Battle *of the* Economists

The inside story of Germany's internal policy knifefight.

BY KLAUS C. ENGELEN

A ghost is haunting major actors in the heated economic policy debate in Germany these days on how to get more than five million unemployed back to work, how to get frightened German consumers to start shopping again, and how to get the German economy to grow faster. This is crucial not only for Germany but also for all of Europe. After all, Germany represents about one-third of eurozone GDP. This country of 82 million needs much higher economic growth to finance its costly welfare system, cope with the long-lasting burden of German unity, and put its fiscal house in order.

Up in arms is the orthodox supply side-wedded economist establishment—at universities, economic research institutes, and even at the German Council of Economic Experts, the panel of five prominent economists who advise the government. Alarmed are the neo-conservative preachers for more reform and more belt-tightening who are dominating the airwaves, television screens, and print media.

They fear that the ghost of Karl Schiller—minister of economic affairs during 1966–72 whose Keynesian thinking was behind major innovations in economic policy-making—might come alive through Chancellor Gerhard Schröder's newly favored economic adviser. Schiller's Keynesian ghost has a name: Peter Bofinger, 50, economics professor at the University of Würzburg, whom Schröder appointed to the Council of Economic Experts last year and also unsuccessfully tried to put at the helm of the Deutsche Bundesbank.

Who was Karl Schiller? In terms of post-World War II German economic history, Schiller could be considered Number Two in the Hall of Fame of the country's economic ministers. Number One was, of course, the legendary Ludwig Erhard, the architect of Germany's post-war "economic miracle" (Wirtschaftswunder) and its special blend of "social market economy." Schiller, who taught economics at Hamburg University to such successful policymakers as former Chancellor Helmut Schmidt, became the first Social Democrat to run the economic ministry on the federal level. Under pressure from a slowing economy and inflation, Schiller argued for abandoning Erhard's laissez-faire orientation

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after he took office in a "Grand Coalition." Schiller was convinced that governments have both an obligation and the capacity to shape economic trends and to smooth out and counter the business cycle. Schiller's formula was "Globalsteuerung," or a global process by which government would not intervene in the details of the economy but would establish broad guidelines that would foster uninterrupted non-inflationary growth. For this purpose he pushed for legislation that would give the federal government greater authority to guide economic policy. In 1967, the Bundestag passed the Law for Promoting Stability and Growth that was considered a "Magna Carta" of economic medium-term management of the economy.

This law (Stabilitaetsgesetz) postulated four optimistic "magic aims" of stability of prices, high employment rate, economic growth, and external economic balance. The Council of Economic Experts was established in order to improve the quality of economic advice to the government. This body is what one might call the Mount Olympus for Germany's established economists. While in the United States the president and his administration can choose their own Council of Economic Advisers, the German Council consists of five independent economists who are appointed by the German president, after being nominated by the government, for a five-year term with possibility of renewal.

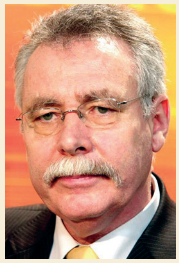
THE BIG GUNS OF GERMANY'S REFORM LOBBY

When Chancellor Schröder, in March 2003, made a U-turn from his social and labor market spending promises in the 2002 federal elections and outlined to parliament a radical downsizing of the welfare state, known as Agenda 2010, he had big guns to give him cover against the trade unions and the left wing in his own Social Democratic Party.

Agenda 2010 aimed at four main areas: relaxing rules protecting workers from dismissal along with other labor market reforms; modernizing the social welfare state; decreasing bureaucracy for small businesses and allowing crafts to launch new business ventures; and providing new low-interest loans to local authorities.

The Mudslinging Brigade

Recent squabbles put the German Council of Economic Experts (Sachverständigenrat), the panel of five leading economists who advise the government, in trouble. Public mud-slinging by its chairman, Wolfgang Wiegard, an orthodox supply-sider, against a newcomer, the more demand-oriented economist from Würzburg University, Peter Bofinger, hurt the Council's standing. Wiegard was upset because Bofinger, in spite of not being an expert on taxation, insisted on writing a minority opinion on tax issues. By now Wiegard has resigned and another member of the Council, Bert Rürup, whom Chancellor Schröder had asked to chair a commission on health-care reform, has taken over as the new ringmaster.



