Local politics & textbook economics at the heart of Europe’s financial crisis

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Introduction

If all politics is local, then all economics is to be found in first-year textbooks. The combined wisdom of Tip O’Neill and Paul Samuelson actually captures most of what can be said about the political economy of any country. It certainly describes much of the German response to Europe’s financial crisis and the frustration of US and other European officials who were urging a more robust response as the postwar project teetered on collapse. There are also continuing consequences today as the US finds itself buffeted by new political impulses and old economic ideas.

It is perhaps unfair – in retrospect and from afar – to criticise the crisis response of a democratically-elected government for excessive sensitivity to the preferences of its voters. Sending taxpayer money to a foreign country with incompetent or corrupt leaders is not a vote winner anywhere, even if Chancellor Merkel and her government ultimately made the case for their vision of European solidarity and conditional German financial commitments. Nevertheless, it remains a great puzzle that German officials and voters alike remain wedded to idiosyncratic macroeconomic theory that reinforced their reluctance to lead. These ideas remain at the heart of a debate around the future of the euro and how best to strike the balance between solidarity and responsibility within the common currency.

1 “All politics is local” is often attributed to Thomas P. (Tip) O’Neill, the Speaker of the US House of Representatives from 1977 to 1987. Nobel laureate Paul Samuelson distilled the power of basic shared economic ideas elegantly: “I don’t care who writes the nation’s laws – or crafts its advanced treatises – as long as I can write its economics textbooks.”
Above all, there is a barely concealed German supposition that debts and imbalances are *prima facie* evidence of political virtue and vice, rather than complex aggregates of economic policies and cycles. Germany’s success, according to this logic, depended upon paying down debt and boosting exports which complicated any discussion of shared responsibility for boosting demand within the Eurozone. It all but precluded a broader conversation about the role of German domestic demand in redressing global imbalances.

US officials, who were just recovering from the turmoil around the 2008 collapse of Lehman Brothers, felt confident that a failure of confidence in the euro’s capacity to respond required a generous and determined reaction from monetary and fiscal authorities. They were equally adamant that the global recovery would not be sustainable if it were driven entirely by the indebted American consumer. “Strong, sustainable and balanced growth” became the mantra of nearly every economic communique with the word “balanced” intended primarily for Beijing and Berlin, where the current account balances were significant. These differences are of more than historical interest. With the Trump Administration now fashioning an international policy that draws on protectionist politics and mercantilist economics, the conversation seems headed for a new and stormier phase.

**Brief history of the crisis**

The global financial crisis, which had its roots deep in the US subprime housing sector, was just starting to recede in early 2010 as a second global shock hit Europe. The response of European leaders and finance ministers bore a striking resemblance to what psychologists describe as the five stages of grief. Initially, there was widespread denial that anything might be wrong or that the ebbing confidence around Greek debt could not be easily addressed within the confines of existing European rules. As the turmoil spread, however, denial turned to anger as officials denounced malign global “speculators” for their attacks on sound European markets. When that failed to settle the storm, there began a scramble of bargaining with investors and other governments through 2011, in an effort to commit to the minimum possible financial commitments that might restore crumbling market confidence.
Loans to troubled states that were initially deemed immoral and illegal were soon approved in limited and highly conditional form. Even that, however, was not enough for the jittery bond markets, who immediately understood what one European official described as the flawed logic of the debate: private investors were being asked to trust euro governments – lending more money with fewer conditions – more than the governments themselves actually trusted each other. Only when Spain and Italy were pushed to the brink in 2012, with lots of peripheral talk about French economic vulnerability, were the ultimate steps toward taken integration, pooled sovereignty and large financial commitments.  

More important than the pace of the crisis in shaping the public debate was the order in which the crisis unfolded. Because the first bailout package was negotiated in Greece, and because the Greek problem was mainly fiscal, the debate was shaped as mainly an issue of prudent budget management. This played right into the most stubborn of German economic ideas around the importance of balanced budgets and paying down debts. In fact, the next countries to negotiate assistance faced very different economic challenges. Ireland enjoyed relatively sound fiscal dynamics until the government assumed responsibility for a collapsing banking system. Portugal’s main problem was poor growth rather than overspending. Overall, Eurozone debts had actually been falling in the years before the crisis. Greece’s disastrous public finances, however, made it easy to avoid discussions of lax bank regulation and imbalances that allowed large Germany surpluses to pour into unsustainable periphery debt and excessive real estate development.

