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Germany and the European and Global Crises

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Abstract - Moving from the current global and European imbalances and crises, and from the consideration of the German reaction to them, the paper explores the political economy origins of the conservative German policy stance. It emerges that an export-oriented economy was a deliberate decision of the German elite after WW II and that the external constraint may be regarded as appropriately designed for internal discipline and efficiency (and vice-versa) in a self-reinforcing process. The conclusions illustrate some possible future scenarios for Europe.

Key words: European Monetary Union, financial crisis, Germany, neo-mercantilism

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1. A Tale of Two Imbalances

The Eurozone crisis and imbalances that surfaced in late 2009 came as a surprise. They arrived after a decade of disappointing low growth of the three major Eurozone economies, somehow compensated by the good and, in some cases, excellent performance of a few of her peripheral countries. Although the Eurozone seemed to suffer from the global crisis, the core of the crisis seemed external to Europe. In the current context, however, the two crises are now compounded.

Non conventional economists are divided over the deep causes of the global crisis that emerged in 2008 (Palley 2009).[1] Minskian authors, associated with the Levy Institute in the US, tend to see it as the result of periodic cycles of financial exuberance. Many conventional economists also share this view, as suggested by their rediscovery of Hyman Minsky's work. Other heterodox economists probe behind the financial excesses and find their origin in the necessity of capitalism, particularly in the US, to sustain aggregate demand after the major changes in income distribution that occurred over the last thirty years, from the working and middle classes in favor of an affluent thin minority of capitalists and related high income groups (e.g. Barba and Pivetti 2009; Cynamon and Fazzari 2008). A few open-minded mainstream economists also openly share this view (Rajan 2010; Fitoussi and Saraceno 2010).

The debate over the crisis is interwoven with that over the global imbalances. The conventional 'saving glut' explanation of the global imbalances supported by Ben Bernanke (2005) blames the high Chinese saving rate as responsible both for the US trade deficit and for excessive credit availability in the US financial market in which the accumulated Chinese surplus was ultimately invested. On the opposite side, there is the less conventional explanation – the so-called 'dollar glut' hypothesis (e.g. Bibow, 2010) – the places the abundant and cheap credit facilities in the US, due to an expansionary monetary stance, at the beginning of the causal sequence. According to this view, the expansion of consumer credit in the US determined the trade imbalances with China. The re-investment of the dollar reserves by the Chinese authorities in the US could be seen as refinancing the American deficit and maintaining undervalued the renmimbi-dollar parity. It will be appreciated that conventional economists support the idea that it is the excess saving in one country that finances excess autonomous consumption (or, for that matter, investment) in another country. Non conventional economists, on the contrary, would see the process as kicked off by money creation that finances private or public consumption (or investment) in the deficit country; savings emerge at the end of the sequence as foreign savings/capital exports in the surplus country.

The core/periphery relationship entailed by the 'global imbalances' is one between successful periphery/catching-up countries and the developed core. This setup has famously been named Bretton Woods II and is assimilated to the Western Europe/American economic imbalances during the Bretton Woods I era (Dooley et al. 2003). By contrast, the European crisis and imbalances evoke the more traditional traits of unsuccessful developing countries in which the trade-surplus/capital-exporting countries are the core economies, whereas weak peripheral countries show trade deficits financed by capital imports. The surprise is that this situation, which had been typical over one century and a half of global capitalism for many developing countries, has taken place within one of the most developed world areas. Of course, a North-South divide also exists in Europe. However, the *differentia specifica* between the global and the European imbalances is that the former look more sustainable for the well known reason that the deficit country is (still) the most powerful economic and political power in the world and is issuer of the dominant international currency. On the opposite side, deficit countries in the Eurozone have given up their currencies. The two imbalances have also common features. In both cases, credit creation is at the beginning of the process, although in the European case the credit creation, mainly in favor of consumption in deficit countries, stemmed from the core economies' banks; whereas in the US case, it was from domestic banks in favor of domestic consumers. In both cases, however, credit sustained aggregate demand and was, in turn, supported by loose monetary policy.

China and Germany have often been accused of mercantilist behavior, i.e. of policies biased towards maintaining a foreign trade surplus. In this paper, we shall discuss the appropriateness of this definition in the German case (cf. also Cesaratto 2011). We shall begin with a discussion of the causes of the recent European crisis. An account of the German reactions to the global and, later, to the European crisis will follow. We shall then describe the main policy decisions taken by Germany during the reconstruction period, in particular price stability, that naturally or deliberately – this is to a certain degree irrelevant – might be the root of the presumed mercantilist stance. In our concluding remarks, we shall point out the limits of the German model, but also its irreversibility when the present circumstances would require a different policy stance.

2. Whatever Happened to Europe?

2.1. An Overview

As in the case of the unhappy families in *Anna Karenina*, every Eurozone peripheral country is unhappy in its own way. Neglecting the national specificities, a synthesis of the events is described as follows below.

Since the inception of the European Economic and Monetary Union (EMU) in 1999, Germany pursued restrictive wage and fiscal policies. This followed a change in the German policy stance since the mid-1990s after the sustained domestic demand growth that followed the reunification of the country (Sabbatini and Zollino 2010). Wage moderation, labor market reforms in the direction of a more flexible use of manpower and fiscal adjustment were the components of the policy reversal. This policy stance was somewhat compensated by a relatively loose policy by the European Central Bank (ECB), tailored to the core countries, whose expansionary effects were, however, predominantly felt in the Eurozone periphery (RMFa 2010: 5). From 1999, in a number of peripheral EMU countries – namely Spain, Portugal, Ireland and Greece - the easier and cheaper access to the European financial markets determined a growth of domestic demand associated with nominal wage and price dynamics above the EMU average. The growth of domestic demand was associated with a housing bubble in Spain and Ireland, and the growth of often nepotistic public spending in Greece.[2] Low or negative *real* interest rates added fuel to the process. According to standard theory, countries of the periphery were importing capital to 'catch up' with the core members. However, growth based on the construction sector rather than on the development of goods and services with an international market was certainly not such as to generate significant productivity and export growth. It was the above-average nominal wage dynamic, rather than sluggish productivity growth that seems to have led those countries to a progressive loss of international competitiveness. The combination of strong imports and weak exports determined persistent current account deficits and the accumulation of foreign debt.[3]

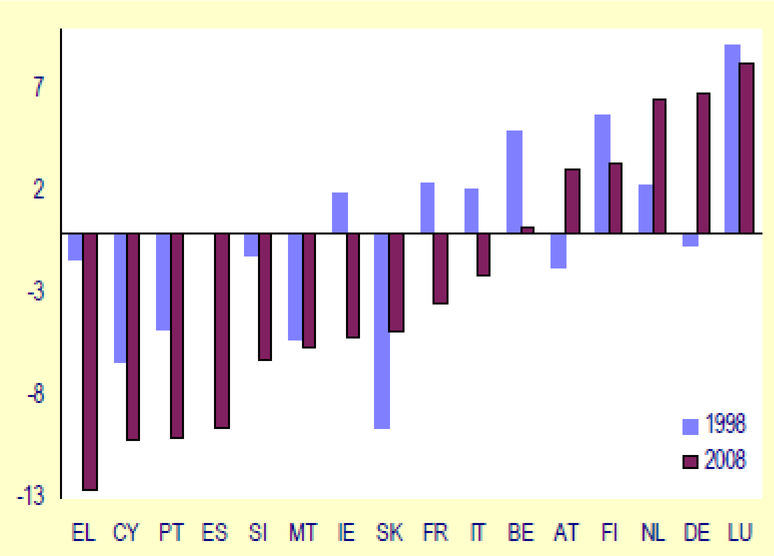
Symmetrically, exports of the core countries of Europe benefited from the Eurozone periphery aggregate demand growth. Although the fortunate families are all alike, each surplus country – Germany, Netherlands, Austria and Finland - presents its own specificities. We shall focus on Germany. Symmetrical to the deficit countries, this country has shown a structural weakness of domestic demand due to the feeble dynamics of nominal wages and to the relatively high *real* interest rates associated with low domestic inflation. The combination of competitive gains, as well as weak dynamics of imports and strong demand from peripheral Europe, generated persistent trade surpluses, particularly with the European partners. Had it not been for the sustained exports to peripheral Europe, Germany would have slipped from low growth to stagnation. France and Italy remained somehow in the middle between the core and the periphery.[4]

Two reports by the European Commission (EC 2009, 2010) provide an authoritative support of this account of the origin of the European imbalances over the period 1999-2009 (see also RMF 2010 a, 2010b).

2.2. Current Account Imbalances

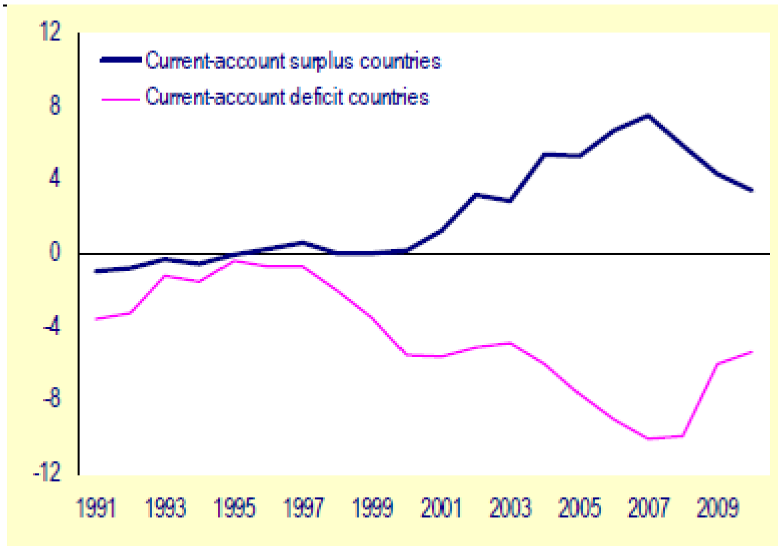
Figure 1 compares the current account balance of the EMU countries over the period 1998-2007 (as a share of GDP).[5] The worsening of the current account balance of the peripheral countries emerges *pari passu* with the improving surplus of the central countries, of Germany and the Netherlands in particular.[6] Figure 2 shows the growing asymmetry in aggregate terms.