Wolfgang Wiegard: *His public mud-slinging against a newcomer, the more demand-oriented Peter Bofinger, hurt the Council's standing.*

Is the Council that advises on reforms in urgent need of reforming itself? Klaus Zimmermann, president of Berlin's DIW, and Michael Burda of Humboldt University have come out in favor of giving up the forty-year-old Council and following the U.S. example. This would mean that each government could choose its own economic advisors who then would be closer to the process of decision making. "No student could get by presenting his statistics the way the Council does, says Ulrich Blum, president of the Halle Institute for Economic Research. For some, the French Conseil d'Analyse Économique (CAE), in which about thirty top-notch independent economists work on half a dozen studies on pressing issues and then discuss the condensed papers with high government representatives, might be a better alternative. Considering that the German Council comes up with an annual report of one thousand pages (annexes included), the question arises of whether decision makers in government actually read it.

Paul J.J. Welfens of the University of Wuppertal also zoomed in on the Sachverständigenrat in a recent study. The main problem, says Welfens, "is lack of focus on macroeconomic problems and inadequate narrowing on supply-side aspects over many years." In Welfens' view, "There is too much emphasis on social security reforms and insufficient focus on potential for joint efforts of German states, the national governments, and the European Union in terms of growth policies. The opportunities associated with the expansion of the digital economy were not adequately considered by either the German Council or by the German government."

This shows that the economic advisers—and the government that isn't listening to their advice—need to start reforming if they want to regain lost credibility and become again worth their cost to taxpayers.

—K. Engelen

Poor Europe, Poor Germany

According to economic consultant Dieter Wermuth, policymakers, central bankers, and most economists in the eurozone—in particular in Germany—lack the pragmatism that characterizes policymaking in the United States, the United Kingdom, and other developed and emerging countries.

The implicit assumption in euro area policymaking, and German policymaking in particular, is that structural problems account for the high level of unemployment—about 9 percent for the European Monetary Union—and the pathetically slow growth of GDP in recent years. This means that monetary and fiscal stimulus would at best have a short-term effect on the real economy and lead to higher inflation later on. Structural reforms mainly mean that the wage spread between low- and well-qualified workers has to widen, that incentives for the unemployed to accept work more readily must be improved, and that income taxes should be cut. By defining away the possibility that there may be a significant cyclical element behind poor economic performance, European policymakers basically pursued pro-cyclical policies at a time when actual GDP growth had been significantly below potential.

The European Central Bank has now even put into question the concept of steady trend growth. To accept that it was still 2.25 percent per year, as it had frequently stated in the early years of EMU, would have meant accepting that output is now about five percentage points lower than at the cyclical high in 2000. Such a large output gap would allow considerably lower interest rates than the present 2 percent, without risking an acceleration of inflation. In reality, the ECB has some sort of rate hike envy and would love to move the intervention rate to what is considered a neutral level of perhaps 4 percent. So the tendency of public statements from the ECB continues to emphasize that a rate hike is not yet necessary, implying that a rate cut is not on the agenda at all.

Policymakers are also in a bind with regard to fiscal policies. The so-called Stability and Growth Pact forces them to adhere to the superficial concept of keeping the headline budget deficit below 3 percent of GDP at all times, a rule that is supposedly necessary to keep in check spendthrift Latin members of EMU who might try to piggy-back on Germany's virtuous policy record, using unusually low real interest rates to go overboard in their spending and tax policies. In effect, all of the recent deficits of 3 percent and more can easily and plausibly be explained by the widening output gap. Fiscal policymakers do not like this concept any more because it goes against their notion that all problems are really just structural, deficits in particular.

Dieter Wermuth:
The policy lacks "pragmatism."

Poor Europe, poor Germany! While the United States pragmatically filled the gap in demand which opened after the stock market decline of 2000 and the ensuing wealth destruction, with the well-known results of full employment, strong growth, and low inflation, politicians and central bankers on the European continent were caught in an ideological straightjacket which prevented, or minimized, monetary and fiscal stimuli. Structural reforms went ahead with considerable vigor, yet there are, so far, no positive results to show, such as briskly rising employment. Moreover, without various accounting tricks, unemployment would actually be higher than officially reported. The euro, meanwhile, moves from strength to strength, and Germany, supposedly the sick man of the continent, has just recorded the world's largest trade surplus ever. The supply side can not be in such deep trouble as policymakers, political opposition parties, central bankers, and mainstream economists have been indoctrinated to believe. There is, by all available evidence, a lack of demand, and hardly any supply side problems that could not be solved.