**Local politics and Germany’s global role**

If the chronology of the crisis allowed Germany to shape the economic debate, domestic politics reinforced the reluctance to act. Beyond the inherent difficulty of convincing voters of the importance of sending support to a troubled neighbour, German politicians were still grappling with their country’s role as a European, indeed, global power. Since WWII, West Germany’s leaders had heard very mixed messages about just how active a role they should play in European and international affairs.

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2 For a more complete summary, please see Smart (2017).
Historically, a strong Germany had led neighbours to feel insecure, which led to tragic confrontation. With German reunification, French President François Mitterrand pressed the languishing common currency project as a key design element that would bind Germany’s growth and success inextricably to the growth and success of all Europe. But this did not end the confusion of the German voter, who may have accepted intellectually that European prosperity was good for Germany, but still focused naturally on what could be done to boost Germany’s own prosperity.

This dilemma highlights one of the great conundrums for outsiders in dealing with Europe – beyond the lack of a single phone number for Henry Kissinger. On issues like trade and investment, European politicians stress that they are part of a single continental juggernaut that can sit as an equal with the United States or China. There are other pursuits, like the United Nations, the International Monetary Fund or the Olympics, where Europeans revel in their many nation states in order to boost their votes or seats at the table or potential medal count. Then there are hybrid strategies where Europe sends both national and European representatives. Summits of G7 leaders, for example, include six European representatives.

In this context, it’s hardly a surprise that German economic policymakers chose to remain intently focused on the post-crisis recovery of Germany with only a glancing eye on developments elsewhere. Thus, while Germany’s fiscal policy remained far too tight for a monetary union struggling to restore growth and tackle unemployment, it was deemed just right for a domestic recovery that was coming along just fine. Outsiders pointed out, during the early phase of the crisis, that the Eurozone, as a whole, was running tighter fiscal and monetary policy than either the US or Japan even while its debt and deficits were smaller. The European Union’s Stability and Growth Pact operated entirely on member state scorecards rather than an integrated view of the currency union and German officials added that they would soon, in any case, have a constitutional requirement to balance their budget.

Strikingly, when the conversation turned to imbalances, German officials were suddenly more European. The Eurozone, they hastened to point out, was broadly in balance with its trading partners, while the German surplus merely reflected idiosyncratic differences that could not be changed and certainly weren’t worth discussing.
On the other hand, when the European Central Bank launched its quantitative easing programme, some German politicians turned apoplectic at what they saw as putting their Bundesbank’s integrity – and balance sheet – at risk. If the value of the euro was clearly too strong for the European periphery, there was little acknowledgment that its relative weakness offered an extra boost to German exports. Germany had managed the best of both worlds, benefitting from its role at the heart of one of the world’s great economies, yet uncommitted to support the broader institutions when outside shocks threatened.³

Talking past each other

While political differences drive most divergences over economic policy, few are aggravated by such stark differences over the economic ideas themselves. Countries may disagree about whether they need to tighten fiscal policy, but they will not disagree about whether tightening contributes to growth. Tracing the dominant strains of German economic policy to their intellectual roots in scholarship and history remains a task of great complexity. The teachings of ‘ordoliberalism’ or the legacy of Weimar hyperinflation surely played some part in shaping a policy framework for Germany’s economic officials through the euro crisis. What was undeniable for US and other European officials engaged with their German counterparts was the absence of a shared intellectual framework around either the role of fiscal policy in a crisis or the malign effect of persistent economic imbalances.

The former was particularly striking as US officials believed they had not only generally accepted theory on their side, but recent practice as well. In terms of theory, the proper role of fiscal policy in supporting economic growth has long been debated, but there is a real consensus that a systemic shock that leads to a sudden stop in capital flows and collapse in demand requires massive and extended response. US officials believed that their own response, which included a fiscal deficit near 10% of gross domestic product and a Federal Reserve balance sheet that more than quadrupled in size, were not only crucial in restoring confidence but conclusive in demonstrating good policy.