Figure 1 – Current Account Positions, Euro-Area Member States (in % of GDP – 1999 to 2008)



(1) Net lending and borrowing from national accounts for all Member States except LU (bal. of current transactions).
Source: Commission services.

Figure 2 – Current Account Positions, Euro-Area Surplus and Deficit Countries (1991-2010, as a % of GDP) (1)



(1) Surplus countries include DE, LU, NL, AT, FI. Deficit countries include IE, EL, ES, CY, PT. Data for 2010 are based on the Commission's autumn forecast.
Source: Commission services.

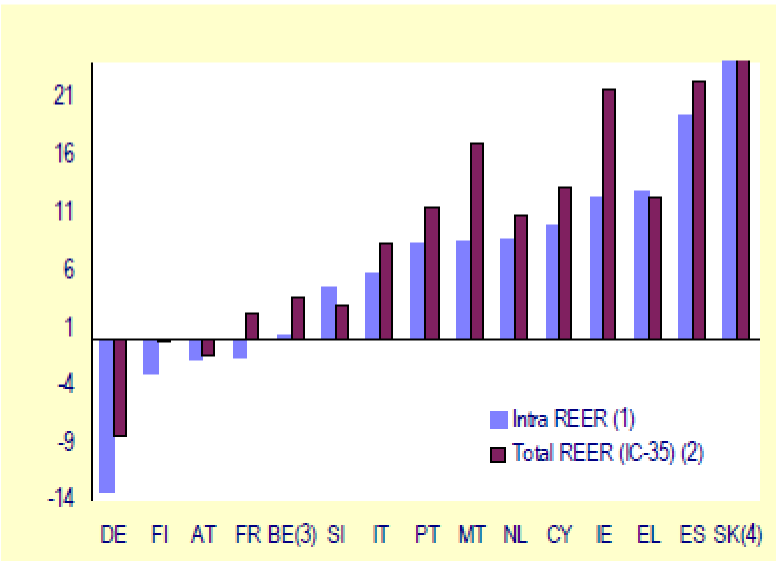
One main difference in relation to the past experiences of the 1970s and 1980s is the persistence of the current imbalances (EC 2009: 19). *ça va sans dire* that the difference is due to the impossibility of exchange rate adjustments. Also the absolute dimension of the current account deficits appears conspicuous if compared, as a share of the GDP, to that of the US, Australia or New Zealand (EC 2009: 22).

The main determinants of the trade balance are the real exchange rate and aggregate demand. It is noteworthy that the EC reports regard the first ‘supply side’ factor less relevant than the second, ‘demand side’, factor. Let us start with the former.

2.3. The Supply Side Causes of the Divergences

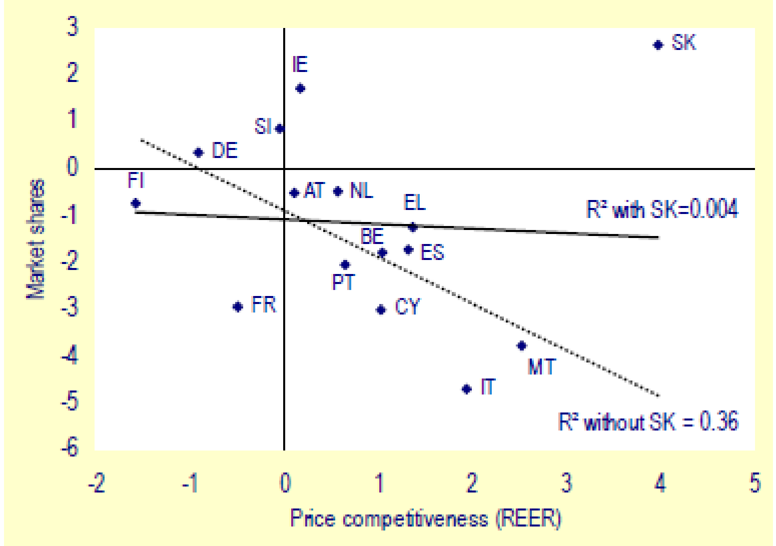
Figure 3 shows the competitiveness spreads between Germany and many European partners accumulated since the start of the EMU.[7] The divergence emerges irrespective of the price deflator that is used. Moreover, it regards both the intra-EMU and the extra-EMU trade (EC 2009: 19; 2010: 7). Variations in price competitiveness are an important explanatory factor of changes in market shares, as suggested by Figure 4.

Figure 3 - Changes in REER (Intra and Total), Euro-Area Member States (in % - 1998 to 2008)



(1) REER (GDP deflator) against other EA countries (EA 16).
(2) REER (GDP deflator) against other industrial countries (35).
(3) Belgium + Luxembourg.
(4) SK is off scale. True rise in REER is 68% (intra), 61% (IC35).
Source: Commission services.

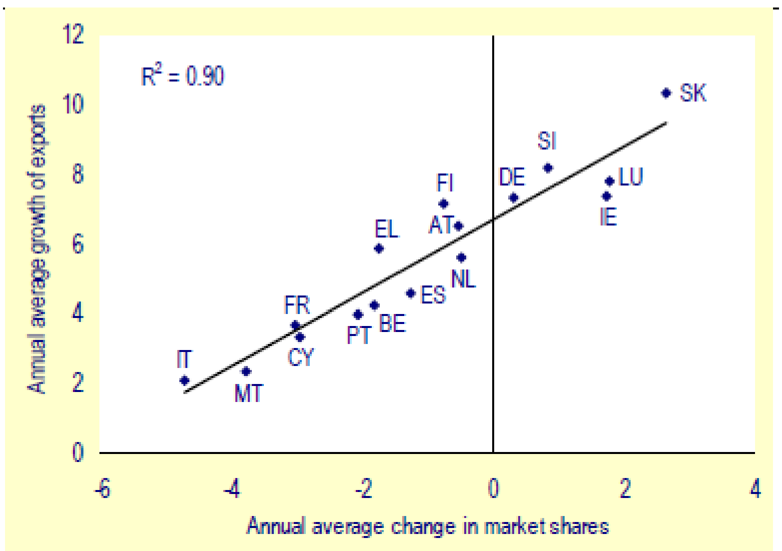
Figure 4 – Price Competitiveness and Market Shares, Euro-Area Countries (Average Annual % Change, REER Based on Export Prices, 1999-2008)



Source: Commission services.

Changes in market shares are also associated with export growth: surplus countries show export growth rates and market-share gains larger than deficit countries, as shown by Figure 5.

Figure 5 – Market Shares and Export Growth, Euro-Area Countries



Source: Commission services.

All in all, according to the EC reports, only about 40% of the changes in the market shares can be attributed to the variation in the *REERs* (EC 2010: 24). Non-price/product-quality factors are also relevant. Notoriously, the importance of price and non-price factors is not the same for any country: price competitiveness is, for instance, more relevant for Italy than for Germany. According to the reports, however, for all countries foreign demand is the main determinant of export growth.

Given foreign demand, price and quality competitiveness make the difference (we shall return to the demand-side issue below). In this regard, Table 1 – where the so-called ‘export demand equations’ are estimated – shows that foreign demand is the main explanatory variable of export growth, and suggests that had the Italian price competitiveness developed in line with the German, Italian exports would have also developed at the same rate.

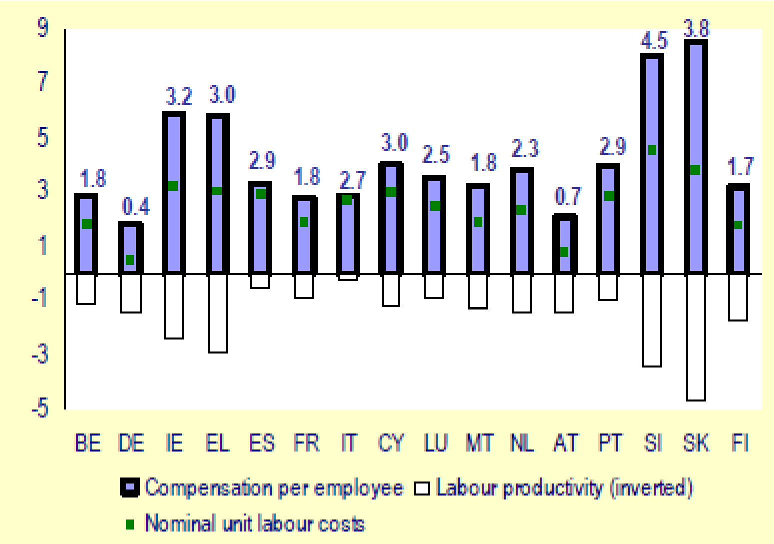
Table 1 – Contribution of Trade Determinants to Export Growth, Euro-Area Member States (1999-2008, Average Annual Growth in %)

	Total export growth	REER	Foreign demand	Unexplained
DE	7.3	0.5	6.4	0.4
ES	4.5	-1.9	7.4	-0.9
FR	3.5	0.8	5.3	-2.6
IT	2.2	-4.6	6.7	0.2
AT	6.4	-0.3	6.7	-0.1

Source: Commission services.

