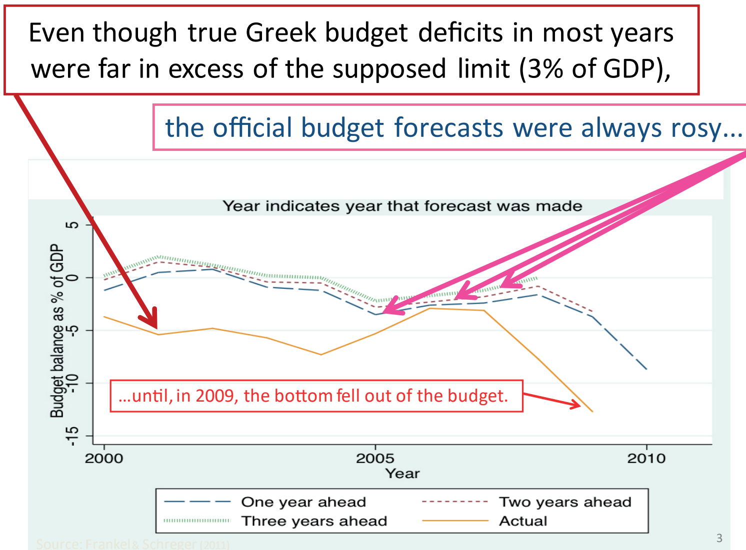
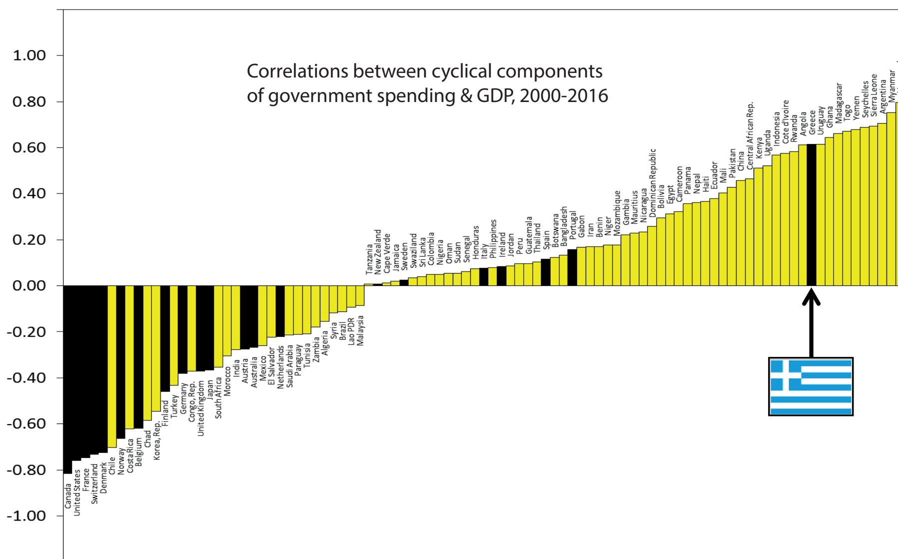


Figure 3. In the years after 2000, Greece adopted a pro-cyclical fiscal policy (positive correlation of G & GDP), while many developing countris began to go the other way.

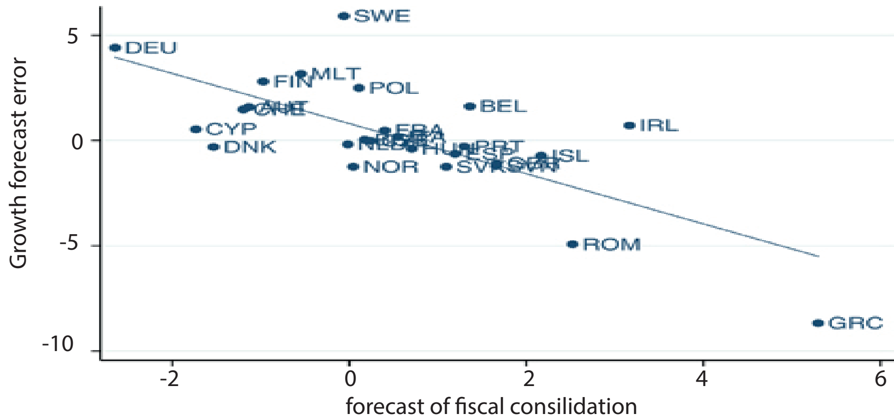


Source: updated from Frankel, Vegh & Vuletin, 2013, "On Graduation from Fiscal Pro-cyclicality", *Journal of Development Economics.* Thanks to Jose Andree Camarena Fonesca

Figure 4. The bigger the fiscal contraction, the bigger the GDP loss relative to what had been officially forecast, in the EU 2010-11

=>True multipliers > than multipliers that IMF had been using.

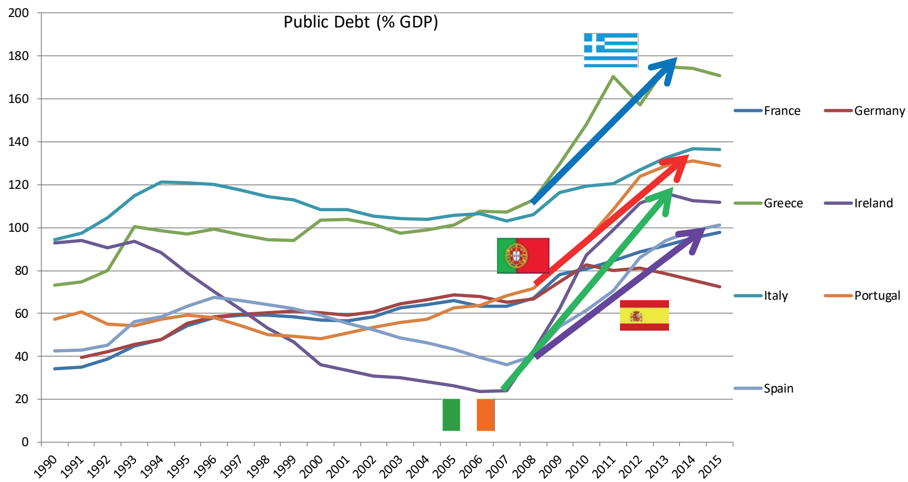
Europe: Growth forecast errors vs. fiscal consolidation forecasts



Source: Blanchard & Leigh, 2014, "Growth Forecast Errors and Fiscal Multipliers", American Economic Review.

Not: Figure plots forecast error for real GDP growth in 2010 and 2011 relative to forecasts made inthe spring of 2010 on forecasts of fiscal consolidation for 2010 and 2011 made in spring of year 2010 and regression line.

Figure 5 With austerity, debt/GDP ratios continued to rise sharply – declining GDP outweighed progress on reduction of budget deficits



Source: Remi Bourgeot, Fondation Robert Schuman. Data source: IMF *WEO*, October 2014

What everyone got wrong

After the EZ came into effect in 1999, the periphery countries experienced large current-account deficits, financed by large net capital inflows. This was perceived as evidence that cross-border financial integration was working well. It seemed that the lifting of financial and monetary barriers had allowed capital to flow efficiently to countries that had a higher return to capital because of relatively lower capital/labour ratios, as in the days of the gold standard before WWI.

Before 1999, it had been expected that more highly indebted euro members would have to pay higher interest rate spreads on their debt, as do states in the US, and that this would furnish a market-based incentive to avoid excessive debt levels. Instead, interest rates among all member countries fell, almost to the level of the interest rate on German debt. This absence of meaningful spreads should have been seen as a signal that the problem of moral hazard from perceived guarantees was alive and well. But the convergence of interest rates was instead seen as another sign that financial integration was working well.

Most observers also made the mistake all along of failing even to think about banking regulation at a pan-euro level let alone to propose to go all the way and create a banking union. It was only Greece that ran egregiously excessive budget deficits before 2008. Budget deficits and debt/GDP ratios were much more moderate in other countries like Ireland. There the problem was instead in the banking sector. To make a government debt problem out of a financial crisis that in turn had originated in a housing bubble, it took the euro crisis and a decision that the government of Ireland should bail out its banks (including large creditors).[10]

What the pragmatists' view still has right

Greek debt is still not sustainable. The target for the primary fiscal surplus should not be 3.9 % while Greek unemployment still exceeds 23%. Even if the fiscal target is achieved, a sustainable path for the debt/GDP ratio will not be achieved. Rather, the debt should be further written down.

10 One of the foresighted lessons in the celebrated book by Reinhart and Rogoff (2009) is that a banking crisis is often followed by a fiscal crisis in this way.

What ordoliberalism still has right

Structural conditionality is in order. This especially applies to labour market reforms. Employers should feel able to hire new employees without fearing that the result will necessarily be expensive lifetime commitments. Shopkeepers should be allowed to sell aspirin without a pharmacist's license. Needless to say, there are serious domestic political obstacles to such reforms in each country. But the same is true of fiscal austerity. Structural conditionality is more likely than fiscal contraction to deliver economic growth. Economic growth is the key both to debt sustainability and political sustainability. Only by combining the points that the ordos have right with the points that the pragmatists have right can the crisis be laid to rest and prosperity restored.

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About the author

Jeffrey Frankel is Harpel Professor of Capital Formation and Growth at Harvard University's Kennedy School of Government. He is a Research Associate of the National Bureau of Economic Research, where he is also on the Business Cycle Dating Committee (which officially declares U.S. recessions) and co-chairs the International Seminar on Macroeconomics. Professor Frankel served at the US President's Council of Economic Advisers in 1983-84 and 1996-99; he was appointed by Bill Clinton as CEA Member with responsibility for macroeconomics, international economics, and the environment.

Before moving east, he had been Professor of Economics at the University of California, Berkeley, having joined the faculty in 1979. In the past he has visited the IMF, the Federal Reserve Board, and the Peterson Institute for International Economics. His research interests include currencies, crises, commodities, international finance, monetary and fiscal policy, trade, and global environmental issues. He was born in San Francisco, graduated from Swarthmore College, and received his Economics PhD from MIT.

12 The euro and ordoliberalism

Charles Wyplosz
The Graduate Institute, Geneva and CEPR

Introduction

Just a few years ago, outside of Germany ordoliberalism was largely unknown or simply considered to be a curious idiosyncrasy of little consequence. The Eurozone debt crisis has revealed the power of this approach to shape events. The insistence on abiding by existing fiscal rules, the deeply flawed Stability and Growth Pact, led to procyclical fiscal policies in hard-hit countries. Yet, the pact had repeatedly failed before, as spectacularly demonstrated by the debt crisis. The response to the pact's failures was to impose more rules, equally unlikely to succeed. Pressure on the ECB to stay put when the Eurozone was disintegrating was predicted on another set of rules, even though it was – and remains – a matter of interpretation as to what these rules say.

In fact, the principle of rules-based policies always has been a relative. The suspension of the Stability and Growth Pact in 2003 is the obvious conspicuous example of rules being bent to avoid a clash with the Eurozone's two largest member countries, and including the bailouts of crisis countries during the crisis. Other significant departures from the rule include the "because it is France" lenient treatment of budget deficits in 2015 or the ESM loans to Spain without a Troika programme in 2012. Within Germany, much the same has occurred again and again as recalled by Young (2014). Rules-based policymaking makes a lot of sense but the need for some discretion is inescapable.

This chapter makes the following points. Explicit rules of the game are a key advantage of the Eurozone architecture but a key weakness is its management of discretion. The decision process is weakly designed, with the unfortunate implication that discretion is highly politicised, systematically working at the discretion of the most powerful countries or country (Feld, 2016). Therein lies the increasingly recognised

"German problem" of the Eurozone. It is sometimes asserted that the German Problem is grounded in an idiosyncratic macroeconomic theory that prevails in Germany. The reality seems subtler. German macroeconomists are, by and large, 'normal' macroeconomists (Burda 2016), but the political establishment, especially the Bundesbank, and the public at large have adopted a crude version of ordoliberalism (Bibow 2017, Young 2014) which is used to protect Germany's narrow interests.

Ordoliberalism as normal, but under-developed, economics

Back when Eucken and his colleagues were developing what has come to be known as ordoliberalism, the field of economics was not unified, macroeconomics was under early development as a separate field, and Popperian hypothesis testing was not seen yet as the acid test of rigorously defined theories. Ordoliberalism stood on its own, as did many other theories. Although mainstream economics is frequently challenged, as it should be, it has become wide and flexible enough to incorporate most old and new shoots. This should include ordoliberalism, and it does.

At the risk of oversimplification, ordoliberalism is a theory based on the assumption that policymaking is subject to failures, in tune with the Public Choice literature developed by Buchanan, North and many others. Ever since Arrow, Samuelson and others unified economic theory, a considerable amount of research has explored the consequences of all sorts of market failures, defined as departures from the exacting requirements of the Arrow-Debreu model. In particular, macroeconomics is understood as the part of economics that relies on assumptions about specific market failures (in the goods, labour and asset markets) that stand to deliver a lasting underemployment of resources. Ordoliberalism is part of this extension of the basic model.[1] As with any theory, ordoliberalism comes in many forms and shapes. The crude version assumes away market failures but a more elaborate version allows for both market and political failures.

1 A fine example is von Hagen (2010), who shows how policy failures driven by political institutions lead to a systemic bias in budget forecasts.

However, while mainstream macroeconomists have developed a synthesis that explicitly models some well-defined market failures, to the best of my knowledge, no such effort has been devoted to embed ordoliberalism into the general macroeconomic framework, including well established market failures.[2] The crude version of ordoliberalism does not need much theoretical effort to derive policy recommendations, since we know that the first best solution to political failures is to limit public interventions, if possible to adopt total *laissez faire*, i.e. to eschew demand management policies.[3] The challenge is to combine market and policy failures. In such a model, the first best cannot be reached and *laissez faire* is not necessarily desirable. The optimal choice of policies is bound to be a hard-to-divine second (or third, or fourth, or worse) best. Most ordoliberal economists seem to implicitly assume that political failures are far greater than market failures so that the crude version is an acceptable approximation.[4]

A second major forthcoming of ordoliberalism is the lack of proper testing. Mainstream macroeconomists are constantly exploring whether their assumptions about market failures deliver predictions that are consistent with actual observation.[5] Given the likelihood that market failures are present and strong enough to play an important role, it is incumbent on ordoliberal economists to test the empirical relevance of their assumption. At this stage, there is no solid basis to the claim that political failures are much larger than market failures so that *laissez faire* is an acceptable first cut.

Ordoliberal economists are likely to point out that the better economic performance of Germany, home to ordoliberalism, is *prima facie* evidence that their theory works in practice. The evidence is far from clear, as argued by Bibow (2017) and as can be seen from Figure 1, which compares France and Germany, the two largest Eurozone countries with very different rules for the political game.

2 I refer here exclusively to the macroeconomic branch of ordoliberalism. Another branch concern the microeconomics of market failures and, in particular, the importance of legal rules.

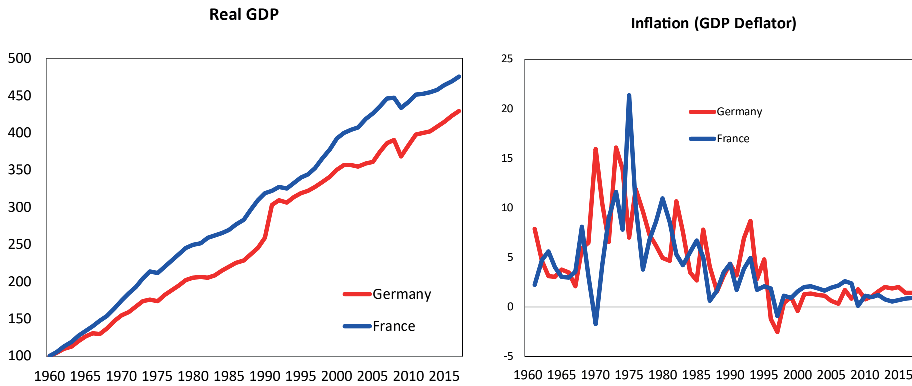
3 The Public Choice school has concentrated on demonstrating the existence of deep political failures, implicitly suggesting that the quasi-first best solution is to keep governments as small and unobtrusive as possible.

4 Conversely, it is equally unsatisfactory to ignore political failures, as most standard macroeconomic models do.

5 This is not meant to be an endorsement of the currently mainstream DSGE approach, which mostly resorts to simulations, rather than formal tests, to determine the adequacy of the theory and of key parameter assumptions. For a view of this debate, see Gürkaynak, and Tille (2017).

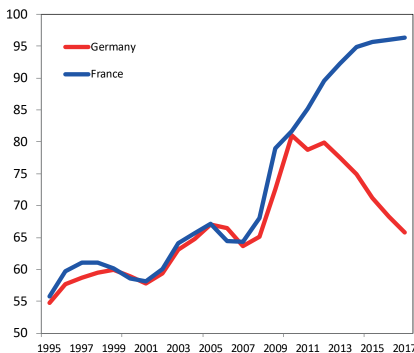
The left-hand chart shows that the French economy has grown faster since 1960. The right-hand chart confirms that inflation has been lower in Germany until the late 1980s and very similar thereafter. True, the French approach to monetary policy changed at that time, but not its political institutions, nor its politics. Figure 2 may be seen as leading to the opposite conclusion, since it shows that public debts have diverged spectacularly after 2010. Yet, until then, the evolution has been almost identical. Once again, there has been no change in the political games at that time and yet fiscal policies have been profoundly different. It could be that ordoliberal principles have then been applied in Germany, but that would be regime change and there has been no such change.