—K. Engelen

Prior to Schröder's reform initiative, there had been numerous calls for reform. Dominated by supply-siders, the "five wise men" had been presenting the Berlin government, year after year, with a long list of urgent reforms, very much corresponding to the advice coming from the six publicly funded economic institutes. Also, Germany's central bank, the Deutsche Bundesbank, joined the calls for tough reforms to prevent a long-term slide in Germany's prospects in a paper entitled "Ways out of the crisis."

Maybe even more effective were the scare-and-doomsday bestsellers, some by respected economists such as Hans-Werner Sinn, who heads the Munich Ifo Institute for Economic

Research and also chairs the Verein für Sozialpolitik (VS), Germany's quasi-equivalent of the American Economic Association. In his 2003 bestselling book *Ist Deutschland noch zu retten?* (Can Germany be saved?), he comes up with a drastic therapy for what he thinks is a hopelessly sick Germany:

- Lower wages by 10 percent to 15 percent, with less-qualified job seekers having to accept wage cuts of about one-third of their present level;
- Unify support payments for unemployed and welfare recipients at a level averaging about one-third below the then-prevailing welfare payments;
- Abolish employment protection laws against dismissal for both large and small enterprises;
- Terminate overall collective bargaining agreements, shifting collective bargaining autonomy into individual firms;
- Extend weekly working hours to at least 42 hours; and
- Cut taxes dramatically.

Also, German business weighed in with a new propaganda campaign aimed at discrediting those who speak out against cuts in welfare and unemployment support and against dismantling employment protection. While not direct, the obvious targets were Germany's trade unions. This way, the well-financed and well-connected new "think tank," the Initiative Neue Soziale Marktwirtschaft (INSM), lent a helping hand to Schröder's government in preparing a skeptical public for a series of austerity shocks. Under the somewhat misleading name "Chances for All," the new think tank is acting, according to its critics, as a "neo-conservative national campaign headquarters."

As Rudolf Speth, an expert on Germany's lobby system, concludes in a study on the political strategies of the INSM: "This modern think tank is most effective in communicating its reform messages to the public because it not only provides well-researched analysis but also makes sure that its contents are packaged to be used in campaigns and delivered in a highly professional manner." What raises questions of professional ethics and independence of the media in a democracy, says Speth, are the "media partnerships" that INSM is using to communicate its reform message to a broader public. "In the media partnerships of INSM, the borderlines between public relations and journalistic activities are not discernable anymore," says Speth. Otherwise highly respected print media—*Wirtschaftswoche, Impulse*, *Frankfurter Allgemeine Sonntagszeitung, Die Welt,* and *Handelsblatt*—are listed as "media partners" in the 46-page study commissioned by the Hans-Böckler-Stiftung, the research arm of Germany's trade unions. INSM also provides the talk shows with the largest audiences—like "Sabine Christiansen" on Sundays and "Berlin Mitte" (Maybrit Illner) on Thursdays—with its "ambassadors," i.e., an illustrious contingent of high-profile economics professors, politicians, company executives, high court judges, and other experts.

Established by one of the most important and well-financed employer organizations (Arbeitgeberverbände der Metall- und Elektro-Industrie) in 2000, the INSM can use the resources of the employer-supported Institut der deutschen Wirtschaft (IDW) in Cologne. It has a yearly budget of at least €10 million, or close to $13 million. With the former president of the Deutsche Bundesbank, Hans Tietmeyer, the INSM got a market reform preacher with high credibility, says lobby researcher Speth. Large segments of the German public—in particular those most affected—have no idea that the frequent appearance of well-known personalities on popular television shows calling for downsizing the welfare state and improving job opportunities by cutting employment protection are arranged by what Speth calls the "INSM public relations machine, the media firm Agentur Scholz & Friends." According to Speth, the INSM, along with similar initiatives financed by business interests to promote economic and social reforms, still have what he calls an "action dilemma": "These initiatives convinced the opinion leaders that reforms are needed, but still 80 percent of the population are still against such reforms." As was to be expected, increasingly the INSM is facing a credibility problem. For Karin Beindorff, a prominent commentator on Deutschlandfunk radio, "The initiative's message on billboards and its advertising all over the media landscape is making people believe that this is an appeal to the responsibility and solidarity of the community, but behind it there is nothing more than a business-sponsored lobby of a well-to-do-elite."