Importantly, nominal unit labor costs patterns rather than differences in productivity growth are behind the divergent patterns of *REERs*. Figure 6 shows that the yearly average rates of change of nominal unit labor costs over the period 1999-2008 vary from 0.4% for Germany over 2.5% for Italy and Spain.[8] In terms of variations of the *REERs* – using the nominal unit labor costs as price deflator – this means a real depreciation for Germany of the order of 15% against a real appreciation of 10-15% for the deficit countries. The EC reports single out the decoupling of the German labor cost dynamics from the economic cycle: “The decline in unit labour costs in Germany which prevailed in 1999-03 continued its downward path during the 2004-08 period, due to persistent wage moderation in spite of an improvement in the country’s cyclical position relative to the rest of the euro area” (EC 2009: 25).

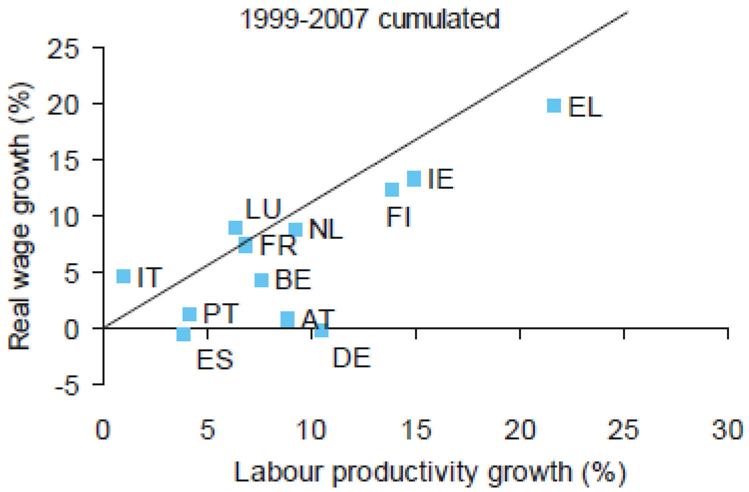
Figure 6 – Compensation per Employee, Labor Productivity and Nominal Unit Labor Costs (1999-2008) (Average Annual Changes in %)



Source: Commission services.

Thus, the growing competitive advantage of Germany during the EMU years is not to be attributed to productivity gains, but to the ultra-moderate nominal wage policy. This result is widely accepted (e.g. REF 2010a: 25). Wage moderation has been backed by high unemployment and by labor market reforms, particularly those implemented during the Schroeder government with the acquiescence of the trade unions, under the threat of the off-shoring of production in Eastern Europe and in other low wage regions. While income distribution has historically been less fair in Germany as compared to France and Northern Europe, research suggests that inequality has increased in Germany over the recent decades and attributes it to the stagnation of real wages compared to productivity, shown by Figure 7 for the period 1999-2007 when the divergence has particularly been accentuated (OECD 2008: 27, 79-84; Bach et al. 2007).

Figure 7 – Real Wages and Productivity Growth

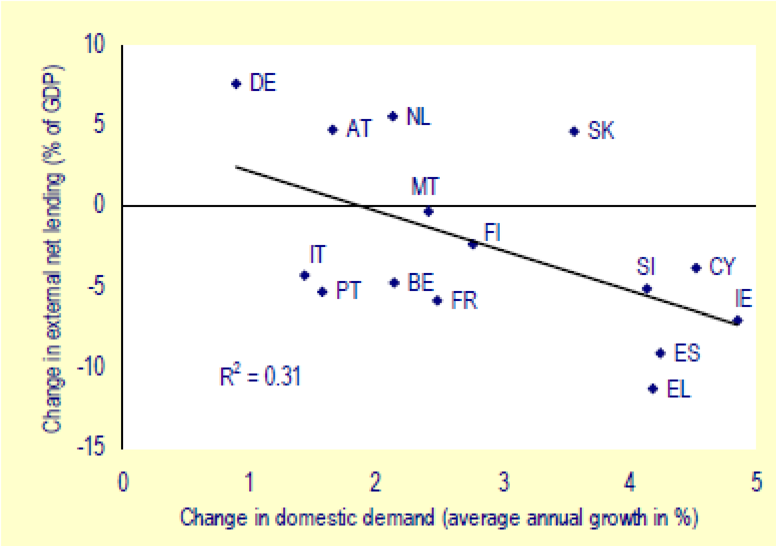


Source: EU (2008)

2.4. The Demand- Side Causes of the Divergences

According to the EC reports, a "large part of the cross-country divergence of current accounts since the launch of the euro has been determined by considerable and persistent differences in the strength of domestic demand across Member States" (EC 2010: 8), as revealed by Figure 7:

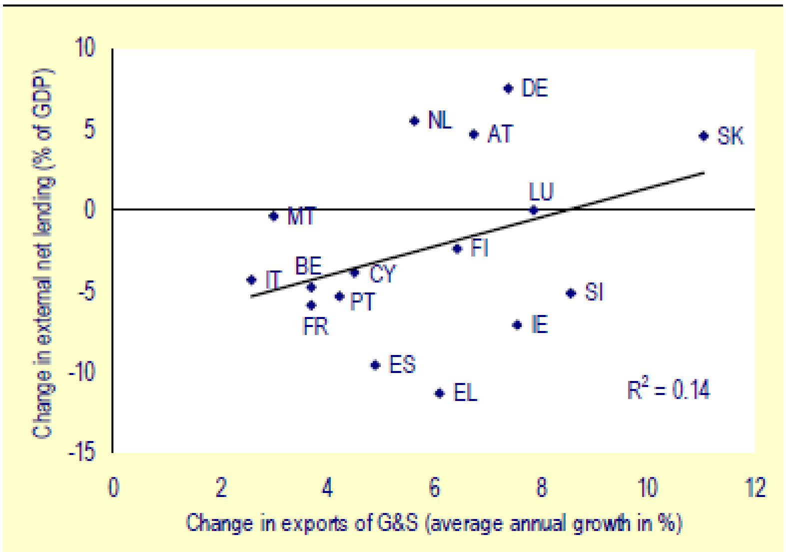
Figure 8 – Domestic Demand and the Current Account, Euro-Area Member States (1998-2008)



Source: Commission services.

In this regard one report (EC 2009: 26-7) comments: "According to conventional wisdom, external factors such as price competitiveness are seen as major drivers of current accounts. However, a large part of the divergence in the current account in the euro area since late 1990s can be traced back to domestic demand … Stronger relative demand pressure in a Member State will tend to fuel import demand and depress the current account … The analysis suggests that changes in domestic demand could account for as much as 40-50% of the differences in current accounts observed in the euro-area since the launch of the euro." The reports suggest that the divergent patterns of domestic demand in member countries have been felt on imports – weak in surplus countries but strong in deficit countries – rather than on exports – strong in surplus countries but not necessarily weak in deficit countries. Indeed, Figure 9 shows a weak correlation ($R^2 = 0.14$) between the export dynamic and current account deficits.

Figure 9 – Exports and the Current Account, Euro-Area Member States (1998-2008)

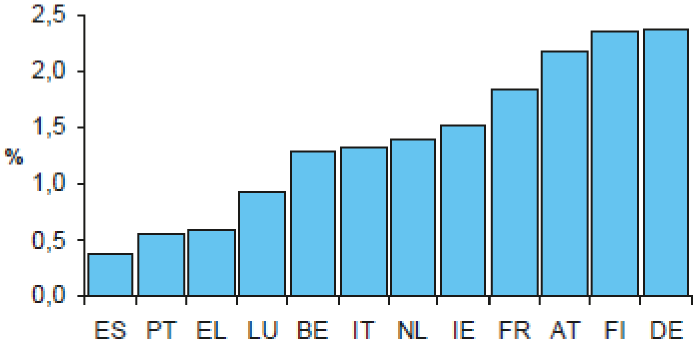


Source: Commission services.

In conclusion: "[The w]eakness in domestic demand has been the central driver of the downshift in imports and increasing current account surpluses" (EC 2010: 18). The reports (2009: 27) also suggest a specific temporal progression in the generation of the foreign imbalances, particularly in Spain and Greece: "The deterioration in current accounts in the late 1990s preceded – rather than followed – a deterioration in exports performance by several years. This suggests a pattern where strong domestic demand first drives the current account down and is associated with a progressive weakening of competitiveness, which later weighs on export performance." Hence, the faster domestic demand growth induced, on the one hand, higher import demand and, on the other, it generated a faster dynamics of prices and nominal wages, a loss of competitiveness and a worsening export performance. *Ultimately, the faster dynamics of aggregate demand in the European periphery is responsible both (directly) of the demand-side and (indirectly) of the supply-side causes of the regional trade imbalances.*

The interest rate policy of the ECB tailored to the (deliberate) depressed economic conditions of core Europe triggered these results. The easier access to the international capital market at favorable interest rates that followed EMU membership determined housing bubbles in some peripheral countries, specifically in Spain and Ireland, and the expansion of public spending in others like Greece. The inflation rate well above the ECB target of 2% led to very low real interest rates compared to core Europe, a further stimulus to indebtedness (see Figure 10).[9] The EMU gave core Europe banks the illusion that they could lend without risk to the peripheral countries.

