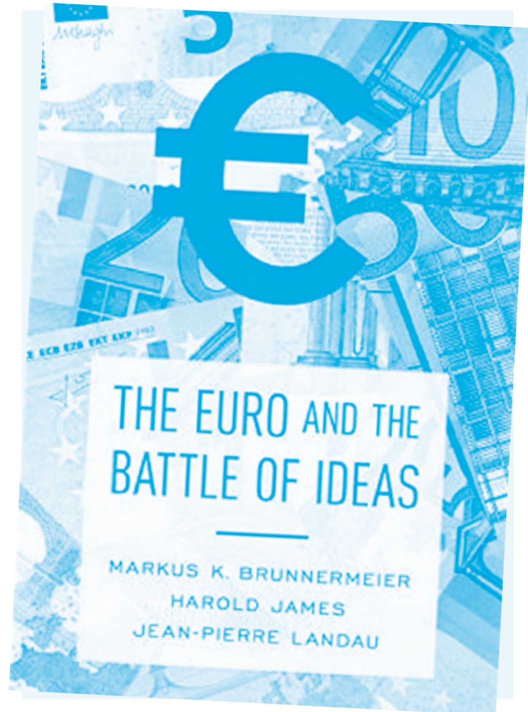
Markus K. Brunnermeier – Harold James – Jean-Pierre Landau

The Euro and the Battle of Ideas



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THE CLASH BETWEEN THE GERMAN AND FRENCH ECONOMIC PHILOSOPHIES DURING THE EURO CRISIS

In their book *Brunnermeier, James and Landau* elaborate on the history of the euro crisis. In an effort to describe the crisis and present the standpoints represented by each of the parties they try to show the reader the economic, business history and ideological factors lying behind these standpoints and their impact on the euro crisis. Unleashed in 2008 and escalating across the euro area at the beginning of the 2010s, the crisis and its management dredged up the different business philosophy mind-sets of each country, in particular Germany and France, that largely determined the economic policy and financial policy solutions applied in the course of the euro crisis and thus the measures to respond to the crisis. In the opinion of the authors, in examining the crisis weltering at the beginning of the 2010s it is inevitable to inspect the different state organisation and business philosophy mentalities originating from the different form of state of the two countries, their economic and financial structures, economic mentality and the historical changes operating in all these fields; indeed, in the lack of such a review, the economic policy and finance policy debates conducted in the course of crisis management would be difficult to understand.

The authors opine that despite a number of common historical and cultural aspects, Germany and France are the two European countries with perhaps the most notable differences, and this condition had a major impact

on the debates related to the future of the European Union. These two states had travelled different historical, economic, politic, state organisation and financial journeys in recent centuries. While France was the most hazardous and contradictory country of Europe in the 19th century, Germany used to be seen as the land of peace and economic prosperity. But the roles were swapped at the beginning of the 20th century and Germany became the country "to fear" in Europe. In addition to the differences in their history, we can see different state structures in both countries. While France is the European model for centralism, Germany is among the roots of federalism. The German federal state grants a significant degree of independence to each constituent state, although the only way to keep the balance between the federal states is to let the authorities act alongside well-defined regulations. One of the basic elements to run the German federal state is, therefore, the rule of law, in other words, compliance with and the enforcement of the law. Federalism has impacted not only the organisation of the state but also the German monetary policy, which is well illustrated by the fact that in the 1960s and 1970s France devalued the franc in response to the strong dollar, while Germany stood by their strong Deutsche mark. This was based on the philosophy that a federal state needs a strong currency that is determined by market rules as a possible devaluation could impact each constituent state in a different way, increasing the competitiveness of some and reducing the competitiveness of others.

The federal state structure also determined, to a large extent, the German banking system: as opposed to France, where banking houses with nationwide coverage are typical, Germany features mainly regional banks. The authors assert that the fragmented and regionalised German banking system needs a much stricter regulatory environment to ensure that none of the stakeholders obtain unlawful market advantage. As pointed out by the authors in the book, strict adherence to the law and the economic and financial policy solutions stemming from the federalist form of state defined the German policy for handling the crisis fundamentally.