Figure 1. France and Germany



Source:AMECO on line

Figure 2. Debt to GDP ratios



Source:AMECO on line

The impact of ordoliberalism on the Eurozone architecture

Germany, in fact, has not been a follower of crude ordoliberalism, irrespective of the narrative from its authorities and influential thinkers. It has not adopted *laissez faire* but, instead, opted for rules to constrain otherwise mainstream policies. Even though demand management policies are often described as a manifestation of political failures, German macroeconomic policies have been flexible (Burda 2016, Young 2014), an implicit recognition that important market failures warrant demand management policy interventions. Yet, when it came to building the Eurozone, Germany took up the leadership and sought to impose strict rules. As the country giving up its cherished currency, Germany won most battles since its partners knew that a monetary union without it would not be credible. The question is why Germany has adopted such a rigorous attitude. This is where ordoliberalism comes into play.

One answer is that Germany realistically considered that political failures were much more important in other countries, so that details of market failures could be dismissed as of second order of importance, as in the crude version of ordoliberalism. The strong-currency status of the mark and its relatively better inflation performance were seen as a crucial proof of this assessment. Germany wanted to enshrine two crucial principles. The first one was the independence of the central bank. By the 1990s, there was strong evidence that central bank independence is highly desirable (Grilli *et al*. 1991, Cukierman 1992) and this aspect was a key benefit from the monetary union. Unfortunately, the principle was translated into a far-from-ideal institutional arrangement. The statutes of the ECB were directly borrowed from those of the Bundesbank. What worked reasonably well in federal Germany could not work as well in the non-federal Europe. The ECB's 'Direktorium' (aka as the Governing Council) is composed of 25 members, the size of a small parliament, including 19 governors of national central banks who, curiously, are not meant to represent and protect the interests of their countries. Yet, repeated disagreements often reflect different country viewpoints. In particular, since the launch of the euro, the Bundesbank has achieved considerable credibility in Germany by presenting itself as a staunch advocate of the crude version of ordoliberalism and it seems to believe that it must continue to do so (Young 2014). Given the size of Germany and its own prestige, the Bundesbank has emerged as a dysfunctional member of the Eurosystem.

In addition, critics of ECB policies during the debt crisis have been able to use German law to challenge these policies in front of the German constitutional court. Even though they lost, the fact is that a national court can censor the ECB, which is a clear constraint on its independence.

Similarly, the Delors Committee had concluded, quite appropriately, that a monetary union requires that each and every member state be fiscally disciplined. Viewed from an ordoliberal viewpoint, this meant adopting rules. Once again, a good objective was met with a faulty design. The Stability and Growth Pact was, again, inspired by German federalism, which gives the centre authority to impose rules on the sub-central authorities, the rules being set in arbitrary numerical constraints (Eichengreen and Wyplosz, 1998). Yet, the pact created a direct conflict between its obligations and the fact that member states fully retained sovereign rights over budgetary matters. As a result, it failed as the rules were repeatedly circumvented and the sanctions were not applied because they were politically too costly. Breaking rules is anathema to ordoliberalism so, unsurprisingly, in 2012, Germany pushed for making the pact stricter and more difficult to game, including through a new treaty that sought, but failed, to impose its own recently adopted ‘debt brake’ framework. The implementation of the treaty is patchy and unlikely to deliver fiscal discipline in each and every member country. It is striking that Germany has not been willing to recognise the inconsistency of its approach with budgetary sovereignty. It seems that the ordoliberal axiom that *pactae sunt servendae* is blocking any serious consideration of alternative routes, including those adopted in other federal countries (Wyplosz, 2012).

Ordoliberalism or self-interest?

A second possible answer is that Germany is simply defending its self-interest, as argued by Burda (2016). It is well known from the Optimal Currency Area theory that national interests diverge in the presence of asymmetric choices. This unpleasant occurrence was always bound to happen, and it did with the Eurozone debt crisis. Germany famously took the lead, for the first time since the start of the European integration process. One result was the creation of the European Stability Mechanism (ESM) and the rejection of any debt reduction. Importantly, the ESM is a bailout institution that stands in violation of the spirit of the no-bailout clause of the Treaty. At the same time, it is in line with Germany’s own bailout system mandated by its Constitutional Court.

Initially, in 2010, some very large German banks were exposed to the Greek public debt, alongside some very large French banks. To protect its banks, already shaken by the subprime crisis, Germany rejected any debt reduction and instead championed a bailout, lending to Greece so that Greece could honour its debt commitments. The rejection was lifted in 2012, once the German banks had disposed of their exposure. By then, much of the Greek public debt was owed to other European governments *pro rata* to their size, so the German governments had become the largest creditor to Greece and to other crisis countries. Since then, Germany has rejected every call for any debt reduction, including repeated calls by the IMF. Internal debates, including in the Bundestag, clearly indicate that the key objective is to avoid any loss, even though the rejection is often dressed-up as being needed for moral hazard reasons. Similarly, moral hazard is the reason often given for German insistence that other countries promptly reduce their budget deficits, even though many were in recession. While this may be just ordoliberalism applied to countries where political failures are deep, it may as well be linked to Germany's fears that it would have to lend more to unreliable partners. Much the same applies to Germany's successful demands that the surveillance mechanism of the Eurozone be tightened, which has led to a proliferation of rules and reporting.

Conclusions

As noted above, ordoliberalism is a not a theory separate from general and widely accepted economic principles. Its crude version rejects Keynesian principles simply because it is analytically very complicated to deal with both market and political failures. It so happened that Eucken and Keynes were rival contemporaries (Bofinger, 2016) building incomplete theories. Extensive research has brought Keynes' theory into the general framework, an agenda yet to be achieved for ordoliberalism. Meanwhile, ordoliberalism has been influential in Germany, its crude version being extensively used in public debates. A generous interpretation is that ordoliberal macroeconomists genuinely believe that it is possible to adopt *laissez faire* to eliminate market failures, an objective most likely to remain beyond reach. Meanwhile, given the country's economic and political weight, successive German governments have applied (mostly crude) ordoliberal principles to the construction of the Eurozone.

There is near consensus that the Eurozone architecture was and remains partly flawed. In order to avoid more traumatic and divisive crises, fixing that architecture ought to be a priority. Such an undertaking deserves to be consistent with current economic knowledge, even if it is imperfect. German economists have a special responsibility: to break to their fellow citizens and their government the bad news that ordoliberalism is a partial theory that cannot be invoked alone in shaping policy choices.

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About the author

Charles Wyplosz is Professor of International Economics at the Graduate Institute, Geneva, where he is Director of the International Centre for Money and Banking Studies. Previously, he has served as Associate Dean for Research and Development at INSEAD and Director of the PhD program in Economics at the Ecole des Hautes Etudes en Science Sociales in Paris. He is a CEPR Research Fellow and has served as Director of the International Macroeconomics Programme at CEPR. He is also CEPR's Policy Director and Co-Chair of the Board of the journal *Economic Policy*.

13 German ordo and Eurozone reform: a view from the trenches

Jeromin Zettelmeyer
Peterson Institute for International Economics and CEPR

In the Spring of 2014, after living and working in English-speaking countries for almost 25 years, I arrived in Berlin to take up a position in the Ministry for Economic Affairs. I had studied mostly with French and American economists, as well as some German economists that had themselves been brought up in the French or Anglo-American traditions. In my professional life, I had been exposed mainly to macroeconomics, international finance, and economic development.

As such, I had barely an inkling of ordoliberalism. I presumed that 'German ordo' consisted in a hodge-podge of free-market thinking and inflation aversion that was either trivial or outdated. But my new colleagues in the ministry were proud of their ordoliberal tradition, and one of my predecessors – Alfred Müller-Armack, the ministry's first Director-General for Economic Policy – was a leading ordoliberal. In my new job, I was supposed to be one of the keepers of the ordoliberal flame. At some point, I needed to sit down and read up on the ordoliberals, particularly on the 'Bible': Walter Eucken's *Grundsätze der Wirtschaftspolitik* ("Principles of Economic Policy"), written in 1949-50 just as Germany's "social market economy" was getting off the ground.[1] So I eventually did – and came away pleasantly surprised.

1 Eucken died in March 1950 while finishing the manuscript, which was published posthumously in 1952. Unlike Eucken's 1940 *Grundlagen der Nationalökonomie*, translated into English in 1950 as "The Foundations of Economics", no English or French translation appears to exist for the *Grundsätze*, which were translated into Spanish as early as 1956 and later into Russian, Korean and Chinese.

Ordo for dummies

Think of a taxonomy of economic systems captured by a two-by-two matrix (Table 1). The vertical axis represents 'control of economic processes' – production, investment, price setting and so forth. On the horizontal one, we have 'control of the economic order' – formal and informal rules and institutions that influence economic processes. The four cells capture various combinations of private and public control. For example, the upper left cell denotes economic systems in which both processes and order are predominantly run by the private sector. For Eucken, 19th and early 20th century *laissez-faire* capitalism belongs in this cell. The lower right cell captures the planned economy (a category in which Eucken includes both the Soviet system and the Nazi economy between 1938 and 1945): state control of both processes and order.

Table 1. An ordoliberal taxonomy of economic systems

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="2">Control of the 'economic order'</td></tr>
<tr><td>private</td><td>state</td></tr>
<tr><td rowspan="2">Control of 'economic processes'</td><td>private</td><td>Laissez-faire capitalism</td><td>Ordoliberal economy</td></tr>
<tr><td>state</td><td>Crony capitalism with an interventionist state</td><td>State planning (Soviet economy, Nazi economy)</td></tr>
</table>

Source: Author, based on Eucken (2003).

The system proposed by Eucken, 'ordoliberalism', corresponds to the upper right box. In it, the private sector is responsible for economic processes while the state creates and maintains the economic order – or, as the ordoliberals would also say, the "steering system" influencing private decisions. The final box – private control of the order and state control of decisions – captures systems in which the state interferes with production, prices and investment, while special interests control political and economic institutions. In today's world, one can think of intervention-heavy developing countries, in which the state is in cahoots with, or captured by, a handful of families, oligarchs, or cronies.

According to Eucken, not only state planning but also unfettered capitalism and crony capitalism with an interventionist state – popular in the 1920s and 30s,

and in some Western European countries at the time in which Eucken was writing – pose grave dangers. With respect to the last two systems, the main danger is the abuse of privately held economic power, at the expense of consumers, innovation, and distributional fairness. The role of the state, according to Eucken, should be to prevent such abuse.

This is a thoroughly modern view of how economic systems should operate – today's dominant paradigm, but one that has become a universal paradigm only relatively recently. The characteristic that most obviously expresses this modernity is the fact that the state and the market are not viewed as substitutes – the view pervading most mainstream economic thinking up to the mid-1990s – but rather as complements. For Eucken, markets have a central role to play, but so does the state. The role of the state is to set the rules that allow markets to operate efficiently – by fostering competition, price stability, and generally ensuring good incentives. Doing so requires strong institutions as well as mechanisms that prevent these institutions from being captured by private interests. The latter, in turn, requires transparency and political accountability. This view of the role of the state bears close resemblance to that of modern institutional and development economists such as Douglass North (1990), Raghu Rajan and Luigi Zingales (2003), Tim Besley and Torsten Persson (2011), or Daron Acemoglu and Jim Robinson (2012). Indeed, the title of Rajan and Zingales' book, *Saving Capitalism from the Capitalists*, sums up the most important insight of the ordoliberal philosophy. Eucken is also modern in that he views competition as essential not only as a condition for efficiency in product markets, but also because it prevents the inequality associated with economic rents. That argument is reminiscent of Piketty (2013).

If Eucken is so great, why do some economists, such as Bofinger (2016), view him as the origin of Teutonic backwardness and stubbornness in economics, particularly in macroeconomics? This has to do with Eucken's abhorrence of discretionary state intervention of any kind. Eucken rejects such intervention for two reasons. First, any state activity that is not somehow steered by a transparent rule or framework is subject to private capture. Second, discretionary intervention gives rise to policy volatility, and policy volatility is bad for private incentives, particularly for investment.

These are valid arguments, with some evidence in their favour. But Eucken takes them one step too far. By rejecting discretionary intervention, he ends up rejecting most stabilisation policy through both fiscal and monetary instruments.

Only rule-based monetary policy is OK. The words "fiscal policy" do not appear in the *Grundsätze*, not even their more traditional German equivalents.[2] When it comes to stabilisation of aggregate output and employment, Eucken's thinking drifts into a sort of ordo-utopia that feels like the macroeconomic equivalent of Marx's communist society – a state in which all problems of the world have been left behind. With a perfect economic order, stabilisation policy is not needed because economic process will be inherently stable. Good incentives, flexible prices and "constancy of economic policy" (*Konstanz der Wirtschaftspolitik*) will lead to abundant private investment and prevent protracted aggregate demand shortfalls. By upsetting the economic order – the ordo – discretionary stabilisation policy can only do more harm than good (Eucken 2003, pp. 308-312).

At this point in Eucken's book, readers brought up with concepts like sticky prices, self-fulfilling expectations and aggregate demand externalities are desperately hoping that Eucken will find a way to retreat to more pragmatic ground. He could, in fact, have chosen an obvious escape route without sacrificing intellectual purity, namely, a second-best argument: at times when the ordo is imperfect and does not achieve the desired internal equilibrium, stabilisation policy could be justified after all. Unfortunately, he fails to take that path. The Great Depression, for instance, is interpreted as a collapse in investment due to poor ordo – price rigidities and uncertainty (Eucken 2003, pp 285-289). Public investment is ruled out as a remedy, even in the short run, for fear that this will make the ordo even worse. Instead, policymakers are told to focus on fixing the ordo.

So, the critics are right that there is a naïve and potentially destructive side to Eucken's doctrine (not shared by other prominent ordoliberals, such as Müller-Armack and Wilhelm Röpke). But it must be seen in context, both intellectually, and historically.

2 In German, the expression '*Fiskalpolitik*' is rarely used by economists with traditional leanings, so one would not expect Eucken to have used it. But neither does he use the more traditional '*Finanzpolitik*', or even '*Haushaltspolitik*' (budget policies). To the extent that he refers to fiscal policy, he does so by discussing state investment ('*staatliche Investitionen*').

Here is someone who is so committed to the principle that "economic process" is for the private sector while "economic order" is for the state that he is not willing to grant even one exception, such as allowing the state to cross into "process" during an economic depression.[3] And it must be seen in the context of its time. Eucken identifies aggregate demand policies with the Nazi approach to stabilisation, in which full employment objectives and state-guided investment to achieve autarky in heavy industry took precedence over anything else: productivity, competition, real earnings, equality, efficiency. He was also writing at a time when his central message, "it's the economic order, stupid!" had to be shouted to be heard against the noise of Western European post-war recovery strategies, which were often characterised by economic nationalism and state intervention (Eichengreen 2007).

Slaves of ordo? Conservative German views on Eurozone reform

German conservative views on the euro crisis and Eurozone reform – as represented, for example, by the pronouncements and policies of Ministry of Finance officials since about 2010, recent reports of the German council of economic experts, and the electoral platform of the Free Democratic Party (FDP) – can be roughly circumscribed as follows. The euro crisis was a result of domestic policy mistakes, including lax fiscal policy. Such mistakes are best avoided by imposing both tougher rules and more market discipline. Any Euro area institutional reform that envisages stronger common stabilisation tools and risk-sharing arrangements runs counter to that objective. Eurozone-level fiscal stimulus and the 'low interest policy' (*Niedrigzinspolitik*) is at best a palliative and at worst counterproductive. It increases debt stocks and creates moral hazard, by taking the pressure off countries such as Italy, that will not reform except under heavy pressure.

Bofinger (2016) has attributed some of these views to the continuing influence of the ideas of Walter Eucken and other ordoliberals. And indeed, during my time in Berlin I found that German conservatives regularly appealed to '*Ordnungspolitik*' to justify their ideas for straightening out the Eurozone. To what extent are they right?

3 Not so Müller-Armack, who sees the "necessity to complement the market economy" using active stabilisation policies, even though he agrees with Eucken that it would be foolish for stabilisation policies to target full employment. See Müller-Armack (1990), pp. 146-154.

Can conservative German policy prescriptions for the Eurozone really be justified by (or blamed on) Eucken?

My take is that conservative German views on the Eurozone reflect four factors:

1. A narrow view of German interests, leading to Eurozone reforms being viewed mainly through the prism of defending the German purse.
2. Low trust in Eurozone partners, combined with risk aversion. Conservatives believe that even if it were possible to conceive a Pareto-improving Eurozone reform that gives more prominence to stabilisation and risk-sharing, this would be fragile, could be exploited by other countries, and could easily result in a worse outcome than the status quo.
3. An obsession with strengthening incentives for good policies, particularly in countries with high debts and relatively low growth.
4. An unwillingness to accept economic concepts and policy prescriptions that would be mainstream outside of Germany and (with exceptions, like on monetary policy) fairly consensual. For example:
    - that it makes sense for fiscal policy to become more expansionary when central banks are persistently unable to reach their inflation targets,
    - that the Eurozone suffered from a lack of aggregate demand during 2011-2013,
    - that the deep causes of low real interest rates in the Eurozone (and beyond) are not ECB policies but structural factors, such as low productivity growth, expected ageing, underdeveloped financial systems in rapidly growing Asian countries, and debt overhang,
    - that the distinction between 'risk sharing' and 'risk reduction' (now part of the Eurozone financial reform vocabulary) is misleading because risk sharing, as traditionally defined by economists, *means* risk reduction for every member of the risk sharing arrangement,
    - that German competitiveness does not, by itself, explain the current-account surplus.