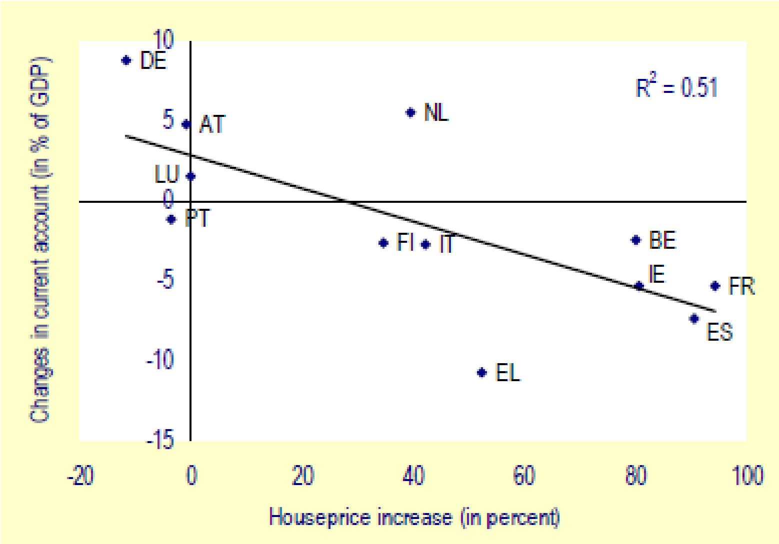
Figure 10 – Real interest rates – 2006



Source: EU (2008)

Figure 11 shows the correlation ($R^2 = 0.51$) between the rates of change of house prices and of the current account over the period under scrutiny: “Housing markets have played a pivotal role in the divergence of external positions across euro-area …over the past decade”, concludes the EC reports (2010: 11). The presumption was that the current account deficits in the European periphery, financed by net capital flows from the surplus countries, were a physiological aspect of a catching-up process. Unfortunately, capital flows did not finance a productive capital accumulation, but mainly households’ consumption, as previous experience from developing countries had also shown (Prasad et al. 2007).

Figure 11 – Changes in Real House Prices and Current Accounts, Euro-Area Member States (1999-2007)



Greek data cover 1999-2006. Luxembourg data give the increase over 1999-2005. Nominal house price data are deflated by GDP deflator. *Source:* ECB, Commission services.

Conversely, had the dynamics of aggregate demand in core Europe not been so weak, due to restrictive wage and fiscal policies, the imbalances would have not occurred, at least not on the dimension we have experienced. In this regard, one EC report (2010: 19) points out: "the share of wages [in GDP] has been falling significantly in the euro area as a whole. However, the fall has been more marked in Germany and Austria than in the euro area as a whole…Wage share developments are broadly in line with disposable income developments which, in turn, have led to weak consumption and domestic demand thereby resulting into current account surpluses." A popular explanation of the German weak consumption is in the necessity to set aside resources in view of the rapid ageing process. Certainly, the German households' propensity to save might have increased as a result of the alarming campaigns about ageing and the future of (public) pensions.[10] The main cause of the German increased saving propensity is, however, the high level of corporate profits due to wage moderation (EC 2010: 19). Finally, fiscal policy has been deployed by surplus countries in a counter-cyclical fashion: public deficits widened in the low phase of the economic cycle in the years 2000-2003 to narrow again with the (export-led) recovery in 2004-2007, mainly as a result of fiscal revenues arising from export profits.[11]

3. The Reaction of Germany to the Current Crises

The German behavior during the crisis has been consistent with its traditional economic stance, non cooperative at the global and European levels, by relying on domestic price stability and export-led growth.

Starting at the global level, in fall of 2008, German policy makers began accusing the Americans of having caused the financial crisis – forgetting that German banks had participated with gusto to the financial excesses – which in their opinion justified German inaction in the hope of export-led recovery led by those allegedly responsible: “We can only hope that the measures taken by other countries ... will help our export economy”, argued the then German minister for the economy (*Financial Times* 30 November 2008). In the G20 meeting in May 2009 the Germans refused any American-sponsored global macro policy coordination – a stance reiterated in the subsequent G20 meetings. In July 2010 in Toronto, Germany championed policy of fiscal retrenchment, while in November 2010 in Seoul, Germany sided with China in rejecting the US proposal of a 4% cap on the trade surplus/GDP ratio.

Renewing an older controversy (Maes 2004; Heise 2005), since the outbreak of the crisis in autumn 2008, the French President Sarkozy repeatedly insisted that the ECB had to be flanked by an *official* Eurozone authority concerned with fiscal policy.[12] The Germans declined, fearing that the independence of the ECB would suffer given that a political counterpart would have higher status. In summer 2009, Germany reinforced its rigorous stance by introducing a balanced-budget clause in the German Constitution; in addition a sentence of the German Constitutional Court ruled any hypothetical European federal economic governance as unconstitutional, thereby reaffirming the nature of the EU as a club of independent states.

In early 2010, the Greek crisis erupted, with its public debt on the verge of default. Suddenly everyone ‘discovered’ that core Europe banks were sitting on an enormous amount of debt from the European periphery, particularly from those that had begun to be offensively dubbed the PIIGS countries. The global crisis and the housing-burst had indeed led to the deterioration of public finances even in countries, like Spain, so far prized for their fiscal rectitude. The bluff behind the high growth rates of those countries was finally called. Suddenly the Eurozone found itself in a Latin-American situation, made even worse than that by the abolition of the national currencies.

Germany reaction during Spring 2010 was unsettling. German public opinion firmly opposed bailout of the ‘profligate’ southern partner, having accepted the domestic rigor over the previous decade, and faced with important local elections to be held in early May. Germany initially opted for direct bailout of Greece to avoid any idea of concerted fiscal help from Euroland and toyed with the constitution of a Eurozone IMF. Once again the French authorities seized the opportunity to ask for co-ordination of European economic policy. The German Chancellor Angela Merkel vaguely conceded something, but interpreting a stronger European Governance as a more effective device to punish so-called profligate governments. In May, a first bail out package of €110bn to support Greece was followed, after the mentioned elections and at the American insistence, by a further European bailout package for troubled Eurozone members (consisting of €750bn partially financed by the IMF). In exchange Germany committed the European partners to measures of fiscal retrenchment. The only effective measure was a limited ECB direct intervention to sustain the periphery countries treasury bonds. The measures did not reassure the financial markets given that the creditor countries would guarantee their same credit. Moreover, the restrictive fiscal stance was expected to worsen the economic downturn. Thus, in the Toronto G20 summit in June 2010 the US unsuccessfully pressed Germany to do more to sustain aggregate demand, precisely when Germany and other European countries, including the newly elected conservative British government, were taking opposite measures. Characteristically, the German government, mass media and (mainstream) economists have retorted the criticism, especially by the Anglo-Saxon press, by blaming 'profligate' countries for their troubles and inviting them to imitate Germany.

What followed from late Spring was farcical. The European crisis led to the devaluation of the Euro that blessed German exports, particularly to China. Thus Germany profited from her partners' drama, although this did not stop the latter from inflicting a fiscal retrenchment on them. The same country championed the fiscal retrenchment in order to assure domestic price stability – in total disparage of the effects on its partners' output and employment levels. The German recovery in the second half of 2010 did not impact the peripheral countries, but only some satellite countries integrated with Germany. In late Autumn 2010 Ireland had to be sustained by an EU financial package and fears of infection of Portugal, Spain and, eventually, of Italy have increased. The spread between the interest rates on the German government bonds and those of the troubled countries widened. The German-French plan to involve the financial sector in future bailouts sustained the widening (with the grotesque joy of the German exporters that saw a further devaluation of the euro).

4. Monetary Mercantilism

The conduct of Germany before and during the crisis has been consistent with its behavior over the post-World War II period in: (i) taking advantage of fixed exchange rates by pursuing a domestic inflation rate lower than competitors to foster exports; (ii) relying on other countries stimuli to aggregate demand and taking advantage of their ensuing inflationary bias; (iii) compensating with conservative domestic fiscal (and monetary) policy any possible labor market overheating, maintaining the external competitive hedge; (iv) replying to foreign criticism with moralistic tones by blaming their indiscipline and proposing itself as a model. We shall mainly focus here on the early fifties, when the main policy choices that shaped this conduct were made, by trying to capture the economic rationale of those decisions.

In the late 1940s, before the 'economic miracle', the German authorities took two decisive options: liberalization of domestic and foreign trade, and price stability as the anchor for economic policy. Full employment was marginalized in the policy debate (Wallich 1955: 82-83; Wadbrook 1972: 61). Ludwig Erhard (1897-1977), responsible for German economic policy until 1963, and Chancellor until 1966, was supported, and partly inspired, by the so-called Ordoliberismus (Mierzejewski 2006; Giersch 1992: 34), on which we shall return. The fundamentalist free market choices of the late 1940s were criticized by the American and British authorities and economists (e.g. Heller 1950; Balogh 1950; Van Hook, 2004: chapt.5).[13] The Korean War in 1951 – an external event – likely saved Germany from the initially disappointing results of its austere policies and began the export-led success (Giersch et al. 1992: 62).