In addition to the state organisation and financial policy topics presented by the authors, it is worth mentioning in connection with the euro crisis the evolution of German economic mentality, which has determined the position of Berlin in this matter to date. In the 19th century Germany focused mainly on the state's role in the economy. Germany's policy was aimed at strengthening the economic and political presence of the country in the international arena. As opposed to this, France preferred a liberal economic policy in that period as an answer to the absolutist centralised state structure reigning before the 19th century.

After World War II, both countries learnt from their mistakes in economic policy and the economic mentality of both countries went through a major paradigm shift. As opposed to the centralised Nazi state, Germany opted for a more liberal market policy mentality called ordoliberalism, built upon the philosophy of the liberal *Friedrich Hayek* on the one hand and *Wilhelm Röpke and Walter Eucken* on the other hand. The ordoliberal philosophy does not reject the state as a player involved in the economy, but instead of its active involvement on the market it prefers the state to respect and enforce the law. One of the key components of this philosophy is the accountability of market players. All this has determined, to a critical extent, the economic policy mind-set of Germany and the position of Berlin forged in the course of the euro crisis. Thus, the players of the market economy bear liability for their actions. If they take disproportionately high risks in the course of their market activities, they will have

to foot the bill; in other words, by taking the risk each market player must also undertake not only successes but also the failures. If the state always protects market players against market failure and players are not called to account and are not held liable, market participants may view the central government as their last resort. However, this would increase the degree of moral hazard, since such market conduct would drive companies to undertake increasing risks knowing that the state would be always there to give them a hand. This ordoliberal concept is also present in monetary policy. In order to minimising moral hazard, the bank of issue should not directly finance the state since in that case, the central bank would stand as a last resort for the state, which could result in the lack of a responsible economic policy. The authors note that neoliberal philosophy had greatly eroded the reputation of ordoliberalism, although the fact that this doctrine is still decisive in German economy is eloquently proved by the policy Berlin applied in managing the euro crisis.

French economic philosophy also drew the consequences of World War II, which contemporary economists and decision-makers attributed to a weak state. Thus, France broke with liberalism and focusing on Keynesian principles, identified the key to economic growth in a more active state. While it is true that France was not left unscathed by the neoliberal turn, economic interventionism has been playing an important role in French economy to this day. The French philosophy is more tolerant to rule breaches and suggests that regulations may be re-discussed in certain cases, such as economic crises, to serve a more flexible crisis management practice, while conferring a key role to the ideal of social solidarity originating from the Declaration of the Rights of Man and of the Citizen of 1789.

The book depicts a detailed picture of the prevalence of these economic philosophies during the euro crisis, namely, the strict German ordoliberal ideology based on the respect of regulations and the more flexible French position placing more emphasis on solidarity. During the crisis, in contrast with the flexibility supported by France, Germany placed emphasis on respecting the rules, which on the German side mainly materialised in the rejection of the aid packages and a preference for structural reforms that were generally coupled with constraints. All this resonates with the German argument that market players – i.e. Member States – have to assume responsibility for their reckless conduct (in this specific case, concerning economic policy) because if they are not called to account and held liable, the remaining players of the European Union will be more prone to violate the rules, and violation may become systematic, increasing moral hazard. As regards constraints versus stimulus packages, the authors recall that Germany and France failed to agree even in their timing. Germans argue that structural reforms should be implemented only in crisis, which again can be traced back to German historic experience (*Gerhard Schroder's* reform measures). It is not by chance that during the euro crisis Germany tied assistance to structural reforms in every cased. The authors certainly remind the reader that the position of Germany was not always this stringent; indeed, during the economic crisis of 2008 all Member States – including Germany – gave preference to stimulation packages that prevented the 2008 global crisis from causing even more massive economic damages. When the deepening of the crisis was successfully averted, Germany – arm-in-arm with the European Commission – increasingly demanded compliance with the budgetary rules of the Stability and Growth Pact, which numerous, heavily indebted (mainly Southern) Member States failed to achieve. By contrast, Mediterranean countries in agreement with France were not worried

about public deficit but about the imbalance of the current account, mainly in Germany.

