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German Ordoliberals Vs. American Pragmatists: What Did They Get Right or Wrong in the Euro Crisis?

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Abstract

The editors of this volume explore the philosophical conflict between German Ordoliberalism and Anglo-Saxon or American pragmatism. This chapter asks which of these two approaches got which questions right with respect to the euro. In advance, the ordos correctly identified the problem of moral hazard in national fiscal policy, while the pragmatists correctly identified the problem that asymmetric shocks would create when national monetary policy was no longer available to respond to them. When the euro crisis hit in 2010, the ordos pointed out the importance of structural conditionality while the pragmatists were right to emphasize that fiscal austerity was highly contractionary and even worsened debt/GDP ratios.

I leave it to other contributors to elucidate the concepts of German Ordoliberalism and "American pragmatism" (or Anglo-Saxon pragmatism).[1] I will assume that we have a general idea to what each of these terms refers. I will focus, rather, on what the two approaches had to say about the euro crisis, including the policy issues that led up to it and the measures taken after the crisis arose.

Neither party had it all figured out. What did they get right and what did they get wrong? We begin with the origins of the euro and the roots of the crisis, before turning to attempts to deal with it in 2010 and thereafter.

What German ordoliberalism got right at the birth of the euro

German ordoliberals got some things right when the terms of European Economic Monetary Union were agreed at Maastricht in December 1991. They recognized that the danger of excessive national budget deficits – to which they are by nature always acutely sensitive – would be exacerbated by moral hazard from the anticipated likelihood of bailouts in the event of difficulty. Ordinary German citizens were wary of monetary union on the grounds that they would eventually be asked to bail out some profligate Mediterranean country. The leaders sought explicitly to address these concerns with a set of rules to bind euro members, which were agreed at the level of the European Union. These rules included:

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

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

Versus what U.S. "Pragmatism" had right

American economists tended to be skeptical of the euro project from the beginning.[4] Many of their concerns have been borne out, particularly concerns that European countries did not constitute an optimum currency area, certainly not to the extent that American states do.[5] They correctly predicted the importance of asymmetric or asynchronous shocks and the difficulty of dealing with them once countries had lost monetary independence. Ireland, for example, in 2004-06 needed a tighter monetary policy than the ECB (European Central Bank) was prepared to set, because it was experiencing a housing bubble and economic overheating; during 2009-2013 it needed an easier monetary policy than the ECB was prepared to set because it was in steep recession.

What German ordo got wrong, when fiscal rules were violated

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

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

- Repeated unrealistic assertion that fiscal targets would be met in the future, assertions that could only be maintained via consistently over-optimistic forecasts. Governments never forecast that they would have a budget deficit in excess of 3% 1999-2008, even

though they did, often in successive years.[6] (See Figures 1 and 2.) Rules that are too stringent to be credible can be worse than no rules at all. Greek indiscipline and ordo discipline interacted in such a way as to produce the worst of both worlds: When Greece joined the euro, it began to run one of the world's most pro-cyclical fiscal policies. (Figure 3 shows by country the correlation of the cyclical components of spending and GDP.[7])

- Refusal to write-down Greek debt in 2010, despite Debt Sustainability Analysis that showed the debt/GDP path to be explosive even with stringent fiscal austerity.

- Other forms of head-in-the-sand procrastination, notably a series of European summits that tended to "kick the can down the road."

- Vast underestimation by the troika (ECB, EU Commission and the IMF) in 2010 and thereafter of the fall in income that would follow from austerity in the periphery countries. Blanchard and Leigh (2013) argue convincingly that the underestimation of the severity of the recessions took the form of underestimation of fiscal multipliers. (See Figure 4.)

- Even leaving aside the economic cost of the recession and the political cost of associated populist anger, fiscal austerity did not achieve its financial goal of putting Greece and other periphery countries onto sustainable debt paths. To the contrary, the fall in GDP was greater than any fall in debt with the result that debt/GDP ratios rose at accelerated rates. (See Figure 5.)[8]

- Successive attempts to revise the SGP rules, such as the "Fiscal Compact" of 2012.

What everyone got wrong

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

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

Most observers also made the mistake all along of failing even to think about banking regulation at a pan-euro level let alone to propose going all the way and creating a banking union. It was only Greece that ran egregiously excessive budget deficits before 2008. Budget deficits and debt/GDP ratios were much more moderate in other countries like Ireland. There the problem was instead in the banking sector. To make a government debt problem out of a financial crisis that in turn had originated in a housing bubble, it took the euro crisis and a decision that the government of Ireland should bail out its banks, including large creditors.[9]