The choice of price stability guaranteed by an independent central bank (CB) in the context of fixed exchange rates – has been denoted 'monetary mercantilism' by the historian Carl-Ludwig Holtfrerich (1999; 2008), notably in a book published by the Bundesbank for the 50th anniversary of the Deutsche Mark (DM). Holtfrerich rejects the view that the German obsessive target of price stability is a legacy of the great hyperinflation of 1922. The relation between hyperinflation and Nazism appears to be, indeed, as historically false since it was high unemployment (*inter alia* due to restrictive policies) that paved the way to Hitler (see also Bibow 2004). This 'memory' would instead be a well fabricated invention by the Buba (memories are, notoriously, a social construct). Even an independent central bank was not a German tradition (the opposite is true), and indeed Adenauer opposed it (he thought that a CB had to be politically accountable).[14] So, if "German inflation fears was [not] the driving motive behind the central bank's determined fight for price stability" (Holtfrerich 2008: 34), what was the reason? "I finally found the clue – the author argues – when I carried out an in-depth study of West Germany's monetary policy during the period of fixed exchange rates (…). It turned out that after the first trade and currency liberalisation measures in the wake of the creation of the Organisation for European Economic Cooperation (OEEC) and the European Payment Union (EPU) as a condition for Marshall Plan aid, the government in Bonn and the central bank in Frankfurt chose and pursued a sort of mercantilist policy strategy. As protectionist tools could not be used in this period, when Germany itself was likely to profit from European and worldwide trade liberalisation, a different way of achieving mercantilism, namely export surpluses, had to be found. The solution was to keep domestic demand restrained by monetary and fiscal policies, thus keeping imports and domestic inflation low and freeing production resources for more exports. This strategy was contingent on a system of fixed exchange rates, without a self-regulating gold standard including freedom of capital movements. The early Bretton Wood system, without fully convertible currencies and with restrictions on international capital movements, left countries the opportunity to gain in international competitiveness by realising relatively more price stability at home than abroad' (Holtfrerich 2008: 34; see also Holtfrerich, 1999: 242-43 *et passim*).[15] The opportunity to gain competitiveness by keeping domestic inflation lower than competitors in a the context of fixed exchange was promptly seized by Wilhelm Vocke, the President of the Bank Deutscher Lander (as the central bank was then called) who in 1949 identified in the newly acquired independent status of the central bank the key instrument to implement this policy: monetary mercantilism, which "had been conceived and planned by the Bank deutscher Lander, and in particular by … Vocke, as a long-term strategy for German monetary policy" (Holtfrerich 2008: 35). Thus, hidden behind the centrality of price stability, the trade surplus became the central target of German policy (Emmer 1955: 69; Holtfrerich 1999: 245-46). Later, Germany obtained the same combination of lower domestic inflation and fixed exchange rates through the adoption of the EMS and the EMU.

Vocke's policy did not fully prevail until the beginning of the Korean War when it was entirely endorsed by Erhard: "A marked change occurred in the overall attitude of the Central Bank Council following the outbreak of the Korean war at the end of June 1950. Vocke and Bernard realised that this was their chance to implement their planned strategy, namely to promote exports by dumping domestic demand by means of a restrictive monetary policy … At about this time, the foundation of the EPU was seen by the Bank deutscher Lander as a 'great opportunity for German exporters' ... Erhard fully supported this approach, writing to Vocke on 2 August 1950 that 'a great opportunity for the future of German exports has arisen out of the current situation. If, namely, through internal discipline we are able to maintain the price level to a greater extent than other countries, our exports strength will increase in the long run and our currency will become stronger and more healthy, both internally and with respect to the dollar'' (Holtfrerich, 1999: 345). In May 1951, in the wake of the 'Korean inflation', Vocke explained that, of course, inflation was worrying; but that "you will see, with satisfaction, that we have consistently remained below [the competitors' inflation rate]. And this is our chance, that is decisive, for our currency and especially for our exports. Raising exports is vital for us, and this in turn depends on maintaining a relative low price level and wage level … As I have said, keeping the price level below that in other countries is the focal point of our efforts at the central bank, and it is a success of those efforts. That should be born in mind by those who say to us: your restrictive measures are too tight, are no longer necessary" (quoted by Holtfrerich 1999: 345). Fiscal policy, Holtfrerich (1999: 346) emphasizes, sustained this mercantilist strategy both "in macroeconomic terms by repeatedly posting budget surpluses (…), which helped to dampen down domestic demand", and through fiscal support to the export sector.[16]

5. Monetary Mercantilism and Ordoliberismus

As known, the most influential economic school in the first decades of post-WW II Germany is often described as the Ordoliberismus (OL), or the Freiburg School or, more famously and misleadingly, 'social market economy' (e.g. Riha 1985: chap. 19).[17] OL can be considered as the German version of neoclassical *laissez faire*, "monetarism within the very structured context of ordo-liberal institutions" Allen (2005: 200). The core idea is that a market economy is the best instrument to achieve social welfare, but that competition cannot exist without an active state presence to preserve it.[18] In this respect, OL can be seen as a forerunner of (neoclassical) New Institutionalism with its emphasis on the role of the state in establishing and protecting pro-market institutions. Indeed, it might be seen as a rhetorical adaptation of *laissez-faire* to the German traditional attribution of a central role to the state.[19] Behind the rhetoric, the impression is that the German state surveillance role advocated by OL went much beyond the market process and rather aimed to assure the smooth interaction of a complex of private and public institutions that an Anglo-Saxon would hardly classify as *laissez-faire* (Riha 1985: 202).

OL rejected Keynesianism (Riha 1985:196, 221), identified with trade union power, inflation and the ensuing necessity of price and foreign trade controls, and focused on supply side policies, not just 'ordered competition' (Allen 2005: 201 *et passim*).[20] Productivity growth was seen as key to overcome the association of full employment and inflation (or, even worse, economic planning) that Walter Eucken (1891-1950), the central figure of OL, regarded as the central economic dilemma: "[O]n the one hand, mass unemployment necessitates a full employment policy; on the other, the policy of full employment makes for an instability in other markets, which is extremely dangerous, and, in addition, forces economic policy in the direction of central planning. This dilemma is the most crucial economic and social problem of our time." (Quoted by Riha, 1986: 195). Profound believers in the neoclassical association of competitive markets and full employment, price stability was seen by the OL, and by Erhard, as the obsessive objective of economic policy.[21] The main disturbance to price stability and to relative prices was seen, of course, to be wage indiscipline. The pursuit of full employment at all costs was seen as the main cause of labor indiscipline. So argued Roepke (1987: 95, 103), adviser and friend of Erhard, in a conference held in 1957: “The present policy of ‘full employment' as one of constant inflationary pressure cannot be quite understood without reference to the pressure of the Trade-unions for ever higher wages which are not justified by a corresponding increase of productivity. …the disquieting fact is, indeed, that the Trade-union pressure for excessive wages tends to create unemployment even in times of prosperity, but since the governments in question are committed to ‘full employment’ there is a parallel continuous tendency to remove this unemployment by monetary measures… wage inflation…involves us immediately and intimately in some of the most profound problems of the modern mass societies of industrial states…inflation is merely the monetary aspect of the general decay of law and a decline of respect of law.” Roepke was of course a supporter of an independent central bank (Roepke 1987: 38-9).[22] These views were not restricted to academics. For instance, close inspection of official documents, led Wadbrook to conclude that “good times lead in the Bundesbank’s eyes to lax labor discipline.” (Roepke (1987: 57)

It sounds impossible to find a smoking gun showing an OL inspiration of the mercantilist bias of German economic policy. However, within the OL, negative premises about Keynesianism, export-led growth seems the only game in town in the pursuit of economic growth, which is also something Erhard seems to allude to when, in 1953, he stated that that “foreign trade is not a specialized activity for a few who might engage in it, but the very core and even precondition of our economic and social order.” (Quoted by Cronin 1996: 92). Therefore, rather than in some explicit statement, the choice of export-led growth must be seen as a logical outcome of the choice of the German authorities to reach full employment not by Keynesian means. That is to say, Keynesianism is seen as conducive to labor indiscipline, while by sustaining aggregate demand indirectly through exports, thereby necessitating price stability, would involve labor discipline.

The German preoccupation with the supply side should also not be underestimated. Wadbrook mentions the Bundesbank’s persistent conviction “throughout the period studied that export competitiveness is desirable and, once lost, cannot be easily regained”, as the experiences of the US and the UK would show – a view “shared point by point by Chancellor Erhard” (Wadbrook 1972: 56-7). Relative low wages were then seen as a safeguard against import penetration, to discourage consumption of foreign goods associated with a higher standard of living (Boarman 1964: 154-55). More importantly, low wages implied a depressed domestic market, forcing firms to find external markets generating an “export hypertrophy” (Boarman 1964: 92).

All of this considered, the trade surplus, a result of export-led growth and wage and domestic consumption compression, became the benchmark of a long-run advantage over competitors. In this respect, Germany can be considered a mercantilist country.