Another important factor related to the euro crisis was the *solvency versus liquidity* debate. While France managed the euro crisis as a 'pure' liquidity crisis and rejected the hazard of solvency, Germany identified the problem as insolvency originating in the irresponsible fiscal policy applied by certain Member States before the crisis as well as imbalances emerging in the banking sector. This dissimilar interpretation of the crisis made finding a remedy much more difficult: while Berlin was ready for monetary intervention in the event of a liquidity crisis, it preferred to focus on structural problems in the case of insolvency, which ultimately gave rise to the policy of austerity.

The authors warn that in order to understand the competing perspectives, the issue of time inconsistency – interpreted differently by both countries – cannot be avoided. The French position places emphasis on managing an already existing crisis – representing, as it were, an *ex post* philosophy –, while the German side favours preventing the crisis. Consequently, according to the German "rule-driven" philosophy, the economy should be run with a view to preventing crises; in other words, to ward off the emergence of a crisis *ex ante*.

Obviously, if everyone had followed the German *ex ante* position, there would not have been a crisis – but, as we know, this was not the case. Therefore, the euro area had to implement crisis management methodologies *ex post*, as described in detail by the authors in their book. Among other things, states can provide guarantees for domestic banks and if this is not enough, a more efficient crisis management method is the recapitalisation of the domestic banking sector, meaning a direct capital injection from the state to the banking sector. This was a routine crisis management method in a number of European countries including Ireland, Germany or Spain. This external recapitalisation solution is referred to as a *bail-out*.

The opposite of this is the *bail-in*, a kind of recapitalisation by internal investors whereby the bank is saved by its own shareholders and depositors. This method was first used during the Cyprus bank crisis under pressure by Germany. Cyprus joined the European Union in 2004 and the euro area in 2008. The island offered a favourable business model for banks combined with a low tax and a weak control environment. In addition, the banks of this island operated with high interest rates since they were investing primarily in venture securities. A large number of citizens arriving from former Soviet member republics used to keep their money of questionable origin in Cypriot banks, which handled a large portion of the laundered assets of Russian oligarchs.

The Cyprus bank crisis exploded in the summer of 2012, when one of the credit rating agencies, Fitch Ratings, downgraded the government bonds of Cyprus and the state formally declared bankruptcy. All this prompted the European Commission, the European Central Bank and France to resort to a bail-out, as they had done so in the case of Ireland and Spain already. However, the IMF and Germany had a different opinion and thought that a bail-in – recapitalisation from internal resources – would be a better solution. In the opinion of Germany the Cyprus case can become systemic if the recklessly operating Cypriot banking sector is allowed to be saved and no responsibilities are sought, sending the message to the rest of the Member States that no matter how hazardous is the monetary policy pursued by a country, it would be ultimately saved by the other countries. This involves a major moral hazard, the avoidance of which was top priority for Berlin, as follows from the ordoliberal econom-

ic philosophy of the country. On the other hand, as noted by the authors, an aid package granted from the money of German citizens to Cypriot banks that in some cases laundered monies of doubtful origin would have been difficult to communicate to German voters. Eventually, in managing the Cyprus crisis the German position geared toward bail-in and the minimisation of moral hazard triumphed. The bail-in proved to be so successful that the European Commission – mainly under German pressure – prescribed it as a preferred crisis management tool.

By contrast, the bail-out – despite having being applied in a number of countries – did not always yield the expected results, the best example being the Greek debt crisis commencing in 2010. The authors considered it important to present the debate related to the Maastricht Treaty to help the reader understand the Hellenistic crisis as indeed, the Greek crisis forecasted such a scenario for euro area members that was not contemplated by the founders of the treaty; namely, that a Member State may be compelled to leave the euro area. The exit option was not included in the Maastricht Treaty mainly due to pressure from France, since in the opinion of Paris the creation of the euro area represents an efficient barrier to speculators. In addition, omitting the regulation on exit intentions – reflecting the French economic philosophy – also supported the opinion that a state that is compelled to leave the euro area may put at risk the existence of the entire currency area and may even call into question the European integration as a whole as a result of the domino effect. In the opinion of Germany, however, the exit of a Member State may even be beneficial in certain cases since that may be the only option for a country to recover its lost economic competitiveness. This is because upon the exit of a Member State, the devaluation of its new currency is inevitable. Therefore, instead of France's strict common currency area strongly opposing any exit option, Germany is contemplating – in the words of German economist *Hans-Werner Sinn* – a 'breathing' euro area where Member States freely enter and exit as needed as long as they comply with the established financial rules. In the light of the above it is even easier to understand the attitude of the German political leaders concerning the Greek euro crisis.