Large segments of the German public have no idea that the frequent appearance of well-known personalities on popular television shows calling for downsizing the welfare state and cutting of employment protection are arranged by what Speth calls the "INSM public relations machine."

WARNING: THE KEYNESIANS ARE COMING

It is somewhat ironic that after Schröder presented his reformist Agenda 2010, it was a former ghost writer of Karl Schiller, Albrecht Müller, who emerged as David against Goliath in the ensuing reform battle. Müller, who also had been economic advisor for two SPD chancellors—Willy Brandt and Helmut Schmidt—and who had run SPD election campaigns before serving in the German parliament for almost seven years, started his own counter movement against the austerity planners in the Berlin government and the Bundestag, the dominating supply-side oriented economics profession, and their reform propagandists in the media. Müller published a bestseller calling much of the reasoning and justifications for the Berlin government reform moves "falsities," "lies," "myths," and "legends" that will ruin Germany (*Die Reformlüge,* 2004).

He also made his Web site, www.nachdenkseiten.de, a popular rallying platform for those who oppose the Schröder government's practice of giving up "core" social promises and solidarity values which make the SPD's program different from the conservative and liberal parties.

Müller got support from other economists for whom "Keynesian" or "macro-demand management" are not dirty words and who still dare to call for wage increases in line with productivity. Peter Bofinger, the boyish-looking, media-friendly economics professor from Würzburg University, began appearing more frequently on the national television talk shows and—with the support of the German trade union federation DGB—was appointed as a new member of the Council of Economic Experts as a counterweight to the neo-conservative, supply-side oriented majority. Thus another member of the "Gang of Five" entered the arena.

Bofinger had been arguing for years that Germans would be better off paying themselves a lot more and spending more in the shops. As was to be expected, this approach created tension within the Council. Because Bofinger insisted on adding a minority opinion on taxes to the Council's annual report on the German economy, Wolfgang Wiegard, a staunch supply-sider, publicly rebuked the newcomer and handed in his resignation. In his view, Bofinger should have stayed away from tax issues because he lacked experience. The "five wise men" (including one woman), a panel of supposedly serious academic advisers, have been entertaining the country recently with some very public mudslinging. Introducing the "Keynesian pragmatist" to a wider international audience at the beginning of this year, the *Financial Times* headlined: "A maverick economist in the limelight as he breaks Germany's cosy consensus: Peter Bofinger has upstaged fellow national advisers by challenging mainstream views on how to solve economic ills."

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BOFINGER: A NEW CELEBRITY ECONOMIST ON THE NATIONAL STAGE

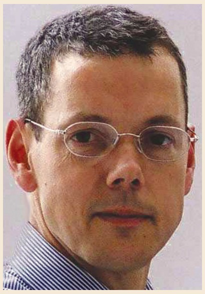
In his bestselling book with the optimistic and reassuring title, *We are better than we think,* Bofinger extensively refers to the legacy of Ludwig Erhard. (This is upsetting to Germany's mighty business-financed reform lobby that has made Erhard's legacy of "social market economy" its central theme.) Bofinger tried to show that Erhard's major concern was "prosperity for all." To achieve this, Germany's first economic minister favored higher wages, consumers unafraid to shop, and enterprises that are investing and creating new jobs in their country. Erhard

In his bestselling book, *We are better than we think,* economist Peter Bofinger extensively refers to the legacy of the legendary **Ludwig Erhard** [left], the architect of Germany's post-war "economic miracle" (Wirtschaftswunder) and its special blend of "social market economy." (This is upsetting to Germany's mighty business-financed reform lobby that has made Erhard's legacy of "social market economy" its central theme.) Bofinger tried to show that Erhard's major concern was "prosperity for all." Erhard would turn in his grave over a German economic policy that in effect lead to "prosperity for a few."