6. Wage Discipline, by Force or by Love

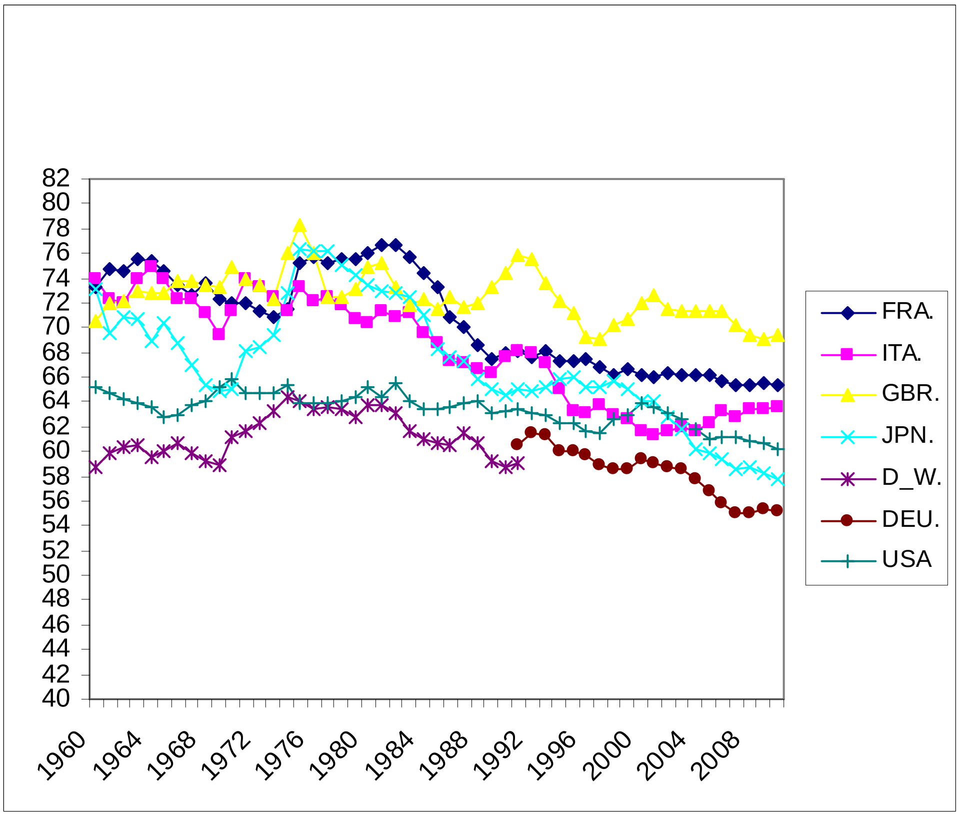
A ‘credible’ CB was a central element of German economic policy, whereby credibility is meant that the trade unions considered the German CB commitment to fight inflation at any cost as convincing. According to Franzese and Hall (2000: 182-83) the centralized wage bargaining in Germany, led by the IG-Metall, made a peculiar interaction between the German CB and the trade unions possible: “The highly public pas de deux between the Bundesbank and the principal wage bargainers, which occurs at the time of every wage round in Germany, is a prominent feature of politics. The bank often issues pointed comments on the initial wage demands made by the union involved in the leading settlement, accompanied by detailed commentary about the state of the economy and warnings about the policy consequences of overly inflationary wage settlements. ... this kind of dialogue between wage bargainers and the central bank is completely absent from U.S. economic politics. … The Federal Reserve and the Bundesbank speak differently because they have audiences with different institutional structures.” Interestingly, the Bundesbank’s credibility was reinforced by the export-led model, given the concentration of the strongest trade unions in the export sectors: “The German case also suggests that the effectiveness of such signalling mechanisms may be enhanced when the export sector is large and plays a pivotal role in wage bargaining (…). The metalworking sector, which produces the lead bargain in most years, has a high export concentration. In itself, this induces lower settlements because wage bargainers in export sectors are especially concerned with maintaining unit labor costs at internationally competitive levels. Actors in such sectors are also especially sensitive to signals from the central bank, however, because the restrictive monetary policies that the bank wields not only depress the level of economic activity but also tend to appreciate the exchange rate, thereby threatening export sectors especially severely by rendering their products more expensive in world markets.” The direct involvement of the German CB in wage bargaining has been inherited by the ECB. Just recall when, infamously, in July 2008, in the aftermath of the crisis, the ECB raised the interest rate, threatening further tightening, to signal the IG-Metall its firm determination to fight its ‘excessive’ wage claims.

Involvement of the public opinion on the importance of exports played also a role. Rather vividly Wallich reported, for instance, that “[e]xports are close to the hearth of every German engaged in economic pursuit. A prominent journalist has called them the sacred cow of German economic policy. The salesman rolls up his sleeves, the businessman drops his competitive restrains, the worker postpone his wage demands, and the government official does violence to his liberal principles where exports are at stake” (1955: 244). According to Baorman (1964: 158), by contrast, “this patriotic motivation should overrule private economic judgment in respect to profit and losses is [not] credible.” Nonetheless, this kind of pressure should not be undervalued.

Wadbrook (1972:23) tries to look behind the German ‘export tradition (or mystique)’ arguing that ‘the payment balance is not an end in itself’ (Wadbrook 1972: 53) since: ‘there exists an important class of goals relating to the whole society’s shape and position which are more or less agreed among decision-makers, but which are not usually announced explicitly among the economic goals’ (Wadbrook 1972: 54). He regards income distribution, social order and the geopolitical position of the country as the prominent hidden agreed goal in Germany, noting that ‘[c]ertainly, the links of the income-distribution issue with price stability and with the balance of international payments ought to be fairly clear to policy makers’ (Wadbrook 1972: 74)

Various sources underline the perverse income distribution in post-WW2 Germany with inequality increasing during the ‘miracle’ when the German standard of living was below that of France. Boarman (1964: 153), for instance, reports that, in 1950, 95% of all income receivers in Germany had gross income of less than DM 7,200 annually. By 1956, this percentage declined to only 86.8% “even though national income almost doubled in the same period’’. Taxation was relative punitive for low income earners (Boarman 1964: 151; Wadbrook 1972: 74).[23] As shown in Figure 12, the wage share as a percentage of output in Germany has constantly been below that of her main partners over the last three decades.[24]

Figure 12 - Adjusted Wage Share as % of GDP at Current Factor Costs, Total Economy.



Source: Ameco database

The German state did not limit itself, however, to austere wage policy, but within the limits of an austere fiscal policy guaranteed a Bismarckian welfare state and excellent education. It has been observed that 'The German government uses incentives for the upper groups and paternalism for the lower' (Allen 2005: 220). The acquiescence of the German trade unions to wage moderation, during the miracle and later, with the exception of 1969-70, is nonetheless difficult to explain, as well as the initial option of codetermination in place of a more conflict stance, and will deserve more research. Giersch et al. (1992: 73-9) enumerate a number of reasons for moderation, none of them fully capable of explaining it: organizational weakness, a factor possibly valid only for the initial years 1948-50, but not later; productivity growth systematically overcoming labour unions expectations and related wage claims; a 'socially responsible' conduct during the reconstruction years accompanied by codetermination as the main political goal, thus distracting the attention from full employment.[25] Of course, although not satisfactory form the point of view of the income share, in the long run high productivity growth led the German real wages to overcome those of the partners thus consolidating the consensus around the model.

7. Importing Inflation…

The 'grotesque' German trade surplus in the 1950s brought strong criticism from the Western partners (Boarman 1964: *x*). From the 1950s onward, Germany replied to the criticism by pointing to the strong 'inflationary policies' abroad that led to the German export upsurge and obliged it to sterilize 'imported inflation' by realizing a fiscal surplus.

The German economic discourse tried to show Germany as the victim of the inflationary conduct of the partners, rather than as a potential source of international deflation. Up to the fall of the Bretton Woods system, the German debate took place over 'imported inflation'. In synthesis, the German thesis – inspired by Roepke (see Boarman 1964: *x*; Yeager 176: 491) – was that the demand for German goods from full-employment, inflation-prone countries brought an undue pressure on fully-employed Germany. To avoid imported inflation, this country had to sterilize excessive demand pressure on her fully-utilized capacity by restrictive monetary and fiscal policies (Boarman 1964: 51, 61-2 et passim).[26] Therefore, the compression of internal private and public consumption had to be interpreted as a result of foreign inflation-prone countries. However, so this argument goes (Boarman 1964: 76-77; Emminger 1977), even the most severe deflation policies were self-defeating. The latter led to even wider trade surpluses since the dampening of domestic demand released further resources for exports, made export prices persistently attractive, and abated imports. Perversely, the relatively higher German interest rates, and sometimes the expectation of a DM revaluation, also attracted capital inflow that permitted German firms to overcome the domestic credit restrictions, compounding the problem of keeping the internal inflationary pressures at bay (Yeager 1976: 110).

The 'imported inflation' argument seems to reflect the monetary theory of the balance-of-payments according to which disequilibria are caused by excess money supply in some of the trading partners (Boarman 1964: 140-41, 144; Gandolfo 1995: 197). From a more Keynesian viewpoint, Germany could be seen as opportunistically exploiting the full-employment policies in other industrialized countries. The German monetary and fiscal policies had the duty of avoiding an excess pressure on output and employment due to the success of exports.

The request to Germany in the second half of the fifties to have 'a nice little inflation' was followed in 1957 by the threat by the European Payment Union to declare the DM a 'scarce currency' so to adopt discriminatory measures against German exports (Boarman 1964: 83; Emminger 1977: 5). Germany reacted through measures devoted to support her imports and by sustaining capital exports. A fierce discussion begun about the possibility of a DM re-valuation. What was considered an 'unpleasant joke' was 'the suggestion that German internal policies be adapted to the inflationary conditions prevailing in the deficit countries' (Boarman 1964: 85).

Roepke argued that it should not be asked from Germany to behave as under a golden standard regime when the inflation-prone countries precisely rejected this latter regime in order to avoid its deflationary implications.[27]

Capital exports, official and not, were seen as a German contribution to the sustainability of the trade imbalances. Confusingly, the eminent Bundesbank economist Otto Emminger argued: ‘If this [trade] surplus is offset and absorbed by an equally large export of capital, the result will be merely to cause the increase of purchasing power due to the export surplus, to be neutralized by the reduction of purchasing power which follow the export of capital’ (quoted by Boarman 1964: 267). This is wrong: net exports have (i) an expansionary effect on output and/or prices that may, if wished, be neutralized by deflationary measures; and (ii) they lead to the accumulation of reserves that may, or may not, be lent abroad. But in no way the lending of reserves is a sterilization measure (Boarman 1964: 256-57). In actual terms, capital exports have the function of re-financing the debtor countries and this was said to have a ‘boomerang effect’: the German re-cycling of the official reserves was in practice a re-financing of her exports. Emminger was critical of Albert Hahn, who coined the concept, since a deficit country could use foreign lending ‘to build up its monetary reserves instead of for the purchase of additional amounts of foreign merchandise’ (Boarman: 267). But unless the deficit country endeavors a deflationary program, the deficit will persist and so foreign lending will be used to finance net imports. Importantly, capital exports perpetuated the original cause of imported inflation by maintaining the DM relatively under-appreciated.

