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Ordoliberalism: A German oddity?

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10 What's wrong with EZ: Conflicting narratives

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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.

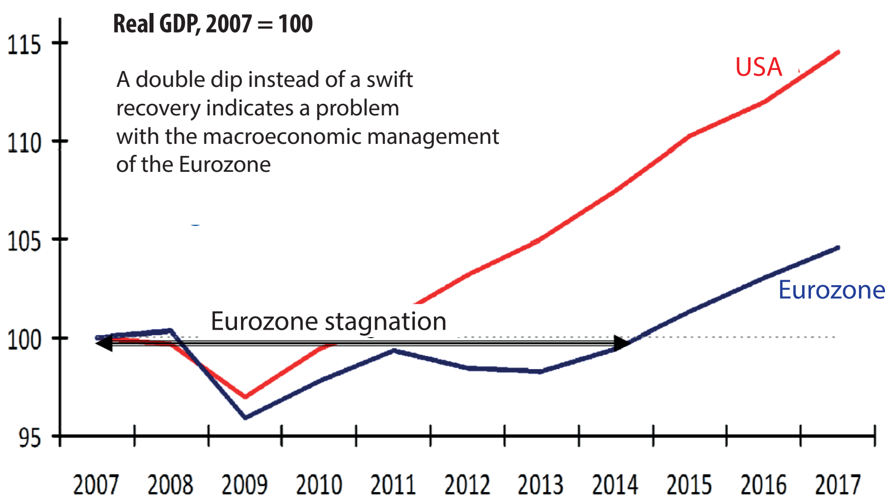
Next, this chapter addresses the economic philosophy from which the policy response to the failings of the Eurozone is derived. Unquestionably, nothing much happens without Germany's blessing. German economic philosophy, in turn, is in line with, if not directly informed by, ordoliberal thought along 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



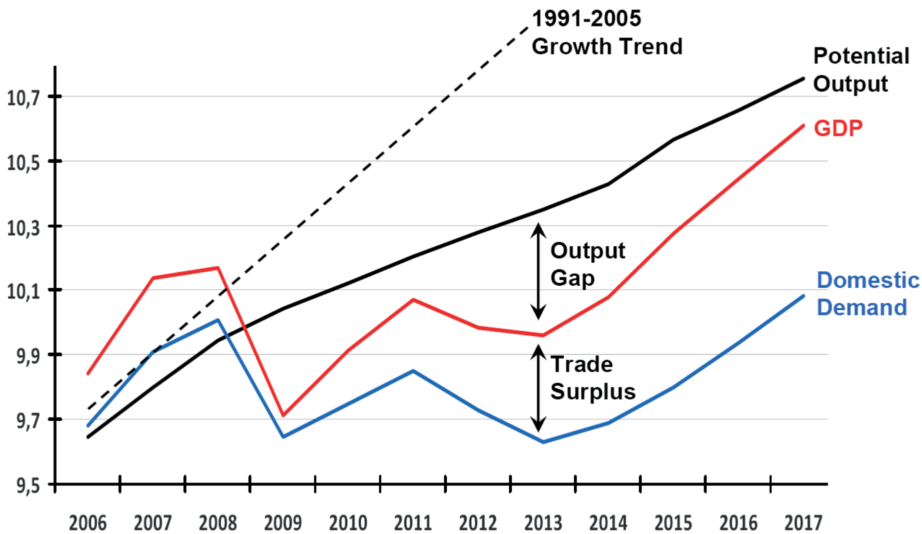
Data Source: OECD Economic Outlook Database (Figures for 2016 and 2017 are OECD projections)

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



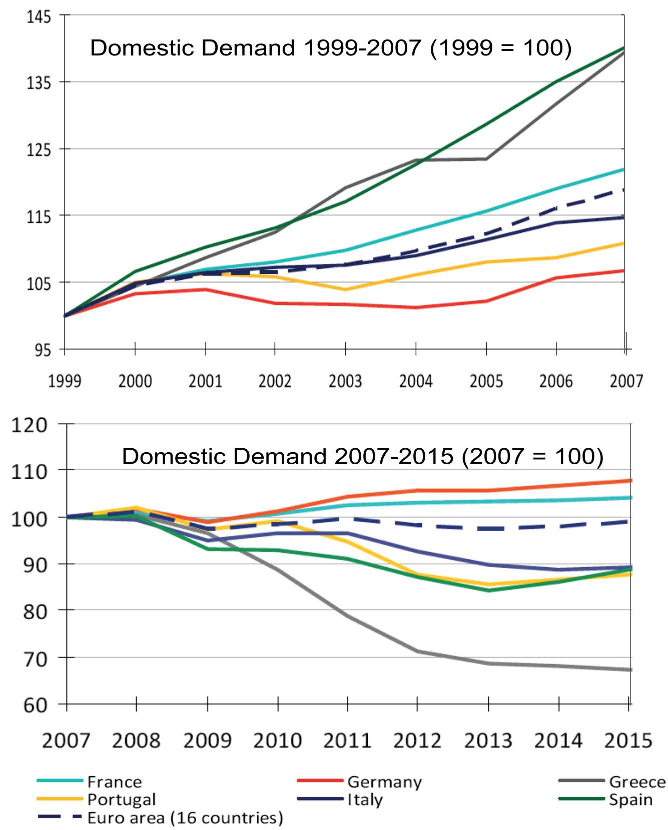
Real values, expressed in billions of 2014 euros

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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