Consequently, Paris – together with the European Central Bank – was against Athens to leave the euro area despite the Greek crisis aggravating in 2012 for fears that the crisis could spill over to other Member States under a potential domino effect. By contrast, Germany would have preferred the immediate exit of Greece to swiftly end the crisis. It is not surprising, therefore, that Germany's Minister of Finance *Wolfgang Schäuble* repeatedly declared at the beginning of 2012 that the fastest way to solve the crisis would be if Greece exited the euro area with an option to devalue its currency and gain a temporary competitive advantage and the opportunity to implement the required reforms. However, in the summer of 2012 the European Commission, the United States, the Greek Prime Minister and other market players convinced the German government and in particular, *Angela Merkel* that a Greek exit would be too dangerous and risky for the overall euro area. Thus in autumn the German government abandoned the Greek exit plan and put together an EUR 34.3 billion aid package for Athens at the November EU summit with the condition that Greece carry out the necessary structural reforms. It appeared, then, that the Mediterranean Member State could be pulled back from the abyss by means of a bail-out.

However, in January 2015 the Greek drama continued with Act II: the landslide victory of the extreme right *Syriza* party at the early elections. The newly elected Prime Minister

promised to eliminate the unpopular austerity measures and to set the Greek economy on a path of economic growth by means of stimulation packages. Prime Minister *Alexis Tsipras* appointed a young and charismatic Minister of Finance – *Yanis Varoufakis* – who attempted to convince a number of European Member States, including Germany, about the necessity of aid packages, but his German colleague utterly rejected the solution proposed by Varoufakis.

After the initial momentum, the economic paradigm shift outlined by the Greek government shortly ran out of breath due to the weaknesses of the monetary and economic aspects, comment the authors. Thus, in February 2015 the Greek Government had to accept a four-month extension of the existing credit programme which, albeit with minor concessions, continued to demand the aforementioned reforms. It is also clear that the February agreement merely gained some time for Athens as during the four months of negotiations that followed the agreement, the parties were unable to reach any solution to restore the confidence of creditors. Germany was increasingly considering the exit as the only possible solution. The only solution for the Greek drama dotted with a referendum, bank closures and a capital regulation was the exit of Varoufakis, which paved the way to a third aid package and the implementation of the necessary structural reforms.

In a review of this book published in The New York Review of Books, *Rana Foroohar* states that the euro crisis caused problems not only in the countries where it reared its head but shook the confidence of the overall population of Europe in the European edifice. Indeed, the only thing ordinary people could see during the crisis was *'a selfish European Union that rewards Germans above measure and favours the elite and among them, mainly the members of the financial elite'*. This was only aggravated by the way in which the EU handled the crisis, where the victim was blamed the most even though the German trade surplus was just as responsible – if not more – for the misbalance of the euro area and for the subsequent emergence of the crisis. For the most part, it was not mentioned during the crisis management that the most important creditors of Greece were German and French banks. Foroohar points out that the authors wisely discuss these facts in their book. The reviewer adds that it is clear now that the rescue of Greece was far from being just a neighbourly gesture; it was also an effort to save the banking system of wealthier countries. The authors of the book also explain why Berlin was against writing off a part of the Greek public debt, which was considered a possible and less painful solution by not only most of US and UK economists but also by the International Monetary Fund.[1]