Having to placate the criticism from the other industrialized countries, Germany resorted twice to a DM revaluation (in 1961 and 1969) and to further measures devoted to liberalize imports and reduce fiscal support to exports. Wadbrook 1974: 250) describes these ‘periodic adjustment gestures’ as ‘dynamic undervaluation’: ‘the German revaluations and border-tax alterations can be described as periodic partial price-level realignments, recouping in each instance part, but not all, of the dynamically effective international price differential accumulated during the preceding period … Thus the advantages of currency undervaluation were prolonged and protracted from the threatened collapse of the very liberal-trade, fixed-rate system which makes undervaluation possible and advantageous’ (see also Wallich and Wilson 1979: 489).

9. …Exporting Stability

Having blamed the partners’ inflationary bias as the cause of the imbalances, German self-pity described Germany as a country that in order to preserve price stability had to surrender *real* wealth in exchange for financial wealth (Boarman 1964: 250-51, 291). It also prided itself for the ‘demonstration effect’ of monetary discipline (Boarman: 287), of ‘exporting stability’ as Wadbrook (1972: 251) expresses it. Wadbrook reads a degree of hypocrisy in the German moral tone (and one cannot refrain from adding, some deliberate ignorance). This would be demonstrated by the complaints heard in Germany whenever the trade balance approaches equilibrium, provoking further domestic stability measures, so that the foreign rabbit will never reach the German tortoise. Wadbrook (1972: 251, 255) deserves to be quoted in full: ‘The German policy of permanent undervaluation has very often been presented as one of ‘exporting stability’ to payments partners, i.e., of forcing them to accept ‘balance-of-payments discipline’: the adoption of less expansionary macro financial policies to avoid balance-of-payments deficits …. the recurrent and vocal worries on the part of all responsible German policy-makers over loss of export competitiveness, that have arisen whenever the German trade-balance surplus has shrunk, very emphatically belie the sincerity of the stability-export thesis. There is no point in ‘importing stability’ from Germany, if Germany will react to this by ‘manufacturing’ still more stability for export’. German policy-makers, Wadbrook continues, are well aware that ‘export stability’ means ‘competitive deflation’ from which ‘the Weimar experience’ should deter:[28] ‘Yet there lingered a strain of moralism in German presentations of the stability-export thesis …it has not been at all uncommon, even in the technical literature, to find the stability-export problem treated almost literally in terms of moral theology [here there is a reference to Erhard]. Bundesbank President Blessing himself either succumbed to or catered to this attitude sufficiently to provoke the criticism that he saw economic, social and political linkages in narrow moral categories. Bundesbank spokesman formerly made many comments on the ‘comfortable’ positions of key-currency nations which ‘live beyond their means’ (Wadbrook (1972: 251, 255).[29] How many times have we listened to these words from German authorities, mass media and economists over the current crisis?[30]

Behind ‘the “moral case” for stability-export’ Wadbrook (1972: 256, 259-60) reads the ‘desire to protect the German social order against imports of or demonstration effects of foreign welfarism and extravagance’ and to ‘justify fiscal restraint and hence small government and less welfare expenditure than otherwise: they justify monetary restraint which puts stability burdens on labor… All this corresponds to a widespread form of social-order consciousness in Germany.’

10. Conclusions

Moving from the current global and European imbalances and crises, and from the consideration of the German reaction to them, the paper delved into the political economy origins of the conservative German policy stance. It emerged that an export-oriented economy was a deliberate decision by the German elite after WW II and that the external whip may be regarded as functional for internal labor discipline and efficiency and vice-versa in a self reinforcing process. This model reminds us of the classic definitions of mercantilism that refer to the pursuit of a trade surplus by encouraging exports and deterring imports, maximizing domestic production and employment, disciplining labor, and keeping consumption, i.e. wages, (relatively) low (Furniss 1920: 200-1; Suviranta 1923: 160-64; Heckscher 1955: 130, 165). This vision is consistent with Kalecki's (1971) (and Rosa Luxemburg's) view of net exports as a way *to realize* the domestic surplus, the excess of production over wages.

Defined as 'almost unconscious' mercantilism (Solsten 1965: 337), the model has been a considerable success, bringing enough prosperity and order to win a wide domestic consensus, confirmed in the present crisis. The question is of course the imbalances that the model brings about. The traditional German answer is that this is not a German problem, and that Germany indicates the direction for change. Leaving apart the fastidious tone, the thesis does make little sense from a Keynesian perspective since it would amount to a generalized adoption of a competitive deflation strategy. Political realism would however suggest that any pledge from Germany to adopt an alternative, more Keynesian oriented, model has little hope. The last time Germany toyed with international Keynesianism was in the well-known case of the 'locomotive theory': in the late 1970s Chancellor Helmut Schmidt reluctantly accepted the idea that Germany had to pull the world economy along with the US and Japan (e.g. Giersch et al. 1992: 240-43). When the second oil shock came, the Chancellor swore that never Germany would have played this game again (Allen 2005: 214). The question is that in the present situation Germany is yet again not prepared to play the leading role in readdressing the current European imbalances.

The events of 2010 have revealed that its participation in the EMU has led the European periphery to a problem of solvability. A solution has to be one that deals with both the question of solvability and the structural one. In the short term, the sustainability of the private and public debts of the peripheral countries must be assured; the medium-term issue is how to address the structural problems that have led to this situation. The preferred choice is, of course, to solve both while preserving the monetary union. This cannot be done by dealing with the adjustment at the national level only. Being 'currency users' and not 'currency creators', peripheral countries have actually issued their debt in a 'foreign' currency and cannot rely on issuing money to preserve the nominal value of their bonds and keep the debt service under control (Nersiyan and Wray 2010). In a system that is similar to a gold standard, fiscal adjustment and wage deflation (the so-called 'internal devaluation') are clearly a Sisyphean fatigue since they both negatively affect output and tax revenues and, ultimately, the sustainability of the debts (that would also increase in terms of falling domestic prices, cf. Corsetti 2010). Competitive deflation at the European level does not help the regional and global recovery – let alone the fact that Germany would always be the best player at this game. The skepticism of the financial markets about the result of these deflationary adjustments has led the debt servicing costs of peripheral countries to intolerable levels, accelerating their default. In the past, similar cases of domestic adjustment were accompanied by a devaluation of the national currency that sustained output, but this is not possible by definition in a currency union. Clearly, the solution cannot be at the national level. In spite of the opposition of Germany, the ECB has hesitantly sustained the periphery government bonds. A more determined ECB action should be associated with some sort of Europeanization of at least part of the national public debts[31] – and this clearly means that the Eurozone would move towards a fiscal union. So much for the short run. To assail the structural problems, a reversal of the German wage and fiscal moderation would be required, consisting of a touch of a 'nice little inflation' in Germany – as substitute for the currency readjustment otherwise impossible within the monetary union – and of an expansion of its domestic demand.[32] Likely, Germany has also its competitiveness in the more promising extra-European markets in mind. In the light of this consideration and of the preceding sections, these policies may sound as an 'unpleasant joke' to Germany (Issing 2010). However, this country might not keep on just saying 'nein' to any reasonable solution. In this respect, it is interesting to note that, at the time of writing (December 2010) the ECB has timidly and progressively acquired a more independent status – this time from the German diktats. Nonetheless, the German-inspired dithering by the European institutions to deal with the crisis (too little, too late) might lead to the default of a number of periphery states with unpredictable consequences on the global economy.

Plan B is a deliberate dissolution of the monetary union. The closer experience we have is of countries leaving a currency board. As we know from Argentina 2002, this is a dramatic experience for the country involved, at least in the short run, but with possible long-term benefits. A break from a currency union by a *number* of countries – possibly including a G7 country – would, however, have systemic effects that go beyond the single country when the *global* dimension of the event makes it even more difficult to prepare and manage.[33]

Notes

1. By non conventional economists, we refer to those who believe that aggregate demand determines aggregate supply, both in the short and in the long run. By contrast, conventional economists restrict the role of aggregate demand at most to the short run.

2. Greece joined the EMU in 2001. The bright performance was short lived in Portugal that saw the deterioration of its current account without enjoying, along with the other periphery, some years of euphoric growth. Events similar to those of the EMU periphery took place in the Baltic countries and in some Eastern European countries that pegged their currencies to the euro (Kattel 2010). Poland did not surrender her monetary sovereignty, and has so far avoided the unpleasant fate of the rest of peripheral Europe.

3. In terms of GDP, at the end of 2009 the Spanish foreign debt was 169%, Portugal 233% and Greece 162%. The proportion of public debt was, respectively, 13%, 15% and 42%. According to the Bank for International Settlements, the exposure of Eurozone banks was $727 bil. in Spain, $244 bil. in Portugal, $206 bil. in Greece and $402 bil. in Ireland. The bulk of the debt was held by French and German banks, but also American banks were heavily exposed (cf. RMF 2010b: 9, 25, 29).

4. Both countries saw the deterioration of their current accounts, although to a lesser degree than peripheral countries. Internal demand in Italy has been deplorable so that sluggish imports averted a more significant deterioration of the trade balance due to the progressive loss of competitiveness vis-à-vis Germany. The negative net foreign income flow, however, is associated with a serious current account deficit.

5. Country's abbreviations are listed at the end of the paper.

6. The 2009 Report examines the period 1999-2008, underlining the slight corrections of the imbalances after the crisis, corrections that are not, however, structural. The 2010 Report considers the period 1998-2007.