³ There is nothing particularly German about this dynamic. Early US economic history was almost entirely a story of farm and industrial states choosing how and how deeply to pool resources in support of federal institutions. For an elegant retelling, see Lowenstein (2015).
The US recovery was well entrenched long after European growth returned to pre-crisis levels. But German policymakers were unimpressed. After a substantial, but brief, fiscal response, Finance Minister Schäuble and his team focused intently on returning their budget to balance – indeed a small surplus – dictated by their new ‘debt brake’. German lawmakers would chuckle at a foreign visitor’s suggestion that not only Germany, but Europe as a whole, needed more support for demand from fiscal authorities and that Germany was the country that could best afford to contribute. “Surely, you don’t still believe in Keynes?” they would ask. US advice was in any case only barely credible (even if it were intermittently welcome) given America’s role in the global crisis and its own broken budget and debt limit process.

Throughout, there was a sense that any response that involved increasing Germany’s national debt was more than a policy mistake, but was a moral mistake as well. Only in Germany, complained Italy’s then-Prime Minister Mario Monti, is economics considered a branch of moral philosophy. It wasn’t just that lending money was difficult for the lender, it was harmful to the borrower as well, enshrining bad habits and discouraging reform. And entwined with this moralism, of course, were basic assumptions about human nature, just as they cut across the political spectrum in many countries. Does support provide comfort for the afflicted or does it encourage profligacy? In the European context, the metaphors (and stereotypes) flew. Greece was an alcoholic who needed tough love. Additional support for Italians would simply finance la dolce vita. There was a natural concern for moral hazard, but the insistence that any support could only follow demonstrated commitment to reforms seemed based on a sly logic: countries need to reform before they qualify for money, but once they reform the money will be unnecessary.

There was a similar conversation over global imbalances, whether within the Eurozone or globally. The intellectual assumption during the early history of the euro had been that imbalances within a currency union like the Eurozone didn’t matter. Even when the union was driven to the brink by a sudden stop in financial flows, there was little sober introspection in Germany at how its own surpluses had financed the periphery’s excesses. There was even less examination of how German banks and investors had profited from the boom and were threatened by the bust.
The broader global conversation similarly fell on deaf ears. “Why do you want us to export less?” was the typical response when the question was raised. In few other countries would suggestions of how to boost economic activity meet so many puzzled looks. More investment in infrastructure, childcare that boosts female workforce participation and deregulation of service industries might all raise domestic demand and German incomes, even as they helped redress imbalances. More often than not, however, explanations that Germany should not export less but import more as part of its continental and global responsibility led straight back to a conversation about the moral evils of deficits and debts.4

The next chapter

These issues might be mostly of historical interest as the European economy recovers, yet local politics and economic theory continue to shape Europe’s continuing efforts to build common institutions. The European Central Bank’s strategy to normalise its balance sheet, Italy’s efforts to address bad bank loans and the prospects of Eurozone deposit insurance will all depend on German ideas about its role within Europe and its understanding of good economic policy. The global economic debate, meanwhile, has taken a sharp turn with the Trump Administration’s fresh blend of protectionist ideas and mercantilist assumptions. “The Germans are bad, really bad,” the President told Der Spiegel in May 2017. “Look at all the millions of cars they sell in the US. It’s terrible.” Germany’s economic ideas are hardly responsible for US presidential election outcomes, but persistent surpluses fuel talk of unfairness and retaliation. Even as Europe struggles to balance competing visions of its future, we may be on the verge of a much greater transatlantic misalignment of politics and theory with even greater consequences.

4 America often forgets that it took a far more benign view of surpluses when it was running one of its own after World War II. See Steil (2013).
References


About the author

Christopher Smart is Senior Fellow in the Geoeconomics and Strategy Program at the Carnegie Endowment for International Peace following six years in the Obama Administration as a senior policymaker for international economic affairs. As Special Assistant to the President at the National Economic Council and the National Security Council, he was principal advisor on trade, investment and a wide range of global economic issues. From 2009-13, he was Deputy Assistant Secretary of Treasury, where he led the response to the European financial crisis and designed US engagement on financial policy across Europe, Russia and Central Asia.

Before entering government, Dr. Smart was Director of International Investments at Pioneer Investments where he managed top-performing Emerging Markets and International portfolios. Following the collapse of the Soviet Union, he worked in Moscow, advising Russian government agencies on economic policy and financial market reform. Earlier in his career, he was a journalist in St. Petersburg, Florida and Paris, France.

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