Points 1 and 2 have nothing to do with Eucken. Point 3 is pure Eucken: a strong concern with incentives, and what specific institutions might imply for incentives. Point 4 partly overlaps with Eucken's views – as regards the downplaying of aggregate demand and the rejection of fiscal stimulus. In this respect – and particularly in his interpretation of the Great Depression – Eucken was simply mistaken. Some economists in Germany and elsewhere repeat this mistake today. Unlike Eucken, they cannot be excused by the historical context.

An ordoliberal approach to institutional reform at the level of the Eurozone

An encouraging implication of the previous argument is that, with regard to the Eurozone, the overlap of the conservative mindset with Eucken is most extensive in the area where both Eucken and the conservatives make the most sense – namely, the need to get incentives right. This may offer an opportunity for a compromise on reform. Perhaps progressives can convince conservatives to undertake stability- and efficiency-enhancing Eurozone reforms if they can out-Eucken the conservatives on how these reforms would be designed.

This is how I tried to approach Eurozone reform discussions with my conservative colleagues in 2015 – with mixed results. We were not able to agree on a common German government agenda for specific Eurozone reforms (other than some regulatory improvements in the context of the banking union). However, we agreed that in principle, ambitious "longer term" reform ideas (understood to mean: ideas that had no chance of being fleshed out until after the 2017 French and German elections) – should be on the table. These were understood to include reforms that would create or transfer significant additional powers to European institutions, and hence require treaty change, provided that five conditions were met:

1. Strengthening incentives for reform at the national level.
2. Maintaining a link between decisions and "liability" for the consequences of these decisions.
3. Ruling out "permanent transfers between member states".

4. Observing the subsidiarity principle.
5. Applying high standards of democratic legitimacy.

Can institutions that allow more risk sharing and give the Eurozone more stabilisation options be designed in accordance with these five principles? The answer is clearly, yes. With the right Eurozone ordo, risk sharing and stabilisation can very well be reconciled with good incentives. For example, a Eurozone safe asset that does not rely on debt mutualisation and creates market-based incentives for reducing national debt levels (Zettelmeyer 2017). A Eurozone unemployment insurance which insures only cyclical, not structural unemployment. A Eurozone budget that relies on its own dedicated revenues stream, operates within the constraints of a clearly delineated mandate, and is accountable to elected representatives. A European deposit insurance that creates good incentives for policies affecting the health of banks, both at the European level and the national level.[4] In all these cases, the devil is in the details – but this is always the case when building institutions that are meant to collectively provide a good ordo.

One could even go a step further. Eucken's thinking does not just *allow* the creation of Eurozone institutions that induce more stability and risk sharing in the Eurozone, in some sense it *requires* such institutions. For Eucken, more than anything else, the role of a good ordo is to create a level playing field for effective private sector competition. In today's Eurozone, this does not yet exist: financing conditions, for example, remain mainly national. National banking systems – and by extension, the private creditors that depend on these systems – are exposed to sovereigns with widely differing debt levels and credit ratings. And EU-wide competition remains hampered by inconsistent national policies, which can create barriers to entry (as in the case of German regulation of some professional services).

'Constancy of economic policy' is lacking in the EU and the common currency area today – not just in the time dimension, but across its members. Achieving a level playing field is not imaginable without closer institutional integration. Eucken's philosophy supports – and indeed requires – such integration, so long as the incentive effects are well thought-through.

4 This likely rules out a one-tier, European-level insurance so long as member states continue to control insolvency law and housing markets, but would allow a two-tier system, with a common European insurance backstopping national funds.

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About the author

Jeromin Zettelmeyer is a senior fellow of the Peterson Institute for International Economics and a research fellow in the International Macroeconomics Programme of the Centre for Economic Policy Research. From 2014 until September of 2016, he served as director-general for economic policy at the German Federal Ministry for Economic Affairs and Energy. Previously, he was director of research and deputy chief economist at the European Bank for Reconstruction and Development (2008–2014) and a staff member of the International Monetary Fund, where he worked in the Research, Western Hemisphere, and European II Departments (1994–2008). Jeromin holds a Ph.D. in economics from MIT (1995) and an economics degree from the University of Bonn (1990). His research interests include financial crises, sovereign debt and economic growth.

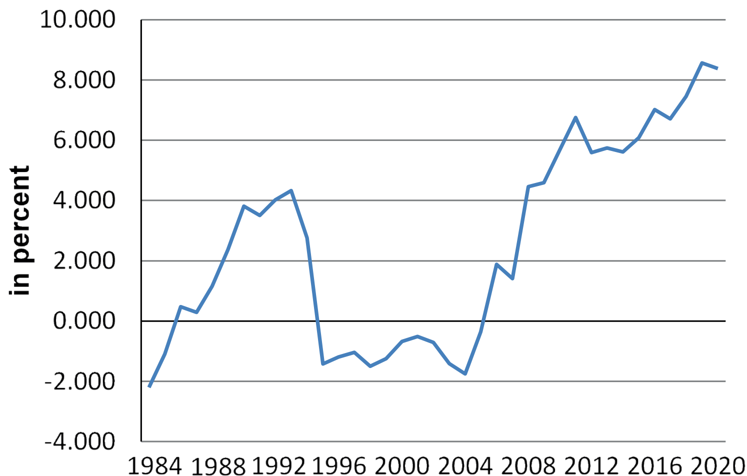
I Ordoliberalism and global imbalances

14 Global imbalances – coordinating with different script books

Philipp Steinberg
Federal Ministry for Economic Affairs and Energy, Germany

Global imbalances are at the top of the agenda again – not least because of Donald Trump's stated approach of economic protectionism. One element blamed for increasing global imbalances is Germany's current-account surplus. The *Economist* recently called it 'The German problem – Why its surplus is damaging the world economy' (*Economist* 2017). And indeed, Germany's current-account balance has had significant surpluses for many years. In 2016, it was equivalent to 8.2% of German GDP or approx. €260 billion. (Figure 1). Because of its magnitude and its effect, it is regularly subject to criticism, especially from the IMF, the OECD, and the European Commission, and now from the USA – but also in Germany. And rightly so. The criticism has to be taken seriously – at the same time, it should be understood that there is no easy solution.

Figure 1. Current account in % of GDP



A balanced assessment of Germany's current-account surplus

The predominant German view on Germany's current-account surplus contradicts that of its trade partners, which consequently leads to tensions between both sides. For instance, the recent international criticism caused by the US-German row over current-account surplus and economic policies is considered by many in Germany to be misguided, unwarranted and harmful. This predominant opinion is based on the assumption that the current account-surplus is the result of market-based transactions which should not be counteracted by policy. From this point of view, the surplus is due to the economic competitiveness of Germany, the structure of its industry, other structural factors and – conversely – the performance of other countries.

However, this is not the whole story. Excessive current-account surpluses can also point to a country's structural weaknesses and problems. They may, for example, reflect distortions, economic policy missteps, and especially structural weaknesses – namely weak domestic investment activity, a lack of domestic demand, unfavourable investment conditions, and weak wage developments – which in turn justify economic interventions. Therefore, understanding the underlying driving factors is of high relevance to policymakers. Boosting internal demand, reducing inequality, creating favourable conditions for stronger wage increases and creating more favourable investment conditions are examples of sound ways in which the current-account surplus might be addressed.

Nonetheless, it has to be taken into account that the current-account is also driven by fundamental factors (demographics, foreign assets, etc.) as well as temporary factors (exchange rates, commodity prices). The development of these factors is mostly beyond the control of economic policy; these findings are also supported by the IMF, ECB and OECD.

Breaking down the German surplus for analysis and explaining the factors driving it is crucial in order to better understand the what is at issue. A large part of the German surplus – possibly half – can be explained by fundamental factors. These fundamental factors include, first, Germany's product portfolio and industry structure. Due to its export-orientated product portfolio, Germany profits from high demand for investment

goods. In this context, the special orientation of the product portfolio of the German export sector towards major emerging economies has played an important role. The German export industry mainly offers goods that are increasingly in demand in growth phases – in particular, capital goods such as machinery. This high demand comes (though not exclusively) from developing countries (Figures 2 & 3). With regard to the future development of the German current account, it must be borne in mind that these effects are not necessarily permanent. The revenue and investment activity of the emerging markets, and thus a portion of the German current-account surplus, are very much dependent on their development. As emerging markets mature, a decline in demand for German investment goods should be observed.

Another fundamental factor that plays a role in Germany's current-account surplus is primary incomes, including revenues from foreign assets; these make up about one-fifth of total current-account surplus. Because income on foreign assets – mainly in the forms of dividends and interest – has risen above the rate of return for national investments in Germany, investments abroad become more lucrative. Germany has also built up high net foreign asset positions through foreign investment in recent years, which can primarily be seen as a result of German companies' successful globalisation strategies. These foreign assets result in corresponding interest and investment income, which, in itself, accounts for almost a quarter of the German current-account surplus. High revenues imply a certain rigidity of current-account position, and therefore the positive impact on current account is likely to stay high.

Figure 2. Germany's current-account balance by component

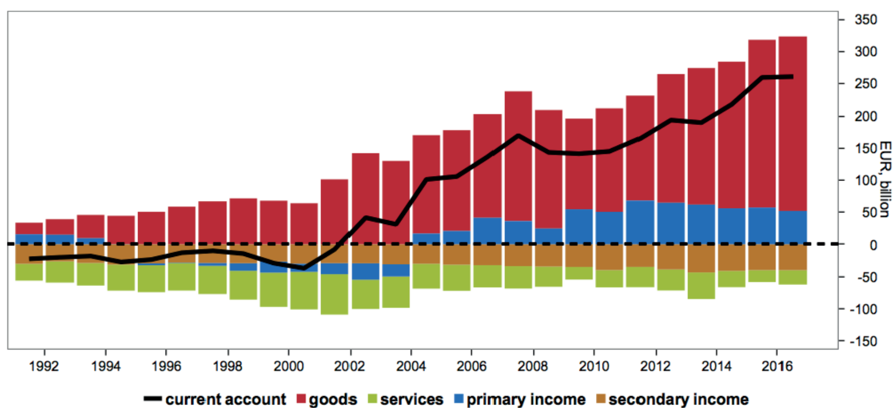
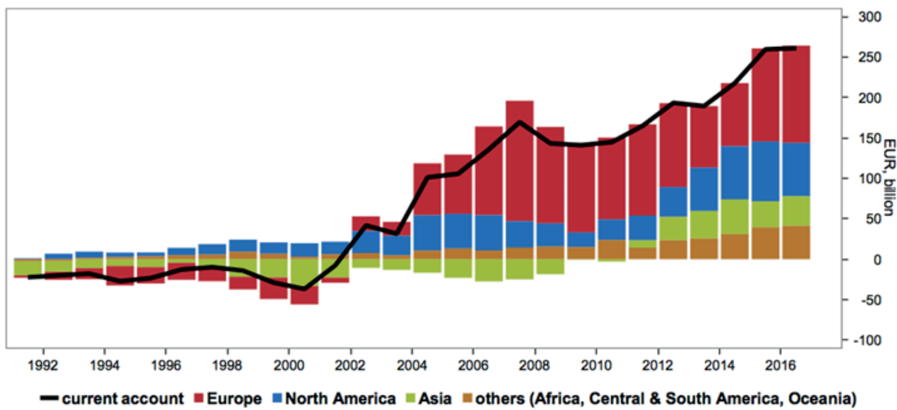


Figure 3. Germany's current-account balance by region



Furthermore, German demography and productivity rates are key fundamental factors behind Germany's current account surplus. In an ageing society, relatively high savings reflect prudential, forward-looking behaviour, with a view to evening out consumption as more people retire. Different estimates put the demography-related share of the current-account surplus somewhere between 1-2% (German Council of Economic Experts) and 3% (IMF). This positive impact on the current account is expected to remain high until the mid-2020s, then to gradually decline and turn negative around 2040. Moreover, the slowing of productivity growth (which is being observed in Germany) should have a mitigating effect on the current account. Expectations of slowing growth based on what is already a high income level in Germany should direct capital flows abroad, putting positive pressure on the current account.

Beside fundamental factors which are difficult to address by policymakers, a significant part of the current surplus is due to temporary factors. For example, about a quarter of the balance can be explained by the current favourable exchange rate and commodity prices alone. In particular, exchange rates and energy prices, which are to be attributed to temporal factors, have caused the current-account surplus to rise in recent years. Germany's current-account surplus stood at 5.6% of GDP in 2008, its lowest level in the last ten years. It subsequently climbed to 6.7% in 2013 and reached 8.6% in 2015. Of those approximately two percentage points, about two thirds can be attributed to the decline in energy and commodity prices, as well as the depreciation of the euro. Simulations using the Oxford Economic Model show that, if the low oil prices and the

weak euro had been factored out, the current-account surplus would have stood at 5.6% in the fourth quarter of 2016 – below the European Commission's 6% threshold. More recently, the rise in oil prices and the stabilisation of the euro exchange rate have had a dampening effect on the current-account surplus. It is probable that exchange rate and commodity prices will continue to normalise.

A temporal increase in business deleveraging has contributed to Germany's current-account surplus as well. Relatively high leverage of German companies before the global financial crisis and a strong increase in liquidity preferences afterwards have contributed to an unusual positive net lending position. However, gradual normalisation has begun and, in the future, this should have a dampening effect on Germany's current-account surplus.

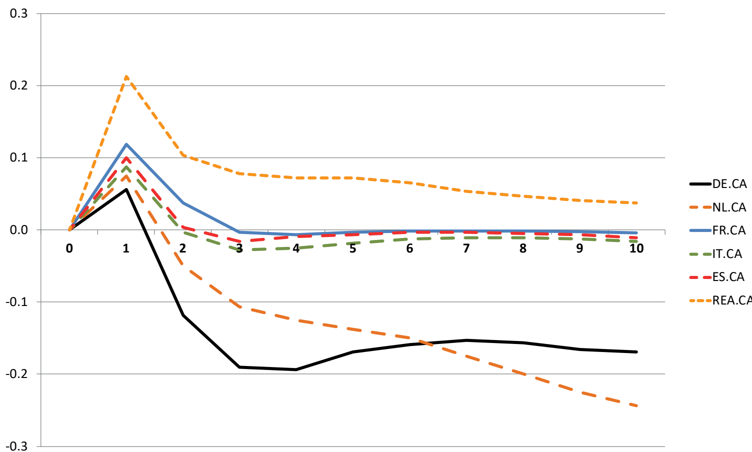
One should also note that a current-account deficit does not necessarily need to be a problem for the US. Indeed, the US can benefit from the US-German trade relationship (BMWi, 2017a).

Policy decisions do matter

Still, there are a number of economic policy factors that have an impact on current-account surpluses and are discussed in the context of Germany's current-account surplus. Even if in Germany, like in other countries, the current account is not an economic policy goal in itself, some policies which are in Germany's general interest should also have dampening effects. Germany has in fact used some of these possibilities – but more could (and should) be done.

During the current legislative term (2013-2017), federal budget funds dedicated to investment have increased by nearly 45%, to €36 billion. In addition, substantial relief has been provided to the *Länder* (Federal states) and local authorities that will allow them to increasingly channel funds towards investment. In 2016, government gross fixed capital formation went up by 2.2% in real terms, following a 3.4% rise in 2015. Due to the relatively small value-added share of imported intermediates in public investment, however, this is likely to have had only a limited impact on the current account. The impact of a 1% increase in investment relative to GDP (€30 billion) only reduces the current account by a minimal 0.2% (Figure 4).

Figure 4. Current account (% of GDP)



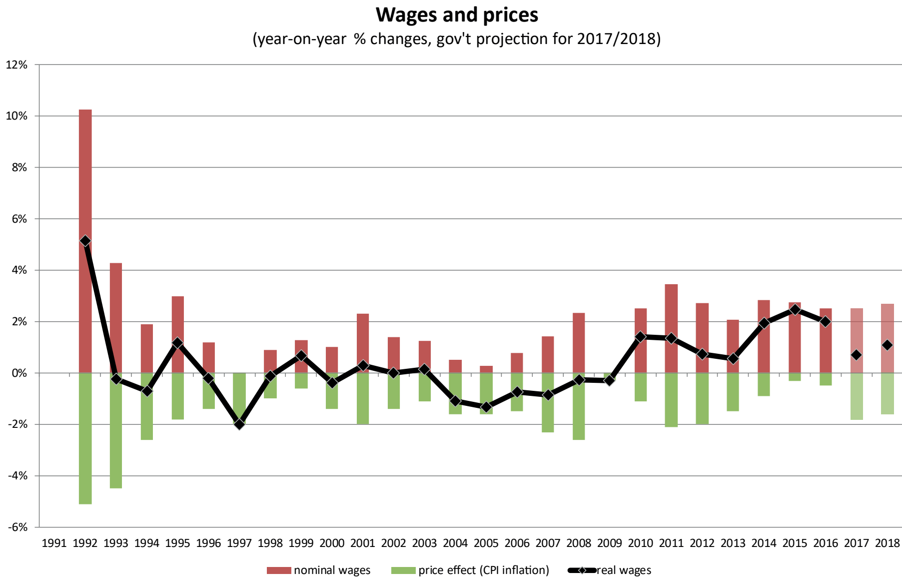
Again, more could – and should – be done. Overall public investment remains stable at 2% of GDP, in spite of these measures. The overall budget surplus of almost €20 billion (2017) is difficult to justify economically. It increases the current-account surplus and contributes to low investment spending. Even under the constitutional debt rule, under current conditions, there would be additional spending flexibility of around €15 billion.

The most relevant economic policy factor in this context which has a strong impact on Germany's current account is the development of wages. In spite of a rather strong surge in real wages throughout recent years, seen from a longer perspective, wage development has been very poor.