7. The country's competitiveness indicator utilised by the reports is the *Real effective exchange rate*-REER (or *Trade-weighted currency index*) defined as: $REER = \frac{eP_d}{P_e}$, where P_d and P_e are domestic and foreign prices, respectively, the latter weighted according to the commercial importance of the foreign partner; *e* is the nominal exchange rate that, in the EMU area, is obviously equal to one. A positive (negative) variation of the *REER* means a loss (gain) of price competitiveness. Alternative deflators (or price indexes) adopted in the Report are: consumption prices, GDP deflator, export deflator, labor costs per unit of product, labor costs per unit of product in manufacturing. The results are not basically affected by the deflator that is used.

8. In turn, the divergent trends in nominal wages have been associated with persisting divergence in inflation rates of the consumer price index; because of this, in two relevant cases, those of Spain and Italy, a higher increase than European average of nominal wages has gone together with a lower than average increase in real wages (Andersson et al., 2008: 21-22).

9. Whoever travels in Spain is struck by the number of newly built dwelling districts. A colleague so synthesised the experience: "Up to 1999 houses were cheap, but mortgages were expensive and only of ten year duration. After the EMU mortgages became cheap and with very long durations, of course houses become also more and more expensive, but by now people could afford to buy them." On the Spanish experience, see De Jouan and Febrero (2010).

10. The neoclassical idea that the ageing process may be dealt with by increasing savings is criticised in Cesaratto (2006). Note also that the German low fertility rate might also be caused, *inter alia*, by wage moderation and labor market insecurity.

11. "The increasing fiscal consolidation can be linked to the world trade boom as rising exports meant higher sales and greater corporate profitability, leading to buoyant (corporate) tax revenues" (EC 2010: 20, fn 19).

12. Presently, the only economic policy forum of the Eurozone countries is the *Eurogroup*, an *informal* committee of the financial ministers that meets after the *Ecofin* meetings, the *formal* council of *all* the European Union finance ministers.

13. Choice (a), the dismantlement of price controls and rationing through the monetary reform of 1949 – when the new DM substituted the Reichmark – resembles the shock therapy adopted by many Eastern European countries after the collapse of communism. Apparently an immediate success – the day after the shelves were again filled with commodities - the monetary reform did not appear so miraculous months later since it was not enough, as it is obvious from a Keynesian point of view, to initiate the necessary economic recovery. In 1950 the Kaleckian economist Thomas Balogh (1950: 102) fiercely attacked Erhard's policies, in particular the currency reform, which, in his opinion, led to an income distribution worse than under Nazism with the unfortunate acquiescence of the German trade unions. The success of those policies was indeed assured by external demand: "The truth of the matter is that Germany, like most other European countries, benefited by President Truman's enlightened Keynesian economic policy, which Dr. Erhardt [sic] and his 'experts' try to discredit in their own country. … the further intensification of demand due to the recent turn in international political relations and the general rearmament to which it gives rise will certainly

result in a continuation and intensification of this trend ... such improvement in Germany as has been experienced was made possible *solely* by the moderation of the Trade Unions which held back wage demands. The worsening of the distribution of the national income continues. On this basis no doubt even Dr. Erhardt's system can be made to work."

14. In this regard, Wadbrook (1972: 63) poses a 'cynic' question on which we shall return later: "Many Germans doubtless had unforgettable experiences of inflation. Many more have been subjected to a constant barrage of denunciation of inflation and exhortation to avoid it. The unvarying tone of the Bundesbank's warnings throughout the sixties is but the most responsible example of the weight propaganda against inflation which has never slackened in postwar Germany. A cynic might be tempted to question whether such an 'extreme' attitude as the Germans' …could be or would be maintained without its being in the direct and tangible interest of some identifiable group".

15. Germany led the way to foreign trade liberalisation. According to Wallich (1955: 235) this was done in order to pressure foreign partners to follow her example (also Giersch et al. 1992: 108). The 'gamble' was, however, taken relying on restrictive domestic policy to keep imports at bay and inflation lower than competitors (Wallich 1955: 243; Giersch et al 1992: 115-6).

16. Wallich (1955: 83-84, 87) notes that: the German authorities pursued a deliberate policy of spare capacity in order to take any opportunity to exploit sudden rises in international demand.

17. The term 'social' just intends to convey the OL idea that competitive markets lead to optimal social results.

18. "Its objective was not the restoration of laissez-faire but the conscious creation of a competitive environment supported by an appropriate political and social framework. For the Freiburg school the concept of the economic and social order, rooted in 'ordered competition', was crucial to the whole approach" (Allen 2005: 192-93).

19. For instance, a major exponent, Roepke, sustained that competition "…is a means of establishing order and exercising control in the narrow sphere of a market economy based on the division of labor, but not a principle on which a whole society can be built. From the sociological and moral point of view it is even dangerous because it tends more to dissolve than unite. If competition is not to degenerate, its premise will be a correspondingly sound political and moral framework. There should be a strong state; aloof from the hungry hordes of vested interests, a high standard of business ethics, an undegenerated community of people ready to co-operate with each other, who have a natural attachment to, and a firm place in, society" (quoted by Riha 1985: 195).

20. Germany played with domestic Keynesianism in 1967-68 with Karl Schiller as Minister of the Economy, although even then exports played the leading role in German recovery (Giersch et al. 1992: 146-48). The inflation surge in the early 1970s sanctioned the end of this Keynesian parenthesis, followed by the departure of Schiller in 1972 and Brandt in 1974, substituted by more conservative Helmut Schmidt (Allen 2005: 209-14). A second, short-lived, Keynesian episode took place in 1979 and will be referred to later.

21. "…Walter Eucken…made price stability one of the almost metaphysical principles of a free social order" (Wadbrook, 1972:62).

22. According to Bibow (2004), OL principles were contrary to the CB independence. In his opinion Erhard's support for CB independence would not contradict the OL stance, since although he sustained legal independence, endorsed *de facto* coordination. But this just shows that the astute Erhard well understood the fiction behind the concept of CB independence: the independent central bank is the labour union watchdog, ready to signal to the unions and to possible socialist governments that it is legally mandated to preserve price stability at any cost, but prepared to co-ordinate action with a conservative government, if it were felt necessary.

23. Broadberry and Burhop (2010: 403, 42) show that German real wage have been historically low relatively to productivity compared to Britain, even during the Weimar Republic when they were said to have risen. They argue that 'the impact of cartels… might have led to a higher markup on Germany compared to Britain' (Broadberry and Burhop 2010: 401).

24. For a comparative analysis of wage shares in the main European countries, see Stirati (2011).

25. This attracted an early harsh comment by Balogh: ‘It is odd, to say the least, that German (unlike English) Trade Unions have agitated more for ‘Representation’ than for full employment which really does secure the human dignity of individual workers’ (1950: 95).

26. In the 1950s the policy of accumulating fiscal surpluses was defined Juliusturm by the name of the place in which the treasury of the first Reich was guarded (Boarman 1964: 74).

27. ‘It is a strange logic to criticise Germany on the grounds of its not behaving as it would have under the gold standard whereas it is precisely the non-existence of the gold standard …which has created the disagreeable dilemma’ (quoted by Boarman 1964: 85; see also Wadbrook 1972: 67).

28. Deflationary policies in the early thirties paved the way to Nazism.

29. More generously, Yeager (1976: 520) maintains that ‘German officials engaged in some wishful thinking about solving their dilemma by somehow exporting Germany’s monetary stability to the outside world.’

30. Alesina and Perotti (e.g. 2010) must be added as the foreign *portavoce* of the German views.

31. As proposed by many scholars and pundits and by the Italian finance minister and the Luxemburg Premier (*Financial Times* 5 December 2010)

32. According to the German economist Heiner Flassbeck_ (now at UNCTAD), Germany should stop its ‘politically induced wage dumping’ and accept that ‘with an inflation target of close to 2% (in EMU established by a decision of the ECB) the implicit contract is that nominal wages do not rise more than national productivity growth plus 2%’ (www.economist.com/debate/days/view/496).

33. The break cannot be discussed in *official* international or national assemblies, since it must take 'markets' by surprise. At the national level, we learn from the Argentinean experience (Blejer and Levy-Yeyati 2010; Eichengreen 2010) that bank runs and capital outflows must be avoided, so deposits must be frozen, although selectively, so as to avoid a disruption of daily transactions, and capital controls introduced. Measures of nominal wage and price control should be adopted. While domestic contracts would be re-denominated in the new currency, this is not easy for the foreign private and public debt. If not, as a consequence foreign debt would become unsustainable in the devaluated national currency, and a debt restructuring unavoidable. Less problematic is the introduction of new banknotes, given that a small letter indicates the country of origin – e.g. an ‘S’ before the serial number indicates the Italian euro-banknotes – and presuming that the ‘S-euros’ mainly circulate in Italy, the introduction of new banknotes (and even of a ‘new lira’) is not an urgent task. In the case in which Germany and satellites leave the EMU, the advantage for debtors is that foreign debts, denominated in euros, would depreciate against the new German-area currency. The question is whether the remaining euro-area will last (with the central bank in Frankfurt!). If not, foreign debts will be necessarily re-denominated in the new national currencies.

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Abbreviations

Name	Abbreviation
Belgium	BE
Bulgaria	BG
Czech Republic	CZ
Denmark	DK
Germany	DE
Estonia	EE
Greece	GR
Spain	ES
France	FR
Ireland	IE
Italy	IT
Cyprus	CY
Latvia	LV
Lithuania	LT
Luxembourg	LU
Hungary	HU
Malta	MT
Netherlands	NL
Austria	AT
Poland	PL
Portugal	PT
Romania	RO
Slovenia	SI
Slovakia	SK
Finland	FI
Sweden	SE
United Kingdom	UK