—K. Engelen

Ludwig Erhard, *Germany's first post-war economics minister and later chancellor (1963-66).*

The Gang of Five

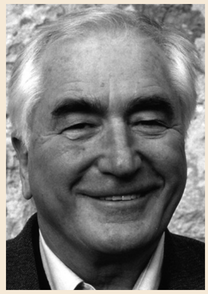


Peter Bofinger, *the boyish-looking, media-friendly economics professor from Würzburg University.*

Gustav Horn, *pushed out as key economist at DIW for supporting productivity-oriented wage increases.*

Heiner Flassbeck, *exposing the flaws of the Berlin government's economic and social policies.*

Rudolf Hickel, *of Bremen University, close to the unions, pushes for demand-oriented policy.*



Albrecht Müller, *advisor for two SPD chancellors, counters the austerity faction in Berlin.*

would turn in his grave over a German economic policy that in effect lead to "prosperity for a few."

Bofinger didn't mince words when taking on his prominent rival, Hans-Werner Sinn. He ridicules Sinn's doomsday thesis of a Germany that isn't really the world's largest export nation—the world's "Exportmeister." Sinn argues that an ever-greater share of cheaply produced imports means that Germany is becoming a "bazaar economy," losing ever more industrial production to the globalized economy and left with no choice other than to trade imported goods like a bazaar.

"Germany isn't really sick, but its doctors are making the patient sick due to the wrong therapy and ever stronger doses of medicine," says Bofinger. As to the wrong therapy: The effective tax burden in Germany is lower than in most other major countries. Only Japan and the United States impose a lower tax burden than Germany. The share of government spending in German GDP is not higher than it was thirty years ago and is close to the European average. That Germany is living beyond its means is fiction and not fact. So is the notion that Germany has problems in international competitiveness. It makes no sense if the huge transfer burden resulting from financing German unity—comparable in size to the total GDP of the Czech Republic or Hungary—is not taken into account. Adding insult to injury, the problems of the contribution-funded social safety system—that the previous Kohl government "shamelessly" used to finance German unity and avoid raising taxes—now are used as justification for drastic cuts of pensions, unemployment support, and raising health care costs, argues Bofinger. Bofinger's key message, as spelled out to the *Financial Times,* is that

> "We are now one of the most competitive countries in the world. … The problem is that demand for German exports is not feeding through into higher wages and thus internal demand. With the exception of Japan, our salaries are increasing less than in any other OECD country. Net real wages are stagnant or even declining."

As the *Financial Times* notes,

> "To some observers, Mr. Bofinger is simply a maverick in demanding stronger wage increases to boost internal demand—a similar stance to that of Oskar Lafontaine, the leftwing finance minister who resigned in 1999. But he is not easy to ignore."

It is revealing how Germany's economics establishment, up in arms about Bofinger's rise to stardom and access to Schröder's chancellery, is appraised by outside observers these days. In a not-so-friendly piece on Germany's economics profession, the *Economist* wrote recently:

> "German economists have long had the knack of going their own way. Until the second world war, they hailed mostly from the 'historical school,' which held that there was no such thing as economic rationality. In contrast, most are now wedded to neoclassicism, declaring that macroeconomic policy is ineffective and preferring to focus on supply-side issues. Labels such as 'Keynesian' or even 'pragmatic' have been insults. This partly reflects Germany's cultural fondness for consensus, not a competition of ideas. Michael Burda, an American economist at Berlin's Humboldt University, argues that German economics is only just escaping the middle ages."

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In order to raise German domestic demand to levels that would support higher growth, Bofinger proposes a return to a "productivity-orientated wage policy" across the eurozone. Wages would rise by the rate of productivity growth plus about 2 percent—the rate of inflation as targeted by the European Central Bank. For less competitive eurozone members, this would mean moderate wage increases. This way, according to Bofinger, "Germans would be substantially better off while improvements in competitiveness that have been made in the past few years would be maintained."

THE GANG OF FIVE IS FIGHTING A POWERFUL REFORM LOBBY

Who but a "gang of five" would oppose the "five Wise Men"?