However, wage negotiations are carried out by means of collective bargaining between firms and workers, and not by public authorities. The Government can only set wages for the small sector of public employment. Still, the German Government has tried to create favourable conditions in order to support the social partners and thus collective bargaining. These measures could – and should – be strengthened. Economic framework conditions might also help. Labour markets are increasingly tight, which might point to real wage increases in the next few years. Real wages in Germany have increased at an above-average rate in the last three years. This is the first phase of increases in nominal unit labour costs in the range of 2–2.5% since German reunification (Figure 5). Nominal unit labour costs in Germany are on the rise, which should have a negative impact on price competitiveness and current-account surpluses.

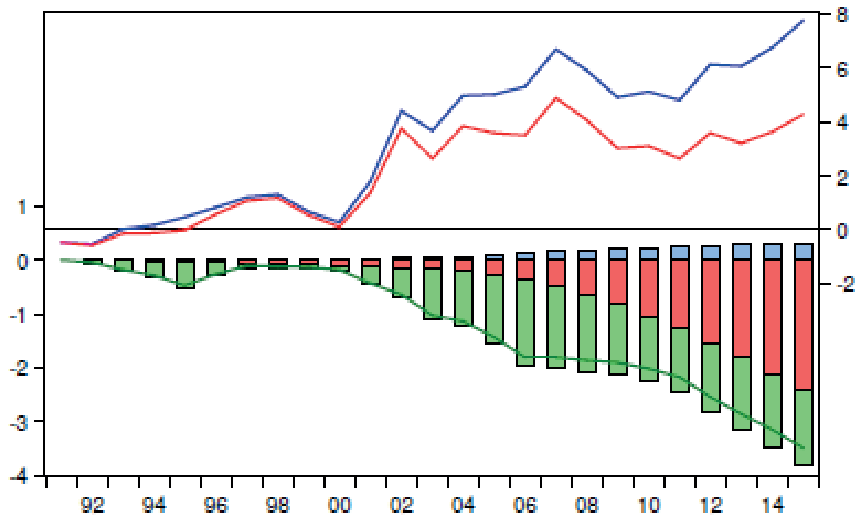
But the real wage increase only amounts to 0.5/0.6%. In the face of positive economic development overall, the small increase in real wage proves that more needs to be done.

Figure 5. Development of wages in Germany since 1992



Reducing the gap in income inequality might have a dampening effect on Germany's current account as well. As some studies demonstrate, there is a negative correlation between income inequality and growth. This also seems to hold true for income inequality and current-account surpluses in developed economies. Even though there is not enough evidence yet, there is one interesting study examining what would have happened with the current account surplus if inequality had stayed at its 1991 level. The answer, as reported by Friedrich Ebert Foundation and German Institute for Economic Research (Albig *et al*. 2017), is that the current account would stand about 3% lower today (Figure 6). The transmission channels would be as follows: higher equality would have led to higher human capital formation, thus higher incomes and savings, boosting consumption, investment and imports. To complete this picture, exports would also be growing, but not as strongly, so that all in all, the current-account surplus would be decreasing.

Figure 6. Nominal CA (% of GDP)



As demonstrated above, the detailed analysis of the different factors driving Germany's current account reveal that the drivers of Germany's surplus are complex. The categorisation in temporary, fundamental and economic factors is based on the IMF's External Balance Assessment (Table 1).

Table 1. Overview of factors explaining Germany's current account surplus

Factors (largely) beyond economic policy control		Factors that can be influenced by economic policy
Temporary factors	Fundamental factors	
Exchange rates	Demographic trends	Public investment
Commodity prices	Returns on foreign investments	Conditions for private investment
Wage trends	Economic structure, specialisation	Structural reforms
Global economic trends	International interdependency	Budgetary/Fiscal Policy

The majority of the proposals to reduce the current-account surplus thus aim at strengthening domestic demand through higher consumption, public and private investment, the use of fiscal space and structural reforms, whilst reducing savings and creating favourable conditions for collective bargaining.

A current-account brake?

An alternative way to strengthen domestic consumption, suggested recently by economist Carl-Christian von Weizsäcker, has attracted some public attention – a 'current-account brake' in the form of a public debt-financed reduction of the VAT rate (Siedenbiedel 2017). The impact of such a measure was examined recently by the Federal Ministry for Economic Affairs and Energy. It tended to reduce the German trade-balance surpluses, though the effects turned out to be extremely limited, with a decline in the trade balance of 1/4 of a per cent relative to GDP. However, the measure would be accompanied by a considerable burden on public budgets, which would result in a massive violation of the constitutionally anchored debt brake. This additional debt would – and this is also intended – further reduce the current account surplus. Politically, however, the VAT reduction would send out a clear but costly signal (BMWi 2017b).

An assessment of the US and EU Commission perspectives on Germany's current-account surplus

The US and EU Commission take an even more critical view on the role of Germany's current account surplus and, more importantly, argue that policy action has a more important role to play in bringing the current-account surplus down. The analysis is based on two lines of argument, one internal and one external. The internal argument states that the current-account surplus is a sign of weak domestic performance, focusing on too much budget discipline, too much saving and too little investment. Here, the answer has largely been given. Policymakers in Germany have done a lot, but more needs to be done. Besides boosting public investment, private investment needs to be stimulated as well, for instance, by cutting red tape or by improving the conditions for private investment, including in the energy sector. Fiscal space needs to be used and conditions created for higher wages. Regardless of recent achievements, there is still a lot of room for improvement in this area. However, the impact on the current account might not be as lasting as many believe. Internal simulations by the Federal Ministry for Economic Affairs and Energy have shown that measures like higher public investment, deregulation of product markets or liberalisation of professions will only show a very limited, temporary dampening effect on the current-account surplus.

In the medium to longer term, however, while enhancing potential growth and competitiveness, they tend to even widen the current account surplus.

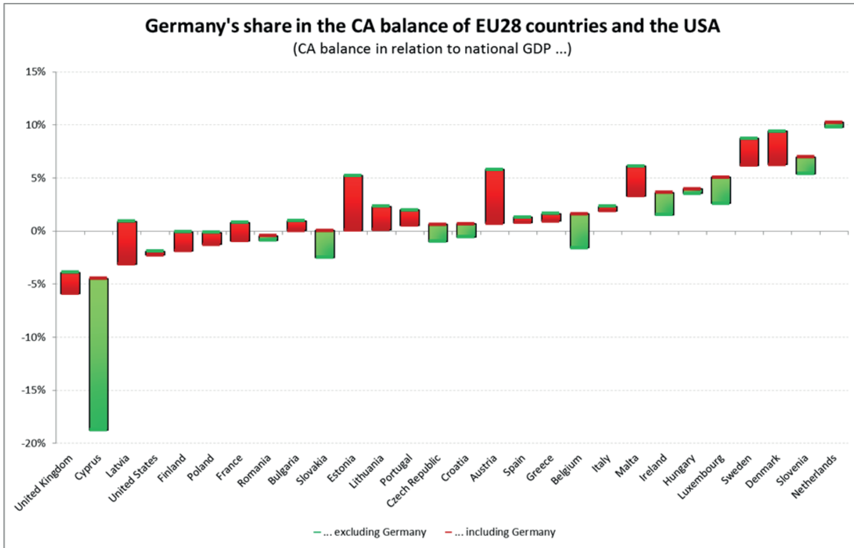
The external argument points to macroeconomic spillovers through the current-account surplus that are potentially destabilising deficit countries (especially within the Eurozone). Spillovers could also complicate certain economic policy problems in deficit countries, such as a credit boom or real estate bubbles that are fed by capital inflows from surplus countries (as was the case in a number of European countries before the crisis), or when deficit countries operate under very difficult conditions (as might be the case in some European countries today). Additionally, critics complain about "German austerity policy" which is argued to be detrimental for the common EU current account as well. These arguments are to be taken seriously. It certainly is true that high debt levels in certain countries are funded by capital inflows from Germany. And it certainly is true that EU deficits have been brought down (in line with the SGP), this is also due to large import growth. However, these critics do not take into account the fact that most trading partners, with whom Germany runs a surplus (red bars), are surplus countries themselves (Figure 7). The impact of trading with Germany on a trading partner's current account (relative to GDP) is usually not large. The largest absolute trade surpluses that Germany has are with US, UK, France and Austria (> 60% of total surplus), however these surpluses do not imply major impacts on these economies.

Needless to say, Germany is not a currency manipulator. As a member of the EU, Germany cannot pursue independent monetary policy – monetary policy falls within the competency of the EU. Actually, from a purely German perspective, the ECB's interest rates are too low, and the Bundesbank (Germany's central bank) has often criticised the expansionary stance of the ECB. However, as Martin Hellwig writes, an argument can be made that German "austerity policies" in the EU have resulted in the ECB not having a real choice but to come up with its expansionary monetary policy (Hellwig 2017). And it certainly can be argued that fiscal policies in the Eurozone have been too contractive throughout recent years.

The predominant view in Germany, however, is that European imbalances are mainly due to both a lack of structural reforms and a lack of budget discipline. The suggestion is therefore that Member States did not build up national fiscal buffers in good times to

cope with shocks, as they ought to have. This view cannot be dismissed totally, but it certainly is too narrow.

Figure 7. Germany's share in the CA balance of EU28 countries and the USA



Furthermore, Germany does not use protectionist instruments. For example, the frequently criticised VAT with an input tax deduction in the EU, and thus in Germany, is in line with the international standard applied by nearly all OECD countries and the overwhelming majority of UN members.

A roadmap towards reducing European imbalances

Even if the German current-account surplus is not the only – and possibly not the major – factor causing imbalances in the EU, imbalances need to be reduced. This cannot be achieved without changing the current institutional and economic set-up of the Eurozone and the EU (Schellinger & Steinberg 2017). Therefore, a fiscal capacity at Eurozone level is needed. This aggregate fiscal capacity could stabilise demand that, for example, will be used for infrastructure investments of common interest. This kind of ambitious project might begin small and scale up in the medium term in order to increase its impact. It should not lead to permanent transfers, as some critics argue.

One possibility would be to develop the European Stability Mechanism into a fiscal capacity with the objective of dealing with temporary, asymmetric shocks. Furthermore, more flexibility of the Stability and Growth Pact (SGP) is needed to cope with cyclical developments. For example, the SGP could give countries credit for a broader set of policy actions, beyond short-term deficit reduction, provided that these new measures are able to improve fiscal sustainability at least in the medium term. Such actions should include, for example: fiscal-structural reforms, which reduce spending responsibilities or broaden the revenue base, and growth-enhancing reforms, which allow the denominator to grow faster than the numerator, thereby reducing the debt-to-GDP ratio. In situations of recession, the combination of such policies with fiscal stimulus would have a greater effect overall and lead to a temporary increase in the deficit (Steinberg 2017).

The role of structural reforms is of high relevance in the context of European imbalances as well. A very German – but largely correct – view on this topic is that structural reforms at national level are necessary to improve competitiveness of individual Member States, hence, to address permanent imbalances. Potentially even more relevant is the view that structural reforms are a necessary prerequisite for closer fiscal and political union.

Conclusion

Global imbalances are a contentious policy area in which the predominant German policy view deviates from the traditional Anglo-Saxon as well as the Southern European approach. Coordinating between different script books in the context of European imbalances is therefore not an easy task. In order to do so, a sound analysis should be the basis for any debate. Germany's current account is driven by fundamental factors and temporary factors; some can be influenced more by policy decisions, others less so. Germany did use some of these possibilities by using different economic policy measures especially to increase investment and create favourable conditions for wage growth recently, but more should – and can – be done. European imbalances are multidimensional and need to be reduced jointly based on a common roadmap.

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About the author

Philipp Steinberg is Director-General for General Economic Policy at the German Federal Ministry for Economic Affairs and Energy. The views expressed in this essay are those of the author and do not necessarily represent the views of the ministry.

Earlier, Mr Steinberg worked at the Federal Ministry of Financial Affairs in the Budget and European Affairs Directorates, as well as at the Headquarters of the Social Democratic Party, where he headed the Financial Policy Unit and was Special Advisor to Party Chairman Sigmar Gabriel.

After having received his International Baccalaureate from the United World College of the Atlantic in Wales, he studied Law, Economic Policy and Taxation at the universities of Berlin (Humboldt-University), Paris (Panthéon-Assas) and Münster (Westfälische Wilhelms Universität). He holds a PhD in Economic Law, an MBA and a Licence en Droit. He has authored two books and numerous articles on economic law, economic policy and taxation. He was born in Ann Arbor, MI.

15 Germany and the world economy

Richard N. Cooper
Harvard University

I am not qualified to address ordoliberalism, either its origins or its subsequent development. I have been asked instead to address the role of the German economy in the wider world economy. But, in my experience, excellent or wise observers of society, including philosophers, make their observations against the background of a particular set of contemporary or recent past circumstances. Understanding that context is important for understanding their message. Walter Eucken and his contemporaries wrote against the background of the Great Depression and the subsequent Second World War, during which Germany's Nazi-party government intervened extensively in the German economy, especially (but not exclusively) in Germany's foreign trade.

If the observer's message appeals to a wider group of acolytes (or is imposed on a wider group through their organisation), it becomes doctrine. And if the doctrine survives over time and becomes subject to uncritical groupthink, despite a change in original context, it becomes dogma. And dogma can become dangerous in a radically different context.

Many people have written about, and worried about, a German 'identity', especially after the trauma of the Nazi era, and the possible role of history in establishing and defining that identity (for a discussion of the role of history, see Maier 1997, pp.139ff). My impression has been that most Germans wanted to forget mid-twentieth century history (although never completely allowed to do so, in contrast to many Japanese), and to focus their attention and efforts on something more positive. In the economic realm this became export performance early in the post-war period, following deficits financed by the Marshall Plan. German-born Yale economist Henry Wallich wrote in 1955 that "Exports are close to the heart of every German engaged in economic pursuits.

A prominent journalist has called them the sacred cow of German economic policy. The salesman roles up his sleeves, the businessman drops his competitive restraints, the worker postpones his wage demands, and the government official does violence to his liberal principles when exports are at stake." (Wallich 1955, p.244). Over 40 years later, Gros and Thygesen (1998) could write that "after 1951 the German [trade] surplus became a near permanent feature of the international monetary system until 1990 and, with the exception of 1979-81 [when oil prices rose sharply following the Iranian revolution], most international crises led to calls on the Federal Republic to adopt more expansionary fiscal and/or monetary policies." (p.7). It was a major focus of the G7 Bonn Summit of 1978 (Putnam and Bayne 1987, chapter 4) and of several G20 summits since 2008.

Germany ran a trade deficit for several years following German unification in 1990, as the German government financed economic development of the eastern laender of the former DDR, and subsequently the movement of the FRG capital from Bonn to Berlin. But, following a few years of euphoria over German reunification, the trade surplus re-emerged and has persisted through the second decade of the 21st century, the current account exceeding 8% of GDP in 2016, much higher than those of China or Japan. In this decade, a prominent German official reported that maintaining export competitiveness was a primary objective of German economic policy; when pressed on how best to measure competitiveness, he reported unit labour costs compared with foreign competitors. He could well have quoted Wallich of 1955.

What is the economic impact of Germany on the rest of the world? Does it make any difference? Germany is not a small economy. It is smaller than the United States, China, and Japan, but it is still large – large enough that events there have a discernible global impact, and of course even more on its immediate trading partners. German public intellectuals and politicians sometimes suggest that if others were more like Germans – fiscally disciplined, hard workers, prudent savers – the world would be better off.

Here it is useful to introduce some economic analysis to show that it would actually be impossible for everyone to be like the average German in these respects, and that a serious move in that direction, seeking the impossible, would be catastrophic.

Three 'laws' of international economics are useful to review. These are not theories, they are accounting identities: they apply to all countries, all of the time. They may be irrelevant for some problems, but they are highly relevant here.

We can divide any closed economy into three sectors, or four if we include interactions with the rest of the world. The sectors are households, which consume and may also produce through family-owned businesses; firms, which produce goods and services and hire labour and capital; and government, which taxes and produces public goods and may transfer wealth from some households to others. And, of course, the country may trade goods and services with the rest of the world.

In Germany, the three domestic sectors are net savers at present. Households are typically net savers in modern economies. But the business sector is typically a net investor (i.e. a net borrower) and the government sector in most years in most economies is also a net borrower: total government expenditures (G) exceed total public revenues (T). Germany's government is one of the few in the world running a surplus. In a closed economy net saving in all three sectors would be impossible; economic activity would drop until public and private saving equalled investment. But in an open economy the excess of (private plus public) saving (S + T – G) over investment (I) can be exported (net of imports) to the rest of the world. In algebraic terms:

$$GDP = C + I + G + X - M = C + S + T$$

Subtracting the third expression from the second and re-arranging terms yields:

$$X - M = S - I + T - G$$

Here X – M is the trade balance (strictly, the current-account balance on goods, services, unilateral transfers and net factor income) with respect to the rest of the world. If X – M (= CA) is positive, net public and private saving must be positive; if net saving is zero, the CA must be zero. Put another way, Germany's prosperity depends on the rest of the world – no surprise there. Put more tendentiously, but still accurately, high German employment comes at the expense of employment in the rest of the world. Competing over net exports is a zero-sum game, because conceptually, for the world as a whole, the sum of all current-account balances must equal zero (apart from errors in measurement), the second identity.

There is a third identity: any current-account surplus must equal net foreign investment, and similarly a current-account deficit must be matched by inward net foreign investment.