What the pragmatists' view still has right

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

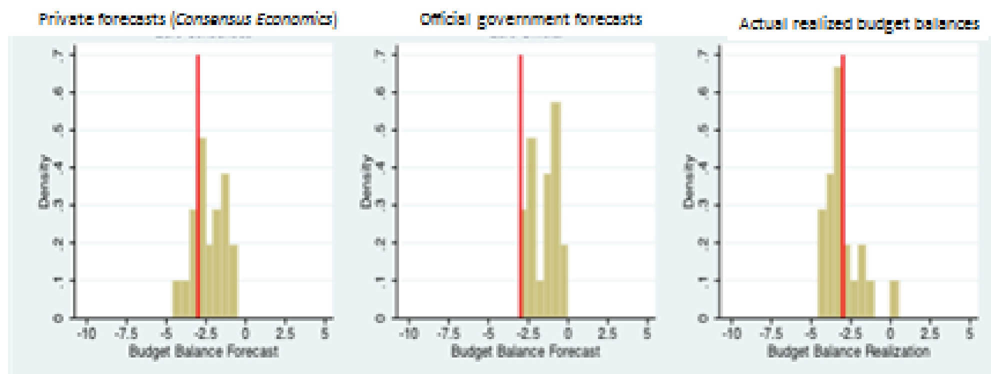
What ordoliberalism still has right

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

Figures

Fig. 1 -- In the euro countries which are subject to SGP rules,
the optimism bias was reflected in the practice of never officially
forecasting next year's budget deficit > 3% of GDP,
even though such deficits recurred, as seen by private forecasters.

Forecasts of budget balances and actual realizations, as % of GDP,
among euro-area countries, pre-2008



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

Fig. 2 -- Even though true Greek budget deficits in most years
were far in excess of the supposed limit (3% of GDP),

the official budget forecasts were always rosy…

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

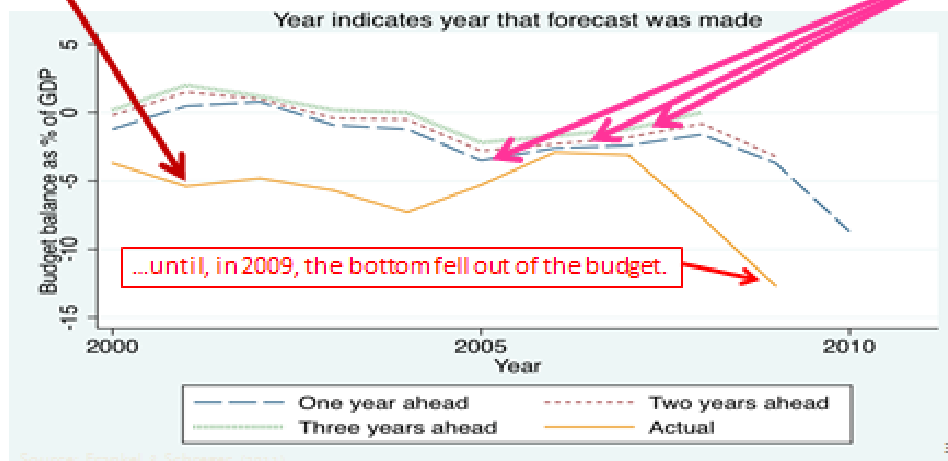


Fig. 3 --In the years after 2000, Greece adopted a pro-cyclical fiscal policy (positive correlation of G & GDP), while many developing countries began to go the other way.

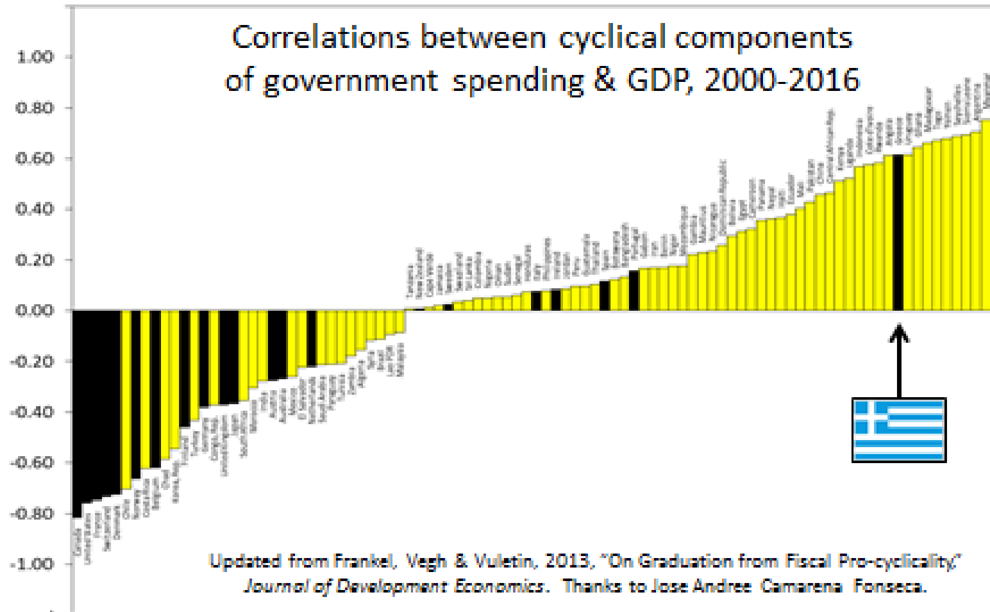
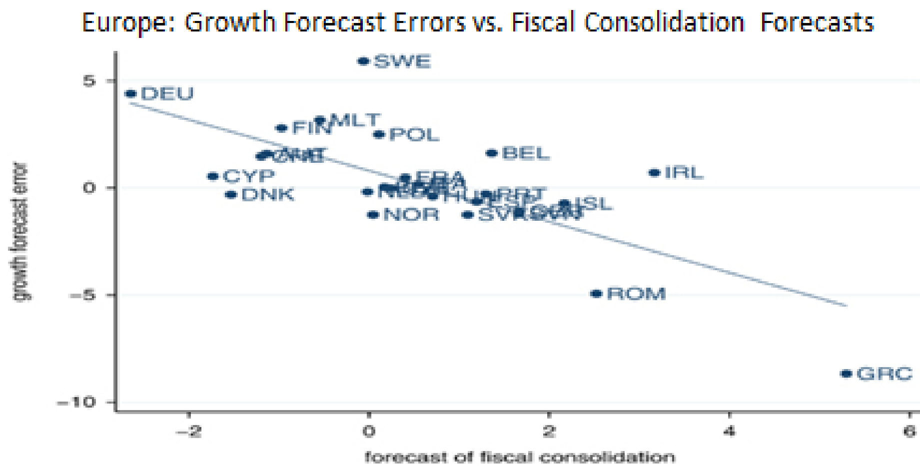