In the course of the euro crisis Germany not only placed expectations on the Member States but also tried to exert a major influence on the European Central Bank (ECB) in charge of implementing the monetary policy of the euro area. All this is not by chance since, when the foundations of the ECB were laid in 1992, the German concept of an inflation targeting system prevailed against the French idea that is also more permissive in this regard. Inflation is a cardinal issue for the German central bank as a consequence of the unpleasant historic experience of Germany concerning the depreciation of its currency. In its 20th century history, Germany went through more than one hyperinflation periods that indirectly contributed to the rise of *Adolf Hitler*. It is not surprising, then, that in the second part of the 20th century one of the most important tasks of the German central bank was containing the inflation. This is why Germany stuck to its position favouring the inflation target in monetary policy in negotiating the Maastricht

Treaty. By contrast, France is much more lenient as regards inflation so it is not by chance that it resorted to the tool of devaluation on several occasions in the second half of the 20th century, since in the opinion of France the primary mission of the central bank is to guarantee social welfare rather than price stability – a far broader goal rooting from the 1789 declaration of human rights.

In the course of the crisis, however, the ECB applied unorthodox tools never before used in Europe that generated a significant resistance on the German side. These new alternative solutions of the central bank significantly jeopardised price stability, one of the most important objectives of German monetary policy. It was precisely because of the need to maintain price stability that the ECB had to resort to certain tools that were alien from the policy of European central banks, since the instruments of classical central bank monetary policy depleted over time, and the currency area was increasingly threatened by the peril of deflation. Central banks applied unconventional monetary policy solutions to exert influence not only on short-term but also on long-term interest rates. However, the German monetary policy interpreted price stability in a broader context including the need to exclude not only current but also future risk factors. Unorthodox solutions, however, imply an increase in future risk more often than not, which contradicts the German concept of monetary policy.

In their book the authors briefly present the differences between the traditional and the unorthodox policy of the central bank, calling attention, in particular, to the risk differences between the two forms of financing. While classical refinancing by the central bank represents low risk, unorthodox central bank policies – such as the bonds purchases, are far riskier since the issuer of the bonds may refuse to pay the debt, which in turn may generate losses for the central bank. On the other hand, the new, alternative monetary policy of central banks often dilutes the barrier between the direct and indirect financing of the state, although Berlin considers forbidden any direct financing of the state by the central bank. All this shows clearly that discrepancies were guaranteed between the ECB and the German government concerning the central bank policy in the course of the euro crisis.

The book guides the reader through the way in which the ECB introduced individual unorthodox monetary policy instruments and how they provoked step by step the resistance of first the German central bankers and then the German citizens. The central bank launched its first unorthodox action in 2009 within the framework of the *covered bond purchase programme* whereby the ECB and euro area central banks purchased covered corporate bonds for EUR 60 billion. This programme did not cause a clash of ideas between Berlin and the ECB until the acquisition of government bonds under the *Securities Markets Programme* (SMP) in May 2010. The introduction of the SMP programme generated tensions between Member States in the General Council of the ECB, although it was only the Governor of the German central bank, *Axel Weber,* who openly criticised the decision arguing that the SMP may give rise to a major stability risk. Despite the fierce attacks of German politicians and the press, the ECB went ahead with the launch of the programme.

In November 2011 *Jean-Claude Triche* was followed by *Mario Draghi* at the helm of the ECB, and his first action was to cut the key policy rate to 0.25 per cent. Not much later, in December the new President announced the ECB's *very long term refinancing operation* (VLTRO) providing liquidity for the banking system with a term of three years.

Despite the initial successes of the VLTRO, the deterioration of the securities market continued from early 2012, induced by the

increasingly high risk factors arriving from certain Southern Member States. As a result, cross-border capital flows stopped overnight in the euro area and thus, Southern Member States faced increasing difficulties in financing their public debts. However, before launching any monetary policy instrument, Mario Draghi intervened first with his notorious London speech. Markets received the words of the ECB President of the positively, and as a result, the bond yields of peripheral countries started to decline despite fierce attacks by the management of the German central bank. The verbal declarations of Draghi, however, convinced not only the markets but also Angela Merkel, who understood that in addition to the inflexible German economic consultants she needed independent experts that understand the behaviour of the markets better and may give a more adequate response to the current crisis. Therefore, the German chancellor supported the next unorthodox step made by Mario Draghi, namely, the intervention of the ECB on the government bond markets of the euro area in order to keep the interest rates on the bonds of indebted countries low. Although the President of Bundesbank *Jens Weidmann* and the German media furiously attacked the plan of Mario Draghi, the Board of Directors of the ECB approved the *Outright Monetary Transactions* (OMT) programme in 2012.