How is this satisfied in the case of Germany's surplus? German firms invest much abroad, especially in Europe, North America, and China. Foreigners – especially Europeans, Americans, and increasingly Chinese – invest much in Germany. German financial institutions also invest much abroad, including (before 2010) in Greek government bonds. This identity nets all foreign investment, inward against outward. Germans firms and households add their net savings to their euro holdings in German banks. The euros are supplied by the European Central Bank, especially since it adopted its 'quantitative easing' in 2015, whereby it purchases €60 billion in sovereign and other bonds monthly from members of the Eurozone, thereby indirectly adding to the net foreign investment by German residents, and also leading to a depreciation of the euro from roughly $1.3 to roughly $1.1 per euro as the Federal Reserve ended its period of quantitative easing. German banks in turn hold reserves with the ECB. Again, if Germany did not have a net capital outflow through all channels, it could not have a current account-surplus. Germans cannot logically object to a net capital outflow so long as they have (and desire) a current account-surplus.

Germany no longer has its own currency. Since 1999 it has been part of the larger Eurozone. That raises a question: how does economic adjustment take place within a currency zone such as the USA, China, Canada – or the Eurozone – where one monetary policy and a fixed exchange rate prevail throughout the zone? Europe prides itself on its linguistic and cultural diversity, including historical antagonisms, in contrast to the USA, as Jacques Delores explained to me when arguing that the USA is not part of European civilisation. European countries have many similarities, especially against much wider global diversity, but they are still subject to different economic shocks, coming both through changes in demand and through technological and other changes in supply. How does adjustment to diverse shocks take place within a currency area?

Three channels come to mind. The first is migration from economically depressed to economically booming areas, as newly unemployed workers seek jobs where work is available. A second is through fiscal adjustments, whereby tax revenues fall in the depressed areas and rise in the booming areas. Local government expenditures do not

follow revenues down and residents from the booming areas lend to governments of the depressed areas through a capital market that embraces the currency area. A third is through relative price and wage adjustment, whereby prices and wages in the depressed area decline (or rise less than average) and prices and wages in the booming area rise more than the average throughout the currency zone.

The German polity, at least under the government of Chancellor Merkel, has strongly resisted the second and third of these channels, at least as far as Germany's role is concerned. Germany (supported by others, especially governments of the Netherlands and Finland) insisted that other Eurozone countries in actual or potential trouble cut their government borrowing, in part by reducing government expenditures; and resisted lending to them without heavy, some would say extremely onerous, conditions. Countries in difficulty, it is true, were encouraged to lower their wages and prices to make them more competitive. But this was not seen as a symmetric obligation, under which Germany and other relatively booming countries increase their wages and prices to preserve over-all Eurozone prices near their target level of 2%. On the contrary, Germans complained about any tendency of prices to rise in Germany, to compensate for price declines in troubled countries, thus threatening deflation throughout the Eurozone as a whole. And German unions supported wage restraint to maintain 'competitiveness'. Thus, Germany was not playing by the (implicit, but well understood) rules of a currency area.

Indeed, in 2007 Germany engaged in an implicit or internal devaluation, despite a continuing current-account surplus, in that it reduced payroll taxes on workers, thus reducing labour costs to firms, while it compensated in revenue by raising the value added tax, which is imposed on imports from all countries and rebated on exports – including trade with other members of the Eurozone. Thus a policy of "competitiveness" was pursued at the expense of Germany's trading partners, including those in the European Union, not long before the so-called 'euro crisis' broke out in late 2009. There are serious problems for the world economy if its largest national economies do not play by cooperative rules. Of course, all eyes recently have been on China and, since 2017, on the United States. But German behaviour should not be exempt from critical observations.

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About the author

Richard Cooper is professor of economics at Harvard University. He has served on several occasions in the US government, as Undersecretary of State for Economic Affairs and as Chairman of the National Intelligence Council.

16 The German current-account surplus: Causes and consequences

Gabriel Felbermayr, Clemens Fuest, and Timo Wollmershäuser
ifo Institute[1]

1 Introduction

In the international economic policy debate, Germany is widely criticised for its current-account surplus. At around €261 billion, Germany has the highest single surplus in the world. In the period after the end of the Second World War, Germany has had a tendency to run current-account surpluses. The 1990s, marked by German reunification, were an exception. But since the early 2000s, the surpluses have grown to unprecedented levels. While the current account was approximately balanced in 2001, it has been growing ever since and reached 8.5% of GDP in 2016. Views about whether or not the German current-account surplus is a problem are divided. In this chapter we describe the factors that have led to the current-account surplus and discuss its policy implications.

The key results of our analysis are as follows: The German current-account surplus is not primarily due to a decline in domestic investment. It is mainly a result of higher savings. These savings take the form of a reduction in the public-sector debt and higher corporate savings. Private household savings have not changed much. The increase in public-sector savings is driven by the desire to prepare the public sector for the financial burden associated with population ageing, in particular fast-growing spending on health and pensions that is to be expected in the next decade. Clearly this saving was also made possible by very low interest rates on government debt.

1 This is a modified and slightly extended version of a paper was published as *EconPolEurope Policy Report No. 2/2017*

Wage restraint or a lack of labour income is not a major factor driving the surplus. The share of wages in GDP fell until 2007 but has been growing since then. The decline in the oil price in 2014 is an important factor: it has increased the surplus by 1.5% of GDP. Declining prices for other imported goods have added another 0.5% of GDP.

The view that other countries are harmed by the German surplus is unconvincing. It is true that countries with unemployment and slack capacities would benefit from higher demand from Germany or anywhere else. But this would come at the price of higher public debt in Germany, undermining growth prospects and resilience in future crises. Moreover, highly indebted countries could also stand to suffer if a decline in the German surplus were to boost interest rates.

Germany has no direct economic interest in reducing the surplus. There is no evidence of a general domestic investment gap in Germany. Saving more and investing abroad makes sense as a response to population ageing. But Germany faces growing political pressures related to the threat of protectionism and the fact that a growing creditor position may lead to political backlash. The European Macroeconomic Imbalances Procedures also include the rule that current-account surpluses should not exceed 6% of GDP. Germany can hardly criticise others for breaking fiscal rules and ignore other European rules itself. These are the main reasons why German economic policymakers should not ignore calls for acting to reduce the surplus.

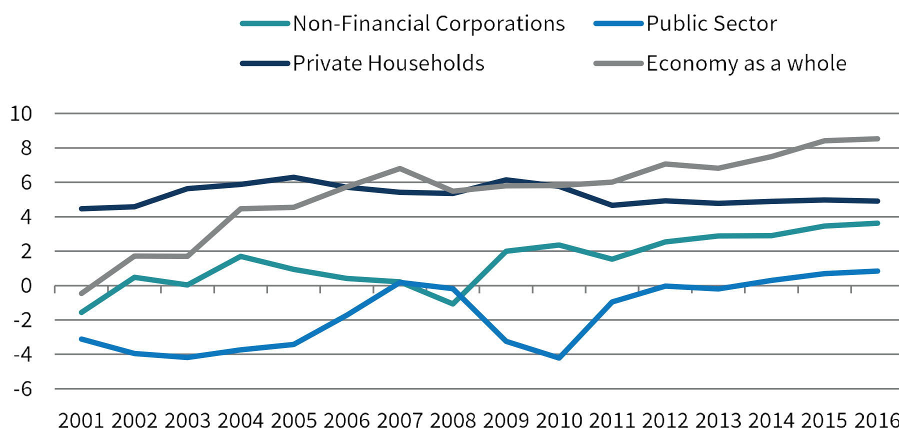
2 Why does Germany have such a large a current-account surplus?

The current-account surplus equals the difference between domestic savings and domestic investment. To understand Germany's current-account surplus it is helpful to consider the development of its financial balance, i.e. the difference between savings and investment, in different sectors of the economy: the public sector, private households, non-financial firms and financial firms (primarily banks). Figures 1 and 2 illustrate how this difference has evolved in the period since 2001, when the German current-account balance was close to zero.

In 2001 the German government posted a financial balance of -3.1% of GDP, while that of the non-financial companies amounted to -1.6%. This was financed by private

household surplus savings, which were 4.5% of GDP, versus savings of close to zero by financial firms. The development in these balances between 2001 and 2016 is illustrated by Figure 1.

Figure 1. Sectorial financial balances



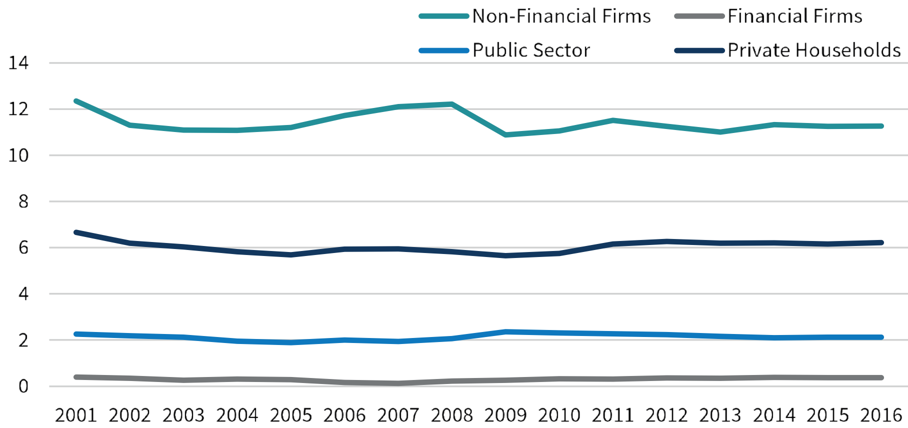
Data: German Federal Statistical Office

In 2016, two things were different: firstly, the government deficit vanished, increasing the financial balance by roughly 4% of GDP. Secondly, non-financial firms had a financial balance that was roughly 5 percentage points above that of 2001. This explains why the current-account balance has improved by 9 percentage points, from -0.5% to +8.5% of GDP. The balances of private households and financial firms, by contrast, are not very different in 2016 from what they were in 2001.

3 What are the economic factors driving the current-account surplus?

What are the economic forces driving these changes? According to a widespread view, the German current-account surplus is the result of weak public and private investment. This is hard to reconcile with the fact that gross investment as a share of GDP was remarkably constant over the period when the current-account surplus emerged. Figure 2 illustrates gross investment as a share of GDP in the different sectors of the economy and reveals that it has basically remained flat.

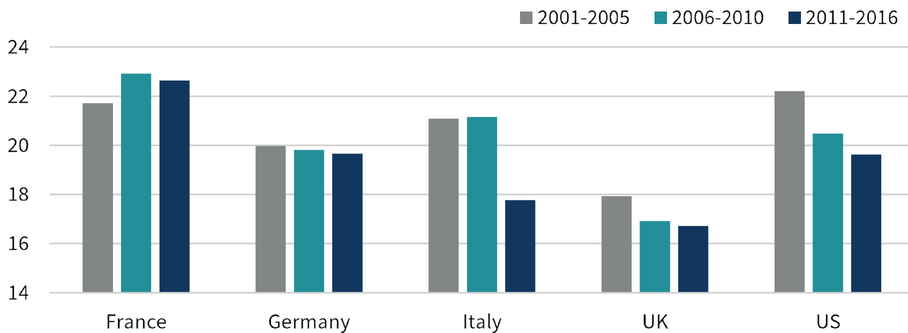
Figure 2. Gross fixed capital formation in Germany (%of GDP)



Data: German Federal Statistical Office

In the period between 2001 and 2016, depreciation increased by 0.8% of GDP, leading to a slight decline in net investment, but that does not explain Germany's soaring current account. Figure 3 compares the development of investment in Germany and other G7 countries. The bar chart shows that investment declined in Italy, UK and the US, but remained almost constant in Germany.

Figure 3. Investment (% of GDP, yearly average)

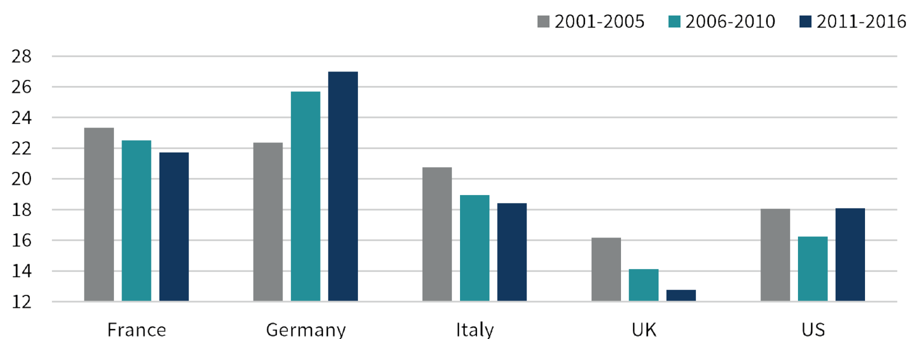


Data: IMF

Figure 4 illustrates the development of national savings, the sum of private and public savings. Savings increased considerably in Germany, but declined in most other countries.

The German current-account surplus is primarily a result of higher savings, not a decline in domestic investment.[2]

Figure 4. Savings (% of GDP, yearly average)



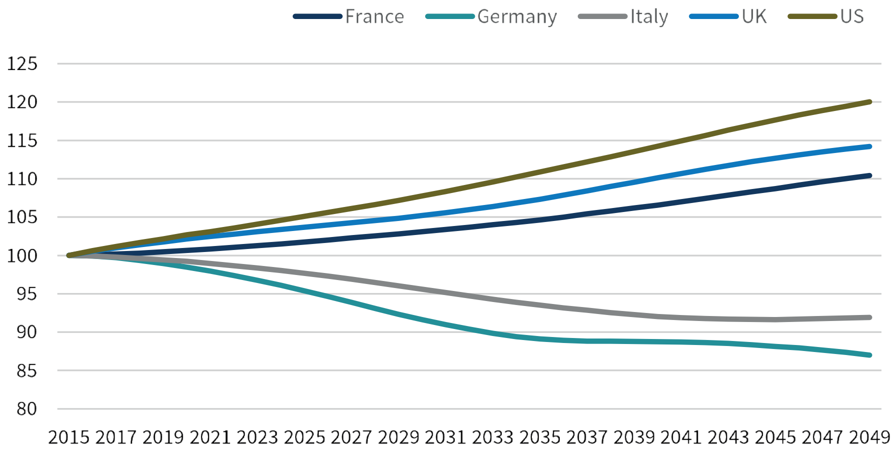
Data: IMF

Why have savings increased in Germany? The main reason is demographic change. In the early 2000s there was a growing awareness that the German public pension and health systems, based on pay-as-you-go financing, were extremely vulnerable to population ageing. Figure 5 shows that Germany is affected more strongly by population ageing than most other European countries. As a result, pension claims were reduced and various measures were taken to increase private saving for retirement. While the impact on private household savings was limited, the debate about population ageing did lead to a fundamental change in the public's attitudes towards public-sector deficit financing and growing public debt. The debate over this issue led to the introduction of the 'debt brake' as part of the German constitution in 2009. Reduced public-sector deficits explain half of the increase in the current account since 2001.

A popular argument in the debate over the current-account surplus is that wage restraint (sometimes denounced as 'wage dumping') is an important factor. One variant of this argument is that low wages have boosted the 'competitiveness' of German companies. The trouble with this argument is that lower production costs do not necessarily lead to a higher current-account surplus, as this requires an increase in savings over investment.

2 Investment was higher in the 1990s, but that was a result of the transitional impact of German reunification.

Figure 5. Labour force projection (2015=100)

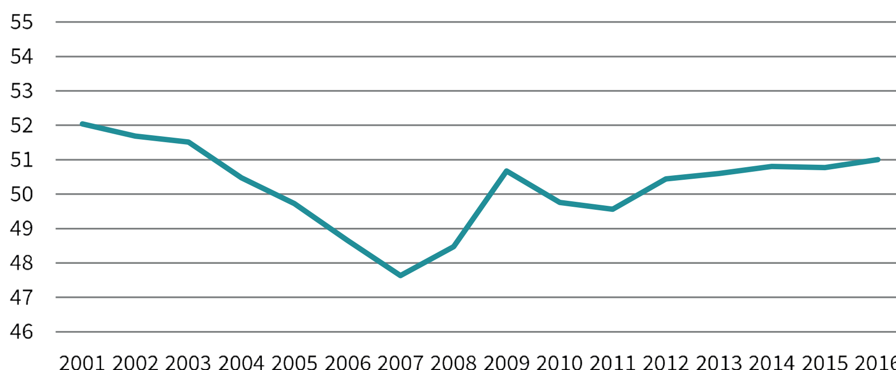


Data: ILO

Another variant of the wage-restraint argument is based on the idea that wage earners save a smaller part of their income than capital owners. So, if labour as a share of overall income declines, savings may increase. Figure 6 illustrates how wage income as a share of GDP has developed over time. It is true that this share declined until the mid-2000s, mainly due to rising unemployment. Since then the share of wage income has increased, as has the current-account surplus. If the wage share had been a key determinant of the current-account surplus, the latter should have declined between 2007 and 2016. Therefore, the argument that a declining wage share can explain the growing current-account surplus is flawed.

Two other factors are more likely to be relevant for the increase in savings. Firstly, various tax reforms have been implemented, including reductions in social insurance contributions financed by higher indirect taxes, and notably the standard value added tax (VAT) rate increases from 16% to 19% in 2006. This policy is sometimes referred to as ‘fiscal devaluation’. The reform boosted profits in the export industry and is likely to have contributed to the increase in corporate savings. There were also two corporate tax reforms, in 2001 and 2008, which reduced the corporate tax rate and broadened the tax base.

Figure 6. Wage share (compensation of employees in % of GDP)



Data: German Federal Statistical Office

Overall, the reform reduced the tax burden on corporate profits and reduced incentives for debt relative to equity financing in German entities of multinational companies. Indeed, German companies have increased domestic equity financing considerably in recent years; another factor that boosted savings in the corporate sector.

