Letter from Germany - Dispelling three myths on economics in Germany

In his latest Letter from Germany, Michael Burda at the Humboldt University in Berlin argues that the state of economics in Germany is being badly misrepresented in the 'Anglo-Saxon' media.

Recently, I was interviewed by the *Economist* for a piece on the state of economics in Germany which was ultimately was published on 9 May 2015 as 'Of Rules and Order'. I was quite vexed about the outcome, which painted a dismal picture of how the representative economist here views the world. Since the newspaper is a flagship of good economic journalism and normally gets it right, I would like to try to set some points straight. The Anglo-American world has been ganging up on Germany long before the financial crisis, but the since the onset of the Greek standoff it has gotten notably worse. Nonstop tirades of the *New York Times*' Paul Krugman and the *FT*'s Martin Wolf's have received support recently from Wolfgang Munchau who wrote on 'Wacky economics' last year (*FT*, 16 November 2014) and recently our colleague Simon Wren-Lewis has posted yet again on his mainly macro blog about deranged Teutonic world views. It is an understatement to say that economics in Germany is getting a bad rap these days.

New perspectives on German bashing
For those who didn't read the *Economist* leader, the tenor is that economists in this country are simply living in a different universe, harping on nonexistent problems, endorsing austerity when it is least needed, committing the fallacy of composition at every possible juncture, and simple getting it wrong. In particular, the article made out the *Sachverständigenrat* (the German Council of Economic Experts) to be particularly backward in its recent pronouncements, which includes its annual report.

As someone who knows the members of the Council, I think I am in a position to vouch for their academic mainstreamed-ness. They publish in serious academic journals, belong to respectable international scholarly associations, and in all cook with the same utensils as other economists. Council members are expected to provide independent and sometimes unwanted advice to the government in the form of an annual report. They are not partisan advocates of government policy; they are expected, however, to advise in the perceived interests of the country. In fact, it is tradition to choose some members who represent German corporatist interests. It would hardly be reasonable to expect that those chosen on the 'trade union ticket' (P Bofinger) would endorse lower corporate taxes just as would be hard to imagine the representative of 'industry' (V Wieland) endorsing increases in the minimum wage.

But all this does not indict the state of economic science or research in Germany. It is useful to recall Lionel Robbins' injunction that economists should refrain from normative judgments and stick to positive economics, which my colleagues sometimes have difficulties sorting out. Members of the *Sachverständigenrat* are expected to deliver normative judgments and do so, ultimately with the (unspoken) goal of furthering German national and economic interests. It is thus disingenuous to implicate the belief system of economists when one doesn't like the policies their government is following, policies which sometimes fly in the face of mainstream economics and economists. In what follows I would like to address rigorously three myths circulating in the media and the blogosphere about 'the way German economists think', because the input of those economists in many national policies is greatly exaggerated.

Myth #1: Economists in Germany fundamentally reject Keynesian ideas
This is nonsense. The importance of aggregate demand in the short-run determination of output and employment is standard, not only in the courses I teach in Berlin, but in those given by all colleagues I know who teach macro. (That includes of course Peter Bofinger, who certainly knows better to claim to be the 'last Mohican' of Keynesian thought). People conveniently forget that not only was Germany unfortunately out front implementing Keynesian ideas before the war — Keynes even said as much, somewhat ignominiously, in the preface to the first German edition of the *General Theory*. During post-war reconstruction, Karl Schiller's central concept was *Globalsteuerung*

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

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

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

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

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

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

It is not surprising that Germans, who may be somewhat more patient than average Europeans, have less patience for short-term views of the world and tend to think in terms of chains of Keynesian short runs which at some level need to be consistent with what policy wants to do in the long run. This may be hard to deal with, but it is not voodoo economics. And it goes pretty far in explaining Germany's focus on reforms in the current Greek drama.

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

Attitudes towards moral hazard and austerity are always in the eyes of the beholder. It's hardly surprising that Germany is more interested in sustainable solutions to southern European problems (and hopefully the lending practices in the north that gave rise to them) as opposed to the recipient perspective of kicking the can down the road and hoping for a structural free lunch. In principle, governments should practice austerity in good times, not bad. After seeing the consequences of its failure (with France) to impose the stability rules and sanctions on themselves in 2003 — and after insisting throughout the Maastricht Treaty negotiations on tough membership criteria for monetary union as well as the Stabity and Growth Pact — Germany is now wedded to austerity or risks losing all credibility on fiscal discipline in the monetary union.

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

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

It is not ordoliberal religion, but a mixture of national self-interest and healthy mistrust informed by experience that guides German economic policy today. At the core is the fact that Europe still consists of sovereign nations, and most Europeans want to keep it that way. A monetary union imposes a one-size-fits-all monetary policy but is silent on the right substitutes for it. Should we seek an insurance policy (as in the US) or allow each nation's self-interests to assert themselves? In the end, German economists will tend to peddle economics that serve Germany's own self-interests, just as we'd expect of the British if and when they decide to leave the EU, or of the US when interest rates are finally raised. If it is to succeed, the European monetary union needs to synchronize national and union interests, or faced being be dashed on the rocks of shocks to come.

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