The OMT programme sparked the resistance of not only the German central bank but also the German public opinion, which is aptly demonstrated by the fact that by civil initiative the programme was submitted to the German Constitutional Court, which turned to the European Court of Justice concerning the matter. The decision of the European Court of Justice stated that the ECB did not breached the boundaries of its mandate. Thus Germany had to accept, more or less unwillingly, this new step of the unorthodox monetary policy of the ECB.

However, in early 2014 Mario Draghi realised that the decisions made theretofore were not achieving the desired effect and inflation stayed well below 2 per cent even in Germany, a country enjoying full employment. It appeared that the whole euro area would be caught in a deflationary spiral and the ECB needed to come up with new actions to counteract this unfavourable process. Following the actions made by numerous other central banks worldwide, the ECB introduced the negative interest rate and then launched its *targeted long term refinancing operations* (TLTROs) to provide liquid assets to the corporate sector. Eventually the ECB introduced the *asset-backed securities programme.* This programme was launched by the ECB to provide liquidity to the SME sector – constituting the backbone of the European economy but struggling with liquidity problems – by purchasing their securities.

By mid-2014 it became clear that the unorthodox toolkit of the central bank needed further enhancement and by January 2015 they formulated the *quantitative easing* (QE) programme. As a consequence, securities were purchased for EUR 60 billion, including government bonds in EUR 45 billion, asset-backed securities and covered bonds worth EUR 10 billion, and other institutional securities amounting to EUR 5 billion.

Opinions were rather different concerning the need for and the effect of the QE. Germany called into question the accuracy of the calculation of inflation expectations. On the other hand, it questioned not only the QE but also the effectiveness of the overall unorthodox monetary policy: in the opinion of Germany it was clear that the negative interest rates did not provide the desired effect and there were uncertainties whether the QE could achieve the desired output since Japanese and US experiences were theretofore ambiguous. Thirdly, Germany did not share a common

denominator with the ECB in the question of deflation either. In Germany's opinion, deflation does not always mean that consumers may postpone their consumption in the hope of even lower prices in the future. And finally, even the negative effect of deflation is unclear since there were several, long deflationary periods during the 19th century when both productivity and demand increased.

In summary, the book depicts how the differences in terms of economic philosophy and state organisation between the two most important countries of the European Union and their diverging historical experiences affect the European Union as a whole and the evolution of the common currency system. Until now, these clashes took place mainly behind the scenes in the history of the European Union, but the euro crisis finally revealed the different economic policy and monetary policy perceptions of the Member States. The authors close their book in an optimistic mood despite being aware of the result of the Brexit referendum, which is not a direct consequence of the euro crisis but certainly affected the voters in the UK indirectly. The book review of *The Economist* attributes the optimism of the authors to the fact that in addition to presenting the differences between the two countries in terms of historical and economic philosophy changes, they also remind the readers that the economic policy traditions of each country are not carved in stone.[2] All this may even mean that the German and French ideas may get closer to each other, and with that in mind, the authors conclude their book with some recommendations that may facilitate the development and the deepening of the euro area. That notwithstanding, *Matthew C. Klein* from *Financial Times* thinks that the arguments of the authors in this regard are not really convincing as indeed, they dedicated almost 400 pages to presenting the ideological gap separating the two predominant Member States of the European Union, which has been present in the history of the EU since the creation of the Common Market. However, in the opinion of Klein the book has an even larger deficiency in not demonstrating that the compromise forged between the two ideas is unable to guarantee an optimal solution and in certain cases, it even aggravates the situation instead of improving it.[3]

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Notes

[1] http://www.nybooks.com/articles/2016/12/08/the-brutal-battle-over-the-euro/

[2] https://www.economist.com/news/books-and-arts/21709281-founders-euro-have-fundamentally-different-ideas-about-how-single-currency

[3] https://www.ft.com/content/b7401bb0–8498–11e6–8897–2359a58ac7a5