Secondly, in recent years, Germany (like many other countries) has benefited from the decline in oil prices. It is plausible that most firms and households viewed the windfall gains from lower oil prices as a transitory effect, encouraging them to use most of the gain to increase savings. Between 2014 and 2016 the current-account balance increased by roughly 2 percentage points because import prices fell relative to export prices; 1.5 percentage points were due to the fall in the oil price, the other 0.5 percentage points were a result of lower prices for other raw materials.

Moreover, monetary policy in the Eurozone is a major driver of Germany's current-account surplus. The low euro exchange rate is a key factor that is raising exports and dampening imports. In addition, policies like the OMT programme are boosting capital flows to periphery countries in the Eurozone. This also raises the German current-account surplus.

Finally, it is worth noting that foreign investment income (the net returns on foreign assets) itself is becoming an independent driver of the current-account surplus. In 2016 this income was equal to 1.7% of GDP.

4 Is the German current-account surplus a problem?

According to the prevailing critique of the German current-account surplus, the surplus is good for Germany, but bad for deficit countries. This view is based on the assumption that the world economy, and the Eurozone in particular, is in a recession that can only be overcome by stimulating demand. By absorbing demand generated in other countries Germany benefits because its economy grows, while other countries suffer from unused production capacities and unemployment. Paul Krugman sums it up as follows: "We are still in a world ruled by in-adequate demand. […] By running inappropriate large surpluses, Germany is hurting growth and employment in the world at large."[3]

It is plausible that countries with slack capacity would benefit from additional demand coming from Germany or anywhere else. There can be situations where generating demand leads to positive externalities. Since individual countries do not internalise the benefits of macroeconomic demand stimulation, they do too little. This applies to all countries. Does that tell us anything about the current situation of the Eurozone, or Germany in particular? Claiming that Germany should do more is based on the view that countries with a current-account surplus or low fiscal deficits should feel morally obliged to stimulate global demand. But asking that Germany should do more to help others is not the same as proving that Germany hurts growth and employment. All countries hesitate to pursue fiscal policies which are not in line with the national economic interest, not just Germany. In addition, using fiscal policy to stimulate demand now would come at the price of higher public debt, undermining growth prospects and resilience in future crises. Moreover, there are other international spillovers. The critique of the German surplus overlooks the fact that supplying capital to the rest of the world may also give rise to significant positive spillovers. Most importantly, the extra supply of capital keeps interest rates low, which is beneficial to debtor countries.

Another, almost equally popular claim is that the current-account surplus is bad for Germany itself. It has been argued that German companies and the public sector are investing too little in Germany, undermining Germany's economic future. The trouble with this argument is that there is no convincing evidence of an investment gap in

3 https://krugman.blogs.nytimes.com/2013/11/01/the-harm-germany-does/

Germany. As mentioned above, the current-account surplus is not due to a decline in investment in Germany, but to an increase in savings. Given that demographic change in Germany will accelerate in the 2020s, it is perfectly rational for the private sector to use additional savings for investment abroad, rather than in Germany. For the public sector, it is equally rational to cut investment in regions of the country where the population is declining. It is certainly true that maintenance has been neglected in some areas of Germany's infrastructure (as it has been in most other countries), but the idea that Germany would benefit from a massive boost in either private or public investment is unconvincing. If these investment opportunities existed, they would be realised. Access to capital is easy and public funds available for investment are not being fully used.

A variant of this argument claims that the surplus is harmful for Germany because capital is invested poorly and generates low rates of return. The implicit assumption is that domestic investment in Germany would yield higher returns, but for some reason does not take place. It is true that some German foreign assets, and particularly the growing TARGET 2 balances in the ECB system, generate low rates of return. But that is related to tensions in the Eurozone, which cannot be readily defused. Generally, however, both foreign and domestic investment decisions are taken in private capital markets and there is no reason to assume that these markets are biased towards foreign investment.

Yet another variant is that current-account imbalances may give rise to future debt crises, as debtor countries accumulate excessive debt. This is hardy convincing because excessive debt may occur without current-account imbalances, and large deficits of individual countries are a better predictor of debt crises than the surpluses of individual countries.

Overall, there are no convincing arguments suggesting that its current-account surplus is harming Germany. For other countries, the surplus in itself is not harmful either; in normal circumstances trade is mutually beneficial. It is, however, true that countries suffering from unemployment and a lack of demand for their products would benefit from more demand coming from Germany. At the same time, however, a decline in the German current-account surplus, i.e. a reduction of capital supply from Germany, would push up interest rates, something that will be less welcome in those countries.

5 'Ordoliberal' versus 'Anglo-Saxon' views of the surplus

Do the 'German/ordoliberal' and the 'Anglo-Saxon' views differ in how they assess the surplus issue and in their policy recommendations? It is certainly true that the emphasis on short-term demand stabilisation is stronger in the public debates in the Anglo-Saxon countries than in Germany, although there was a broad consensus in Germany that fiscal stimulus was the right reaction in autumn 2008, when the worldwide recession broke out and growth in Germany plummeted as in many other countries.

A second difference may be that the ordoliberal perspective would put emphasis on the general rules for international economic relations, much less than on discretionary management. It is part of these rules that companies and, by implication, entire economies should compete for markets and customers. There are no rules saying that, above a certain degree of competitive advantage companies should adjust by increasing their cost or by reducing their productivity. Of course, the European Macroeconomic Imbalances Procedures do include a rule stating that the current-account surplus should not exceed 6% of GDP. Moreover there are, of course, rules against dumping. But it is hard to pin down where fair competition ends and dumping begins. In international trade currency manipulation of subsidies can be sources of dumping, but Germany cannot manipulate its currency and it is subject to state aid control, which makes dumping through subsidies difficult.

Another part of the difference in views between German and Anglo-Saxon commentators may be related to national economic interests although commentators should, in principle, be neutral. Why should Germany or any other country deviate from the nationally optimal fiscal policy just because other countries benefit from it? In the same way, the US would hardly think about choosing a nationally suboptimal fiscal policy just because other countries would benefit from this. Of course, if there are gains from the coordination of national fiscal policies for the world economy as a whole, it should, in principle, be possible to realise these gains, possibly using side payments or linking different issues. But whether those gains exist is an open question.

6 Policy implications: what should Germany do?

Germany currently has no direct economic interest to stimulate domestic demand in order to reduce its current-account surplus, but political pressures on it to do so are growing. There are three reasons why Germany may be forced to do more to rein in its surplus. Firstly, foreign governments may threaten to turn to protectionism. This is a negative-sum game, but Germany depends more on international trade than other countries, which means that it has a stronger interest in defending free trade. Secondly, a growing creditor position relative to other countries may become a political problem by giving debtor countries a growing incentive to seek ways to avoiding servicing their liabilities. Creditors seldom attract sympathy. Thirdly, in the framework of the European Macroeconomic Imbalances Procedures Germany has accepted the rule that its current-account surplus should not exceed 6% of GDP. Germany can hardly ask other countries to respect European fiscal rules while ignoring other regulations itself.

So, if the German government wanted to bring down the surplus, what are its options? The first option would be to stimulate domestic investment and the second would be to boost consumption.

As explained above, there is no evidence of a general investment gap in Germany, but if something needs to be done to reduce the surplus, stimulating investment is preferable. Increasing public investment is difficult in the short term. Growing funds have been made available in recent years, but they are not being used. Moreover, Germany's public investment accounts for just 2% of GDP. Even if this figure could be increased by 20%, for example, the impact on domestic demand would be just 0.4% of GDP. A quantitatively more powerful option would be to boost private investment. This could be achieved through improved loss offset, accelerated depreciation and R&D tax credits.[4]

Which instruments are available to raise consumption? A temporary cut in the value added tax rate (VAT) would boost spending, albeit only until the end of the reduction period.

4 It would also be helpful to revise regulations of certain service sectors like pharmacies or taxi transport to allow for more competition, which might also trigger more investment, an issue that has repeatedly been addressed by the European Commission, albeit with limited effect .

Then the effect would be reversed. A permanent cut in VAT or a lower income tax would have little impact because private households will react to the tax cut by saving more.[5] Low income households are often expected to save less in response to tax cuts but the evidence on this effect is ambiguous.[6] Another option would be to increase public consumption. Germany, for example, could increase its military spending and buy more foreign equipment. But, overall, increasing consumption is not compatible with the desire to save more to prepare for ageing.

It is sometimes suggested that Germany should increase wages to reduce its current-account surplus. This is not a convincing proposal. Firstly, wages are set by unions and employers, not by the government. The government only sets the minimum wage. Increasing the minimum wage more aggressively would be risky because it would reduce employment opportunities for low skilled workers, an area of the workforce in which unemployment remains high. More generally, the impact of rising wages on the current account is ambiguous. If higher wages were to reduce employment, domestic demand may fall and the surplus could continue to grow. Whether wages are too low or too high should be judged in the light of labour market conditions. From that perspective, German wage developments seem perfectly acceptable.

Overall, it should not be overlooked that various factors which are currently boosting the current account-surplus are transitory. The oil price may rise again, and as Germany's population ages and the baby boomer generation retires, the German current-account surplus may soon be a thing of the past.

5 A recent study from the German Ministry of Economic Affairs and Energy finds that a permanent cut in the VAT rate by 5 percentage points, which would reduce the tax burden by 1.8% of GDP, would only reduce the surplus by 0.25% of GDP, see *Schlaglichter der Wirtschaftspolitik* 07/2017, pp.13-14. Priesmeier uses a macrosimulation model to analyse the impact of a fiscal expansion in Germany and finds that the impact on the current account would be small, with a corporate tax reform having the largest effect, see C Priesmeier, 'Lässt sich der deutsche Leistungsbilanzüberschuss mit vertretbarem Aufwand reduzieren?', forthcoming in *Wirtschaftsdienst* 97 (9), 2017, pp. 637-643.

6 A study on tax rebates in the US in 2008 shows that low income households on average saved a larger part of the rebate than higher income households, many of them paid back consumer credits, see M. Shapiro and J. Slemrod, 'Did the 2008 tax rebates stimulate spending?', NBER Working Paper, No. 14753, 2009.

About the authors

Gabriel Felbermayr is Director of the ifo Center for International Economics at the ifo Institute – Leibniz Institute for Economic Research at the University of Munich. Simultaneously, he holds a Chair in Economics at the University of Munich. His research deals with international trade agreements, trade and labour market outcomes, trade and environment.

Clemens Fuest is President of the ifo Institute, Professor for Economics and Public Finance at the University of Munich, Director of the Center for Economic Studies (CES) and President of CESifo GmbH.

His research areas are economic and fiscal policy, international taxation, taxation, and European integration.

Timo Wollmershäuser is Deputy Director of the ifo Center for Macroeconomics and Surveys at the ifo Institute; Coordination: Service area “Business Cycle Analysis”.

His research agenda is largely influenced by the global financial and euro crisis. Besides studying the impact of banking on the macroeconomy, his research focuses on heterogeneities in a currency area and in particular on intra-euro area imbalances.

17 Unequal imbalances

Agnès Bénassy-Quéré[1]
Paris School of Economics, University Paris 1, and French Council of Economic Analysis

1 Introduction

It is now recognised that one of the deep causes of the euro area crisis that started in 2010 was, before the crisis, the almost exclusive focus of Member states' surveillance on fiscal imbalances and the corresponding neglect of other types of imbalances: nominal divergence, excess leverage in the private sector, or housing bubbles. On the eve of the global financial crisis, among the 19 countries of the current euro area, only Greece displayed a budget deficit exceeding 3% of GDP. Conversely, all those countries facing severe financial crises were experiencing current-account deficits exceeding 6% of GDP (Figure 1).

Prior to the crisis, economic policies were loosely coordinated through the Broad Economic Policy Guidelines (BEPGs, see Art. 121.2 of the TFEU) and Employment Guidelines (EGs, Art. 148) – an annual, relatively formal exercise. Attempts by the Eurogroup to exert some pressure on member states considered to be in imbalances (notably on Ireland in 2000) were only short lived.

In 2011, the European Semester was introduced to make the coordination of national economic policies more effective. The objective was to transform BEPGs and EGs into a binding process through encapsulation of three instruments: the Stability and Growth Pact (SGP), the Macroeconomic Imbalance procedure (MIP) and the Europe 2020 process ("Integrated Guidelines").

1 This paper partly draws on a presentation made by the author in Sintra in June 2017.

Figure 1. Budget balance and current account balance of 19 European countries in 2007

Source: European commission, Ameco database.

The MIP was introduced as part of the "six pack"[2] to monitor imbalances that may be unrelated to the public sector. Incorporated in the European semester, the procedure starts at the end of year N-1 with the publication by the European Commission of an "Alert mechanism report" which, based on a set of indicators gathered into a scoreboard, designates a group of countries likely to present imbalances. In the spring of year N, the Commission then publishes an in-depth analysis for each of these designated countries (now incorporated in each country's country report). It then classifies the countries into four categories (initially five): 'no imbalances', 'imbalances', 'excessive imbalances', or 'excessive imbalances requiring the activation of the excessive imbalance procedure'. The latter category may lead to sanctions.

Here we argue that, although the introduction of the MIP was a very appropriate initiative, its excessively broad coverage has somewhat diluted the initial purpose of preventing the building up of dangerous macroeconomic imbalances in the context of a monetary union.

2 Legislative package consisting of five regulations and a directive adopted in October 2011.

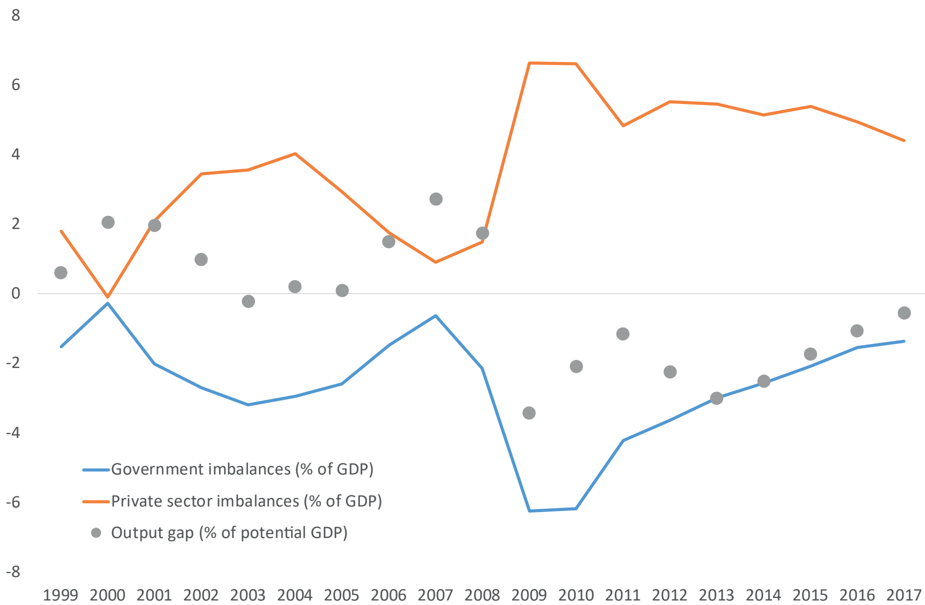
The SGP then has remained the only constraint in town, leading to asymmetric adjustments. It seems that in the Eurozone, not all imbalances are equal: deficits are more “imbalanced” than the corresponding surpluses, and public sector imbalances are considered more toxic than private sector imbalances.

2 Macroeconomic imbalances after the crisis

Figure 2 evidences a continuous reduction in the aggregate fiscal deficit of the Eurozone after the financial crisis, from -6.2% of GDP in 2010 to -1.4% of GDP in 2017 (provisional figure). Over the same period, the surplus of the private sector (calculated as the difference between the current account and the fiscal balance) was slightly reduced, from 6.6% of GDP in 2010 to 4.4% in 2017. The result was an increase in the current-account surplus of the Eurozone: reduced dissaving in the public sector was not matched by less saving in the private sector. Such combined evolution of public and private aggregate imbalances would have been benign had the output gap been progressively reduced. Unfortunately, as evidenced in figure 2, the aggregate output gap of the Eurozone fell again in 2012 and 2013.

One could argue that it was the task of the European Central Bank to address the ‘second dip’ of the output gap in 2012. As a matter of fact, the ECB cut its main policy rate three times in 2012 and 2013. However, it could only slightly cut the rate on the deposit facility because it was already at 0.25% in the first semester of 2012, the short-term market interest rate (EONIA) being also very close to the zero floor. In theory, the ECB could have started its quantitative easing programme earlier than 2015. However, the issue was extremely controversial at that time, especially since headline inflation was relatively high (2.5% in 2012), and neither the fiscal compact nor the banking union were in place yet. In a nutshell, there was a coordination failure between monetary policy and the 19 fiscal policies during these years, which produced a shortage of aggregate demand in the Eurozone.