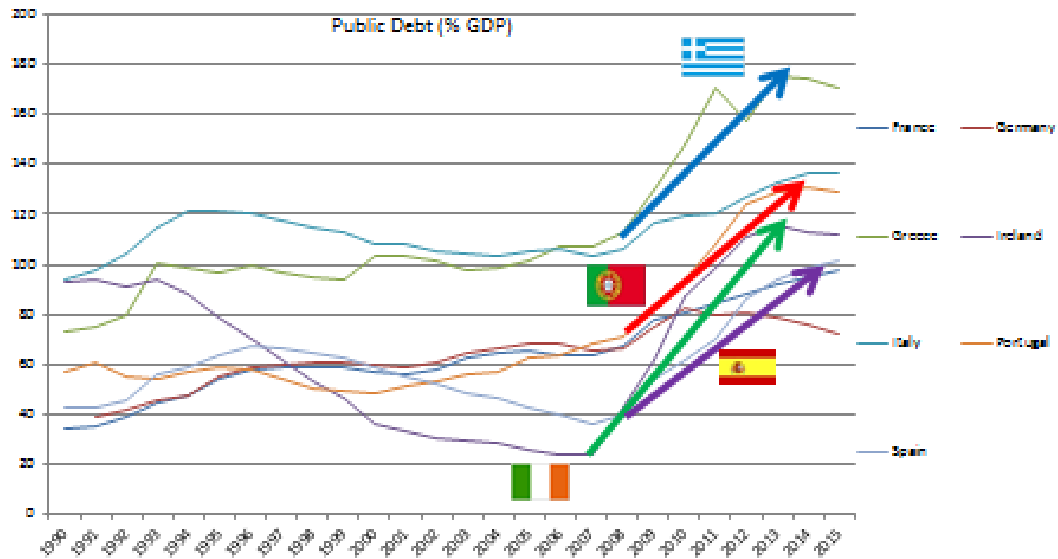
Fig. 4 -- The bigger the fiscal contraction, the bigger the GDP loss *relative to what had been officially forecast,* in the EU 2010-11.
=> True multipliers > than multipliers that IMF had been using.



Note: Figure plots forecast error for real GDP growth in 2010 and 2011 relative to forecasts made in the spring of 2010 on forecasts of fiscal consolidation for 2010 and 2011 made in spring of year 2010; and regression line.

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

Fig. 5: With austerity, debt/GDP ratios continued to rise sharply:
Declining GDP outweighed progress on reduction of budget deficits.



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

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Endnotes

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

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

[3] E.g., Buiter, Corsetti, and Roubini (1993).

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

[5] Eichengreen (1992).

[6] Frankel and Schreger (2013).

[7] The cyclical components of each were computed using a HP filter with $\lambda = 6.25$ and expressed as percentage deviations from the trend. For each country, the HP filter was applied exclusively to the common sample of spending and GDP (i.e., considering only the years for which data for both were available, so that any start-/end-of-sample bias of the HP filter would apply symmetrically to both variables). In addition, forecasts in the out-years until 2022 were included in both series before applying the HP filter.

[8] Fatás and Summers (2017) argue that fiscal austerity may have exacerbated debt/GDP paths not just in the short run but even in the long run.

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