Take Gustav Horn, who was pushed out as key economist at Deutsches Institut für Wirtschaftsforschung (DIW) in Berlin by his new boss Klaus Zimmermann, an orthodox supply-sider, because Horn was in favor—like Bofinger—of more productivity-oriented wage increases to support domestic demand. Horn was put in charge of a new research institute, the Institut für Makroökonomie und Konjunkturforschung, supported by the German trade unions through their foundation, the Hans-Böckler-Stiftung. Battered by a relentless "more reforms" campaign by the media—in recent years cleverly supplied with propaganda from the business-financed INSM—Germany's trade unions came to the conclusion that they needed a new "think tank" to defend what was left of Germany's "Sozialstaat" in which the unions for decades have been playing an important part, not only protecting their members but also defending the interests of the poor, sick, and old in society.

Also take Heiner Flassbeck, who once held Horn's job as head of the Business Cycles Department at DIW (1990–98) before moving to Bonn as State Secretary at the Federal Ministry of Finance under the Keynesian-oriented finance minister Oskar Lafontaine. From his present position as chief economist of UNCTAD in Geneva, Flassbeck has appeared in several German newspapers exposing the flaws and costly consequences of the Berlin government's economic and social policies. For example, he criticizes the "tunnel vision" of Germany's business-linked economists, like Michael Hüther, director of the Institut der deutschen Wirtschaft. Hüther, who took over the position from Gerhard Fels, laments that German consumers are not spending their money because they are afraid of the future. Thus the private household savings rate, in 2004, moved up from 10.7 percent to 10.9 percent, the highest level since the mid 1990s. To blame the problem of a bad consumer climate on higher savings—0.2 percentage points—and not to look at what happened to real wage income of the working people in 2004 is "treating people as stupid," says Flassbeck. According to the German Federal Statistics Office, wages paid by employers in 2004 stagnated at zero. Because the inflation rate was 1.5 percent, real wages dropped into negative territory for the first time in the history of the Federal Republic. Since average productivity growth for 2004 in the German economy was 1.3 percent, real income losses of employees amounted to 2.8 per cent for last year. That this important fact is not at the center of the public discussion, says Flassbeck, shows how much the reformers have come to present only their version of economic reality.

Finally there is another "maverick" economist, Rudolf Hickel, who teaches at Bremen University, who never stopped fighting for a more demand-oriented macro-management pointing to "what all the U.S. presidents and U.S. administrations under Alan Greenspan and before him have been doing." Hickel, who is close to the German unions, also serves on the supervisory boards of major German companies such as Allianz, Salzgitter, and Howaldtswerke-Deutsche Werft.

That this "gang of five"—Müller, Bofinger, Horn, Flassbeck, and Hickel—has not many nice things to say about the European Stability and Growth Pact isn't surprising. "For the governments that try to fulfil the pact, it will hurt growth," warns Horn. The pact, if not improved significantly, will require more restrictive fiscal policy—spending cuts or higher taxes—that in times of poor growth will lead to the opposite of what an economy needs to get back on its feet. For Bofinger, "The whole Stability and Growth Pact is conceptually flawed." In his view spending should only be restrained if it proves to be inflationary. And inflation is low in Germany, France, and Italy, the three countries that together account for three-quarters of the eurozone economy and are posting the slowest growth rate.

All this shows that the battle among the economists is still raging. Although the "Gang of Five" is dismissed by the supply-side mainstream as "ghosts" from Germany's Keynesian past, no one can deny that their contrarian views are shared by an increasing number of international economists and market strategists. In a recent interview with the German weekly *Die Zeit,* Jim O'Neill, head of global economic research for Goldman Sachs, characterized the German mainstream in economic policy as "absurd." And Daniel Gros, director of the Centre for European Policy Studies, argues that "Germany is engaged in 'competitive deflation' by curbing wage increases and increasing working hours." That even the *Economist* considers Germany a better place to invest than the United States (Germany's economy: A view from a different planet, February 19, 2005) should be reassuring. The outcome of Germany's reform struggle is still open. There might be surprises. With respect to one possible surprise, the *Financial Times* notes: "Mr. Bofinger's prominence has prompted speculation he might one day become Germany's representative on the ECB's executive board—or take over from Axel Weber as Bundesbank president. In either post his forthright views might make him even more of an attraction." ◆