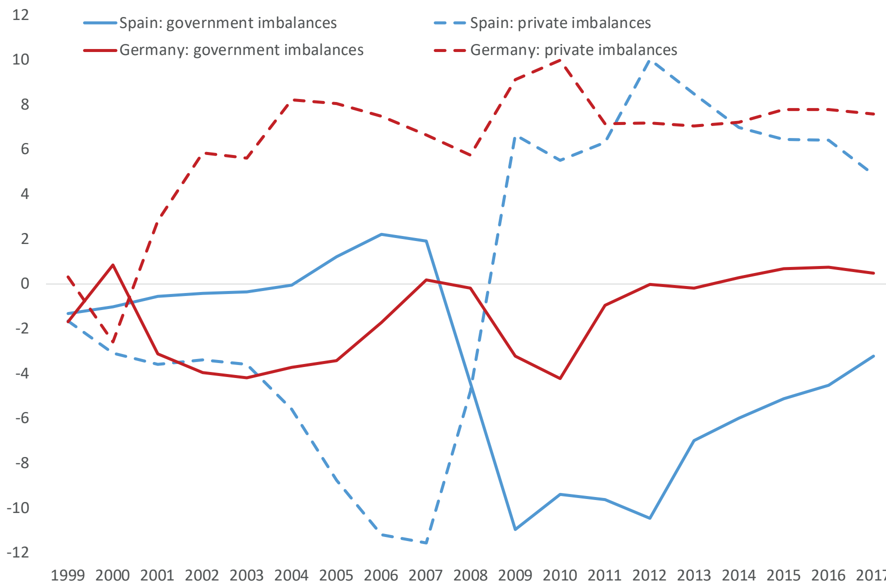
Figure 2. Public and private imbalances, Eurozone



Source: European Commission, Ameco database. Private sector imbalances are calculated as the difference between current account imbalances and government imbalances.

Looking at the details of each Member state, it appears that the process of deleveraging in crisis countries, that involved both the public and the private sectors, was not compensated by more demand in non-crisis countries. Figure 3 illustrates this point by comparing two large Eurozone countries: Spain and Germany. In 2008-09, the private sector in Spain switched from being a large dis-saver to becoming a saver comparable to Germany. Meanwhile, the public sector was also saving more in both countries and the German private sector was remaining a large saver. Hence there was a coordination failure also between fiscal policies (monitored by the SGP) and non-fiscal policies (monitored by the MIP). The question then is whether the MIP could have avoided such sub-optimal macroeconomic outcome.

Figure 3. Public and private imbalances – Spain and Germany (% of GDP)



Source: European Commission, Ameco database. Private sector imbalances are calculated as the difference between current account imbalances and government imbalances.

3 The evanescent role of the MIP

The concept of 'macroeconomic imbalances' underlying the MIP is very broad, as evidenced by the MIP scoreboard used at the beginning of the process, which includes 14 main indicators and 28 auxiliary indicators. The current-account balance is one indicator among many. Although there is no direct relationship between the scoreboard and the Commission's assessment of imbalances in each country, a bird's eye view of the 2017 MIP vintage suggests that the concept of macroeconomic imbalances goes beyond the mere current account imbalance or excess leverage in the private sector (Table 1). In particular, a country may be considered in 'excessive imbalances' due to slow productivity growth, inefficient judiciary system, corruption or fiscal deficit.

Table 1. Origin of macroeconomic imbalances in 2017 according to the European Commission's in-depth reviews

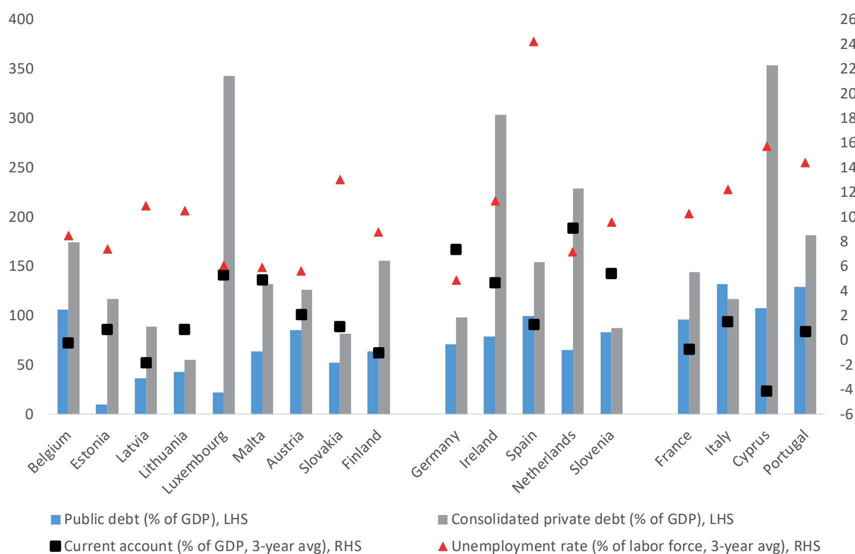
Countries experiencing "imbalances"	Countries experiencing "excessive imbalances"
Germany : excessive current external surplus, insufficient public investment	France : lack of competitiveness and productivity, public debt
Ireland : persistent public and private indebtedness	Italy : lack of competitiveness and productivity, public debt, fight against corruption and tax evasion, non-performing bank loans, unemployment
Spain : persistent public and private indebtedness	Cyprus : external deficit, non-performing loans, deficiencies in justice
The Netherlands : excessive current external surplus, private indebtedness	Portugal : public and private debt, non-performing loans, unemployment, lack of productivity
Slovenia : banking sector weakness, private indebtedness	

Source: European Commission (2017a), annex 3.

Figure 4 offers a complementary view of this problem by plotting four of the 'main' indicators of the scoreboard that may more directly be related to macroeconomic imbalances: current account, public debt, private debt, and unemployment. Three groups of Eurozone countries are considered on this figure:[3] "no imbalances" (including those countries not subject to an in-depth analysis), "imbalances", and "excessive imbalances". Countries with excessive imbalances are characterised by relatively high levels of unemployment and public debt. In general, the countries with imbalances show a large current account surplus. However, some countries in the no-imbalance group may display large surpluses, high unemployment or high private debt. The problem then is the lack of predictability and ownership for national governments.

3 Greece is excluded because its surveillance is carried out under a programme of the European stability mechanism.

Figure 4. Four indicators of the 2017 MIP scoreboard (% of GDP except for unemployment which is in % of the labour force)



Source: http://ec.europa.eu/eurostat/web/macroeconomic-imbalances-procedure/indicators, data based on end-2015 statistics.

The final stage of the MIP is the formulation of recommendations to the Member States in May of each year (after the latter have drafted and submitted their programmes of reforms). Table 2 summarises the country-specific recommendations to the four countries considered “in excessive imbalances” in the 2017 vintage of the MIP. All of them include fiscal adjustment, which is already monitored under the SGP. Some of them mention instruments that can be activated “at the margin”, such as tax cuts, public investment or the evolution of the minimum wage. However, the recommendations under the MIP heading also cover a number of structural reforms (such as the reform of vocational training, or of collective bargaining rules) that can hardly be implemented (and can even less deliver results) over a one-year window. As a matter of fact, the implementation of country-specific recommendations has proved relatively poor (Alcidi and Gros 2015, Darvas and Leandro 2015).

Table 2. Country-specific recommendations to the four countries considered "in excessive imbalances" in the MIP 2017

France	Fiscal adjustment, tax cuts/base broadening, vocational education & training, minimum wage, regulatory burden
Italy	Fiscal adjustment, efficiency of justice, competition laws, NPLs, insolvency, collective bargaining, social spending
Cyprus	Fiscal adjustment, justice, insolvency, NPLs, public invest., education, employment service
Portugal	Fiscal adjustment, open-ended contracts, NPLS, SME financing, administrative burden, insolvency.

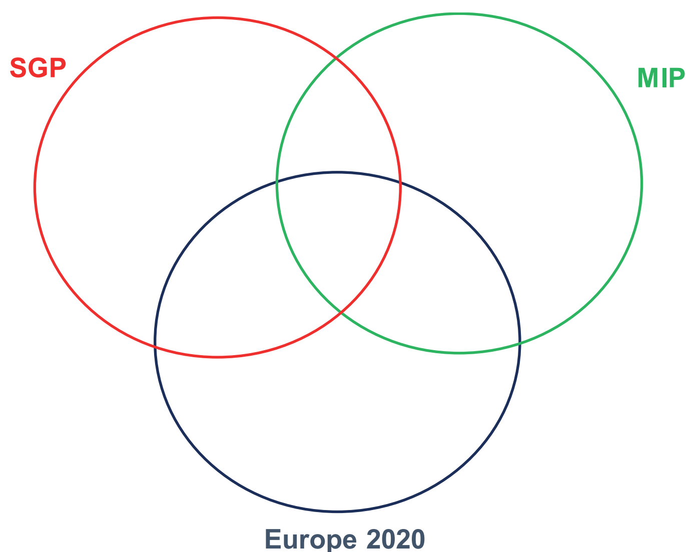
Source: European Commission (2017a), annex 3. NPLs: Non-performing loans.

4 Re-focusing the MIP

As already mentioned, the European semester encapsulates three procedures: the SGP, the MIP and the "Europe 2020 integrated guidelines" (Europe 2020 hereafter). Perhaps because the MIP is perceived as more binding than Europe 2020, most of the country-specific recommendations – whatever their objective – tend to be grouped under the MIP heading rather than Europe 2020, for those countries considered with (excess) imbalances. In 2016, for instance, France received several recommendations under the MIP for structural measures related to the labour market: apprenticeship, unemployment insurance, and labour laws. Simultaneously, Slovakia, which was considered to have "no imbalances" (and was not even subject to an in-depth review), also received recommendations for structural reforms related to the labour market, although not under the MIP heading. Ultimately, the labelling of the different types of recommendations appears somewhat arbitrary and their overlapping is detrimental to the overall readability of the scheme (Figure 5).

The objective of the SGP is fiscal discipline. The MIP was introduced in 2011 in order to supplement the SGP, so as to avoid the accumulation of risks outside the public sector: corporate debt, household debt, banks' fragility, housing bubbles, labour cost divergence, etc. The objective of the MIP was initially short- and medium-term. The policy instruments would then need to be instruments that can be changed rapidly "at the margin", e.g. the minimum wage and remuneration of civil servants, tax rates, or macro-prudential policies.

Figure 5. Three overlapping surveillance procedures



Source : Author.

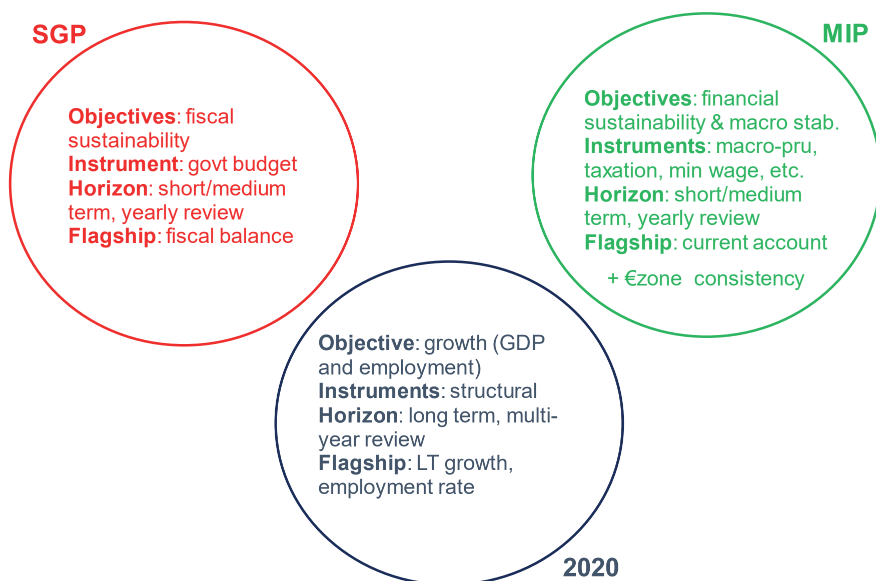
The European Union's growth strategy aims at full employment and productivity growth, hence it has a long-term objective. The corresponding instruments are structural. In some cases, structural reforms may help in achieving a medium-term objective. For instance, more flexibility in real estate and housing supply regulations may curb a housing bubble; likewise, reducing the duality of the labour market may limit wage growth. In general, however, structural reforms only deliver after several years, so they cannot be relied on to prevent the building up of short- and medium-term risks. Furthermore, mixing up structural reforms with policies that can be activated "at the margin" encounters the risk of repeating the same recommendation year after year, since structural reforms are typically implemented over a multi-year window.

Burdening the MIP with structural, long-term issues has turned it into a complex, blurred process (see Bénassy-Quéré 2015). A way to restore the MIP as a frontline instrument would be to re-focus it on its initial objective: prevent the building up of macroeconomic imbalances that could degenerate in a severe crisis. In order to improve the overall readability of the scheme (and its appropriation by national governments and parliaments), the current account could be used as a flagship indicator, like the fiscal deficit for the SGP. For sure, there are "good" and "bad" current-account imbalances.

Looking back at figure 1, though, it is quite clear that a large deficit tends to signal a risk of crisis. Conversely, a large surplus within a monetary union tends to put some deflationary pressure on the economy, since the domestic currency cannot appreciate. Countries with large current-account imbalances would then be scrutinised by the Commission through in-depth reviews that would study whether these imbalances are actually worrying or not. Consistently, the policy recommendations under the MIP heading would concentrate on instruments that can be changed "at the margin". One difficulty is that macro-prudential instruments are activated following an entirely separate process with independent macro-prudential authorities at national level and the European Systemic Risk Board at European level. Some institutional adjustment may be required to incorporate the assessment of these different institutions into the country-specific, MIP recommendations.

Structural reforms would then be monitored under a separate process, with possibly multi-year objectives and surveillance, and a clear objective of raising productivity growth and employment rates (see figure 6).

Figure 6. Towards a clarification of macroeconomic surveillance processes



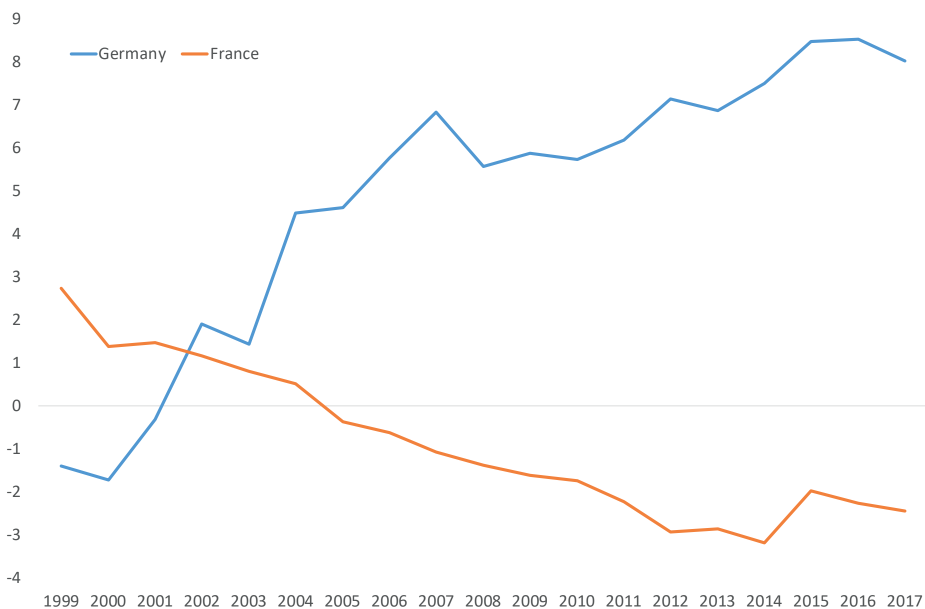
Source: Author.

5 Cross-country consistency

Re-focusing the MIP on its initial objective could also help to foster more cross-country consistency, for the sake of the Eurozone as a whole. To understand this point, it may be useful to study the case of Germany and France.

Since the 2000s, Germany has posted a growing current-account surplus, which culminated at 8.6% of GDP in 2016. Meanwhile, France has experienced a fall in its current account, which reached -2.3% of GDP in 2016 (Figure 7). In order to rebalance the two economies, a standard macroeconomist would advocate a demand-side policy in Germany and a supply-side policy in France.

Figure 7. Current-account balance, Germany and France (% of GDP)



Source: Ameco.

In this spirit, country-specific recommendations for Germany in 2017 have insisted on the need to "use fiscal policy to support domestic demand and achieve a sustained upward trend in investment". This would be achieved through higher public investment, but also by "further improving the efficiency and investment-friendliness of the tax system and stimulating competition in business services and regulated professions".

The Commission also recommended it to “create the conditions to promote higher real wage growth”. In contrast, France was asked to further consolidate its public finances and continue to reduce the labour cost, and to “ensure that minimum wage developments are consistent with job creation and competitiveness”. Like Germany, France was also required to “continue to lift barriers to competition in the services sector”.

These recommendations are broadly in line with the view that reducing the German current-account surplus would require higher aggregate demand, whereas reducing the French current-account deficit would require higher aggregate supply. Furthermore, the recommendations correctly identify the non-financial corporate sector in Germany as one major contributor to the Germany surplus.

However, the steady rise in Germany’s non-financial corporate excess savings since 2008 – from -1% of GDP in 2008 to +3% of GDP in 2015 (see European Commission 2017b, p. 7) – has resulted from a rise in gross savings much more than from a decline in gross investment. In fact, the decline in investment from the non-financial corporate sector in Germany dates back to the beginning of the 2000s. The ability of public policies to raise the level of private investment may then be questioned. Another way to boost aggregate demand in Germany would be to shift some purchasing power from non-financial companies to households, especially at the lower end of the remuneration schedule. This is the spirit of the recommendation to “create the conditions to promote higher real wage growth”. However, higher real wage growth could be obtained by lower inflation (given the liberalisation of the services sector) rather than through higher nominal wage growth, in which case such evolution would go against the recovery of inflation in the Eurozone and re-convergence of price levels across Eurozone members. Additionally, the recommendation for “further improving the efficiency and investment-friendliness of the tax system” may go against the objective of shifting some purchasing power from the companies to the households.

On the whole, whereas the recommendations to France are clearly (and correctly) supply-side, it is not clear that the recommendations to Germany are entirely demand-side. Additionally, the impact of the different recommendations on Eurozone aggregates are not clear-cut. Refocusing the MIP as explained in the text would streamline the process and make the implications of the different recommendations on basic supply-demand imbalances more apparent.

Germany has traditionally been reluctant to consider current account imbalances as an issue of macroeconomic policy. A popular argument is that the rising current account surplus in Germany over 2008-2014 is the result of higher competitiveness rather than excess supply. However, Germany's global market share fell from 8.36% in 2008 to 7.82% in 2016, according to the 2017 MIP scoreboard. This is more than Spain lost over the 1999 to 2007 period (2.36 to 2.22), while it was experiencing a huge increase in its current-account deficit.

Another argument for the German benign attitude vis-à-vis its current-account surplus has been the ageing population, which tends to save more and invest less domestically. However, ageing is a smooth process, whereas the rise in the current account has been very steep.

Finally, the rise in the Eurozone current account may be due to the sharp fall in the prices of oil and other commodities in the recent period. To the extent that these price variations are not expected to be long-lasting, the windfall would be saved, and the current account would rise. From 2013 to 2015, Germany's terms of trade did increase in parallel to the current account. However, they fell sharply from 2009 to 2012, while the current account was already rising.

A different line of argument is the fact that the government has no direct tool to curb the current-account surplus. Indeed, the Bundestag does not decide on the current account, whereas it does decide on the parameters of federal expenditures and revenues. Nevertheless, the government has indirect instruments to affect the current account, e.g. decisions on the minimum wage and public service remunerations, on taxation, or on macro-prudential policy (which has largely remained in the hands of national authorities), not to mention the impact of fiscal policy itself.

6 Conclusion

Economic governance in the Eurozone has become extremely complex, which reduces national ownership: national governments and parliaments already find it difficult to master the SGP rulebook; when it comes to the MIP, which is a multi-dimensional process, they generally have, at best, a vague understanding of it.

This situation makes the implementation of a coherent macroeconomic strategy very difficult in the Eurozone, and the lack of readability also contributes to citizens' perplexity. Still, the European semester could be made much more efficient with the existing tools, provided a clarification is made and each procedure (SGP, MIP and Europe 2020 guidelines) is re-focused on a small number of objectives with the corresponding instruments, consistent with the standard economics textbook.

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About the author

Agnès Bénassy-Quéré is a Professor at the Paris School of Economics - University of Paris 1 Panthéon Sorbonne, and the Chair of the French Council of Economic Analysis. She worked for the French Ministry of economy and finance, before moving to academic positions successively at universities of Cergy-Pontoise, Lille 2, Paris-Ouest and Ecole Polytechnique. She also served as a Deputy-director and as a Director of CEPII and is affiliated with CESIfo and IZA. She is a Member of the French macro-prudential authority and of the Banque de France's General Board, and a former columnist at *France Culture*. Her research interests focus on the international monetary system and European macroeconomic policy.

18 Local politics & textbook economics at the heart of Europe's financial crisis

Christopher Smart
Harvard Kennedy School, Carnegie Endowment for International Peace

Introduction

If all politics is local, then all economics is to be found in first-year textbooks. The combined wisdom of Tip O'Neill and Paul Samuelson actually captures most of what can be said about the political economy of any country.[1] It certainly describes much of the German response to Europe's financial crisis and the frustration of US and other European officials who were urging a more robust response as the postwar project teetered on collapse. There are also continuing consequences today as the US finds itself buffeted by new political impulses and old economic ideas.

It is perhaps unfair – in retrospect and from afar – to criticise the crisis response of a democratically-elected government for excessive sensitivity to the preferences of its voters. Sending taxpayer money to a foreign country with incompetent or corrupt leaders is not a vote winner anywhere, even if Chancellor Merkel and her government ultimately made the case for their vision of European solidarity and conditional German financial commitments. Nevertheless, it remains a great puzzle that German officials and voters alike remain wedded to idiosyncratic macroeconomic theory that reinforced their reluctance to lead. These ideas remain at the heart of a debate around the future of the euro and how best to strike the balance between solidarity and responsibility within the common currency.

1 "All politics is local" is often attributed to Thomas P. (Tip) O'Neill, the Speaker of the US House of Representatives from 1977 to 1987. Nobel laureate Paul Samuelson distilled the power of basic shared economic ideas elegantly: "I don't care who writes the nation's laws – or crafts its advanced treatises – as long as I can write its economics textbooks."

Above all, there is a barely concealed German supposition that debts and imbalances are *prima facie* evidence of political virtue and vice, rather than complex aggregates of economic policies and cycles. Germany's success, according to this logic, depended upon paying down debt and boosting exports which complicated any discussion of shared responsibility for boosting demand within the Eurozone. It all but precluded a broader conversation about the role of German domestic demand in redressing global imbalances.

US officials, who were just recovering from the turmoil around the 2008 collapse of Lehman Brothers, felt confident that a failure of confidence in the euro's capacity to respond required a generous and determined reaction from monetary and fiscal authorities. They were equally adamant that the global recovery would not be sustainable if it were driven entirely by the indebted American consumer. "Strong, sustainable and balanced growth" became the mantra of nearly every economic communique with the word "balanced" intended primarily for Beijing and Berlin, where the current account balances were significant. These differences are of more than historical interest. With the Trump Administration now fashioning an international policy that draws on protectionist politics and mercantilist economics, the conversation seems headed for a new and stormier phase.

Brief history of the crisis

The global financial crisis, which had its roots deep in the US subprime housing sector, was just starting to recede in early 2010 as a second global shock hit Europe. The response of European leaders and finance ministers bore a striking resemblance to what psychologists describe as the five stages of grief. Initially, there was widespread denial that anything might be wrong or that the ebbing confidence around Greek debt could not be easily addressed within the confines of existing European rules. As the turmoil spread, however, denial turned to anger as officials denounced malign global "speculators" for their attacks on sound European markets. When that failed to settle the storm, there began a scramble of bargaining with investors and other governments through 2011, in an effort to commit to the minimum possible financial commitments that might restore crumbling market confidence.

Loans to troubled states that were initially deemed immoral and illegal were soon approved in limited and highly conditional form. Even that, however, was not enough for the jittery bond markets, who immediately understood what one European official described as the flawed logic of the debate: private investors were being asked to trust euro governments – lending more money with fewer conditions – more than the governments themselves actually trusted each other. Only when Spain and Italy were pushed to the brink in 2012, with lots of peripheral talk about French economic vulnerability, were the ultimate steps toward taken integration, pooled sovereignty and large financial commitments.[2]

More important than the pace of the crisis in shaping the public debate was the order in which the crisis unfolded. Because the first bailout package was negotiated in Greece, and because the Greek problem was mainly fiscal, the debate was shaped as mainly an issue of prudent budget management. This played right into the most stubborn of German economic ideas around the importance of balanced budgets and paying down debts. In fact, the next countries to negotiate assistance faced very different economic challenges. Ireland enjoyed relatively sound fiscal dynamics until the government assumed responsibility for a collapsing banking system. Portugal's main problem was poor growth rather than overspending. Overall, Eurozone debts had actually been falling in the years before the crisis. Greece's disastrous public finances, however, made it easy to avoid discussions of lax bank regulation and imbalances that allowed large Germany surpluses to pour into unsustainable periphery debt and excessive real estate development.

Local politics and Germany's global role

If the chronology of the crisis allowed Germany to shape the economic debate, domestic politics reinforced the reluctance to act. Beyond the inherent difficulty of convincing voters of the importance of sending support to a troubled neighbour, German politicians were still grappling with their country's role as a European, indeed, global power. Since WWII, West Germany's leaders had heard very mixed messages about just how active a role they should play in European and international affairs.

2 For a more complete summary, please see Smart (2017).

Historically, a strong Germany had led neighbours to feel insecure, which led to tragic confrontation. With German reunification, French President François Mitterrand pressed the languishing common currency project as a key design element that would bind Germany's growth and success inextricably to the growth and success of all Europe. But this did not end the confusion of the German voter, who may have accepted intellectually that European prosperity was good for Germany, but still focused naturally on what could be done to boost Germany's own prosperity.

This dilemma highlights one of the great conundrums for outsiders in dealing with Europe – beyond the lack of a single phone number for Henry Kissinger. On issues like trade and investment, European politicians stress that they are part of a single continental juggernaut that can sit as an equal with the United States or China. There are other pursuits, like the United Nations, the International Monetary Fund or the Olympics, where Europeans revel in their many nation states in order to boost their votes or seats at the table or potential medal count. Then there are hybrid strategies where Europe sends both national and European representatives. Summits of G7 leaders, for example, include six European representatives.

In this context, it's hardly a surprise that German economic policymakers chose to remain intently focused on the post-crisis recovery of Germany with only a glancing eye on developments elsewhere. Thus, while Germany's fiscal policy remained far too tight for a monetary union struggling to restore growth and tackle unemployment, it was deemed just right for a domestic recovery that was coming along just fine. Outsiders pointed out, during the early phase of the crisis, that the Eurozone, as a whole, was running tighter fiscal and monetary policy than either the US or Japan even while its debt and deficits were smaller. The European Union's Stability and Growth Pact operated entirely on member state scorecards rather than an integrated view of the currency union and German officials added that they would soon, in any case, have a constitutional requirement to balance their budget.

Strikingly, when the conversation turned to imbalances, German officials were suddenly more European. The Eurozone, they hastened to point out, was broadly in balance with its trading partners, while the German surplus merely reflected idiosyncratic differences that could not be changed and certainly weren't worth discussing.

On the other hand, when the European Central Bank launched its quantitative easing programme, some German politicians turned apoplectic at what they saw as putting their Bundesbank's integrity – and balance sheet – at risk. If the value of the euro was clearly too strong for the European periphery, there was little acknowledgment that its relative weakness offered an extra boost to German exports. Germany had managed the best of both worlds, benefitting from its role at the heart of one of the world's great economies, yet uncommitted to support the broader institutions when outside shocks threatened.[3]

Talking past each other

While political differences drive most divergences over economic policy, few are aggravated by such stark differences over the economic ideas themselves. Countries may disagree about whether they need to tighten fiscal policy, but they will not disagree about whether tightening contributes to growth. Tracing the dominant strains of German economic policy to their intellectual roots in scholarship and history remains a task of great complexity. The teachings of 'ordoliberalism' or the legacy of Weimar hyperinflation surely played some part in shaping a policy framework for Germany's economic officials through the euro crisis. What was undeniable for US and other European officials engaged with their German counterparts was the absence of a shared intellectual framework around either the role of fiscal policy in a crisis or the malign effect of persistent economic imbalances.

The former was particularly striking as US officials believed they had not only generally accepted theory on their side, but recent practice as well. In terms of theory, the proper role of fiscal policy in supporting economic growth has long been debated, but there is a real consensus that a systemic shock that leads to a sudden stop in capital flows and collapse in demand requires massive and extended response. US officials believed that their own response, which included a fiscal deficit near 10% of gross domestic product and a Federal Reserve balance sheet that more than quadrupled in size, were not only crucial in restoring confidence but conclusive in demonstrating good policy.

3 There is nothing particularly German about this dynamic. Early US economic history was almost entirely a story of farm and industrial states choosing how and how deeply to pool resources in support of federal institutions. For an elegant retelling, see Lowenstein (2015).

The US recovery was well entrenched long after European growth returned to pre-crisis levels. But German policymakers were unimpressed. After a substantial, but brief, fiscal response, Finance Minister Schäuble and his team focused intently on returning their budget to balance – indeed a small surplus – dictated by their new 'debt brake'. German lawmakers would chuckle at a foreign visitor's suggestion that not only Germany, but Europe as a whole, needed more support for demand from fiscal authorities and that Germany was the country that could best afford to contribute. "Surely, you don't still believe in Keynes?" they would ask. US advice was in any case only barely credible (even if it were intermittently welcome) given America's role in the global crisis and its own broken budget and debt limit process.

Throughout, there was a sense that any response that involved increasing Germany's national debt was more than a policy mistake, but was a moral mistake as well. Only in Germany, complained Italy's then-Prime Minister Mario Monti, is economics considered a branch of moral philosophy. It wasn't just that lending money was difficult for the lender, it was harmful to the borrower as well, enshrining bad habits and discouraging reform. And entwined with this moralism, of course, were basic assumptions about human nature, just as they cut across the political spectrum in many countries. Does support provide comfort for the afflicted or does it encourage profligacy? In the European context, the metaphors (and stereotypes) flew. Greece was an alcoholic who needed tough love. Additional support for Italians would simply finance *la dolce vita*. There was a natural concern for moral hazard, but the insistence that any support could only follow demonstrated commitment to reforms seemed based on a sly logic: countries need to reform before they qualify for money, but once they reform the money will be unnecessary.

There was a similar conversation over global imbalances, whether within the Eurozone or globally. The intellectual assumption during the early history of the euro had been that imbalances within a currency union like the Eurozone didn't matter. Even when the union was driven to the brink by a sudden stop in financial flows, there was little sober introspection in Germany at how its own surpluses had financed the periphery's excesses. There was even less examination of how German banks and investors had profited from the boom and were threatened by the bust.

The broader global conversation similarly fell on deaf ears. "Why do you want us to export less?" was the typical response when the question was raised. In few other countries would suggestions of how to boost economic activity meet so many puzzled looks. More investment in infrastructure, childcare that boosts female workforce participation and deregulation of service industries might all raise domestic demand and German incomes, even as they helped redress imbalances. More often than not, however, explanations that Germany should not export less but import more as part of its continental and global responsibility led straight back to a conversation about the moral evils of deficits and debts.[4]

The next chapter

These issues might be mostly of historical interest as the European economy recovers, yet local politics and economic theory continue to shape Europe's continuing efforts to build common institutions. The European Central Bank's strategy to normalise its balance sheet, Italy's efforts to address bad bank loans and the prospects of Eurozone deposit insurance will all depend on German ideas about its role within Europe and its understanding of good economic policy. The global economic debate, meanwhile, has taken a sharp turn with the Trump Administration's fresh blend of protectionist ideas and mercantilist assumptions. "The Germans are bad, really bad," the President told *Der Spiegel* in May 2017. "Look at all the millions of cars they sell in the US. It's terrible." Germany's economic ideas are hardly responsible for US presidential election outcomes, but persistent surpluses fuel talk of unfairness and retaliation. Even as Europe struggles to balance competing visions of its future, we may be on the verge of a much greater transatlantic misalignment of politics and theory with even greater consequences.

4 America often forgets that it took a far more benign view of surpluses when it was running one of its own after World War II. See Steil (2013).

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About the author

Christopher Smart is Senior Fellow in the Geoeconomics and Strategy Program at the Carnegie Endowment for International Peace following six years in the Obama Administration as a senior policymaker for international economic affairs. As Special Assistant to the President at the National Economic Council and the National Security Council, he was principal advisor on trade, investment and a wide range of global economic issues. From 2009-13, he was Deputy Assistant Secretary of Treasury, where he led the response to the European financial crisis and designed US engagement on financial policy across Europe, Russia and Central Asia.

Before entering government, Dr. Smart was Director of International Investments at Pioneer Investments where he managed top-performing Emerging Markets and International portfolios. Following the collapse of the Soviet Union, he worked in Moscow, advising Russian government agencies on economic policy and financial market reform. Earlier in his career, he was a journalist in St. Petersburg, Florida and Paris, France.

Dr. Smart is also the author of *The Imagery of Soviet Foreign Policy and the Collapse of the Russian Empire* (New York: Praeger Publishers, 1995) and numerous analytical and opinion articles. He earned a B.A. in History from Yale University and a PhD in International Relations from Columbia University. He is a member of the Council on Foreign Relations and holds the Chartered Financial Analyst designation.

He is also Senior Fellow at the Harvard Kennedy School's Mossavar-Rahmani Center for Business and Government and Associate Fellow at Chatham House.

German economics and German economic policymaking appear to be a land apart. Critics have even suggested German policymakers and academics live in a "parallel intellectual universe". This book includes a number of contributions by leading German and international researchers, and (former) policymakers on ordo-liberalism, an economic policy approach developed at Freiburg University after WWII. It is compared to the more flexible and pragmatic Anglo-American approach. This eBook attempts to shed light on the pertinence of economic ideas and on the interpretation of these ideas – and thus explore the mediating, or even determining, influences of the respective (national) interests

The approach to the Eurozone crisis has illustrated this difference. On the one hand, there is the insistence that rules have to be obeyed, no matter what. This, however, sits also uncomfortably with the reality of the Eurozone crisis and, specifically, the unsustainability of the Greek sovereign debt burden. On the other hand, it is based on the moral hazard argument that ignoring rules invites "bad" behaviour. This points to a core problem of economic policy making – what is optimal ex-ante is not optimal ex-post. Advocates of ordoliberalism have pointed to the German economic miracle as best argument in favor of their policy approach, while critics have pointed to the dismal macroeconomic performance of the Eurozone over the past ten years.

Where do we go from here? For the sake of a sustainable Eurozone and for the global economy to grow, bridges have to be built. The pragmatists have to accept the role of incentives and the importance of strong institutions, while the German side has to accept the role of macroeconomic stabilisation policies and risk-sharing mechanisms. The market cannot take care of itself and the state has a role to play beyond enforcing rules even though incentives are critical in making markets work properly.

Centre for Economic Policy Research
33 Great Sutton Street
London EC1V 0DX
Tel: +44 (0)20 7183 8801
Email: cepr@cepr.org www.cepr.org

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