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Bad for Euroland, Worse for Germany—The ECB's Record

by

Jörg Bibow*

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*Franklin College Switzerland, Via Ponte Tresa 29, CH-6924 Sorengo, jbibow@fc.edu.
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The Levy Economics Institute
P.O. Box 5000
Annandale-on-Hudson, NY 12504-5000
<http://www.levy.org>

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ABSTRACT

This paper assesses the contribution of the European Central Bank (ECB) to Germany's ongoing economic crisis, a vicious circle of decline in which the country has become stuck since the early 1990s. It is argued that the ECB continues the Bundesbank tradition of asymmetric policymaking: the bank is quick to hike, but slow to ease. It thereby acts as a brake on growth. This approach has worked for the Bundesbank in the past because other banks behaved differently. Exporting the Bundesbank "success story" to Euroland has undermined its working, however; given its sheer size, Euroland simply cannot freeload on external stimuli forever. While Euroland cannot do without proper demand management, the Maastricht regime and especially the ECB are firmly geared against it. The ECB's monetary policies have been biased against growth and have thus proved bad for Euroland as a whole. Meanwhile, the German disease of protracted domestic demand weakness has spread across much of Euroland. Yet, by pursuing its peculiar traditions of wage restraint and procyclical public thrift, the ECB's policies have had even worse results for Germany. Fragility and divergence undermine the euro's long-term survival.

Key words: German unification, Bundesbank, policy inconsistency, stability culture, ECB, EMU

JEL classifications: E31, E42, E58, E61, E63, E65, E66, H62

OF THE GRAND IDEA OF A GERMAN-STYLE EMU, BUNDESBANK TRADITIONS, AND WHAT MAASTRICHT REALLY MEANT

The idea of establishing an economic and monetary union in Europe goes back a long way to almost the beginning of the post-WWII era, reaching a first peak with the famous “Werner Plan” of 1970. It may be fair to say though that Germany was never at the forefront of this movement towards a single European currency. In the age-old dispute between the so-called “economists” and “monetarists,” both Germany’s economics profession as well as political authorities championed the “coronation theory,” according to which a common currency had to be the gracious final step in a drawn-out process that could only be risked if economic and political integration had been firmly achieved beforehand. Germany’s acclaimed guardian of monetary stability, the Deutsche Bundesbank, represented a stronghold of this view. And suspicions of the bank’s fierce opposition to EMU were never far from the surface, abroad and at home. For good reason, some would say, this influential institution was never too keen to lose its powerful grip on monetary affairs in Germany, and Europe too.

While the complacent view that what was good for Germany had to be good for the rest of Europe too, may have been popular in Germany, much of the rest of Europe found Germany’s monetary hegemony increasingly intolerable; and quite understandably so. In the second half of the 1980s, in the context of the “Single Market Programme” and as the Basle-Nyborg agreement confirmed the deutschmark’s status as the anchor currency within the “hard EMS,” the idea of replacing the unloved (outside of Germany) hegemon attained new strength. Europe was lucky that not all German leaders were unsympathetic to the idea, as the Genscher memorandum of 1988 showed. Helmut Kohl’s part in getting the Bundesbank aboard and the euro afloat cannot be overrated.

In any case, it was probably always clear to the German mind that if Germany were ever to give up its beloved deutschmark at all, the successor would have to be at least as hard and strong and sound as the deutschmark itself ever was. From a German perspective, the prospect of a successful EMU always featured exporting the Bundesbank cum deutschmark “success story” to Europe as a *sine qua non*. The Delors Commission—with Bundesbank president Karl-Otto Poehl in charge—set the scene. And while a number of details may have been compromised on at the Maastricht negotiations of 1990-91, reflecting the fact that views and predispositions in the rest of Europe were in many cases fundamentally different ones,

essentially, Germany got its way in the end. In a nutshell, if German monetary hegemony was to be overcome, Europe simply had to swallow Germany's conditions (or, the Bundesbank's; for its own abdication, that is).

Not only was the ECB modelled on the Bundesbank—Germany's acclaimed guardian of monetary stability provided the blueprint for the structure of monetary policy in EMU. The ECB's independence even surpasses the Bundesbank's, secured at the constitutional level rather than just by a simple law. In addition, under the Bundesbank's former chief economist Otmar Issing, the pursuance of a "stability-oriented" course was guaranteed, too; as was the adoption of other Bundesbank traditions. The ECB's overall autocratic style and peculiar public relations is a case in point, featuring a passion for continuous public criticisms of issues relating to any other policy area—paired with the standard dismissal of any criticism of its own policies and practices as an attack on its all-important independence.¹ To make the case really watertight, the ECB was to be further protected from fiscal policy by a "Stability Pact" that would keep finance ministers' fingers firmly away from the printing press. Clearly, the presumption in all this was that by exporting Germany's success model, this would work even better, both for Europe as well as for Germany itself.

Alas, this is not the way things have played out since 1999—which raises the question why not. One answer stresses the role of allegedly all-pervasive "structural problems" in Germany and across Euroland as the sole cause of all troubles. This "explanation" is especially popular in Germany itself, where a tradition of "supply-side-only" economics holds sway (for a critique see Hein and Truger 2005). While the emphasis of structural problems is popular among Anglo-Saxon mainstream economists, too, the attitude is usually a more balanced one, with structural reform and demand management seen as complements (Posen 2003).

My own position is that while I would not deny the desirability of certain reforms, carrying through with structural reform without proper demand management may be worse than useless. The fact is that, except for the four-year interruption around unification, Germany has operated way below potential ever since the early 1980s. And, for reasons to be investigated in what follows, the situation for much of the rest of Euroland is becoming more and more similar

¹ See Henning 1994, Kenen 1995, and Dyson and Featherstone 1999 on the route to Maastricht. See Bibow 2004b on Bundesbank history and the intellectual origins for the Maastricht regime. In this context, it is quite extraordinary that Otmar Issing should try to paint this regime as having anything to do with the views of Walter Eucken on sound "Ordnungspolitik" (see Issing 2004). Discretionary interest rate policies by uncontrolled central bank politicians are totally alien to Eucken's (1952) scheme. One might then just as well assert that Keynes's key insight was that fiscal policy is always and everywhere ineffective.

to the German malaise. Arguably, under such conditions structural reforms may actually do more harm than any good. Certainly I consider assertions to the effect that structural reforms and/or fiscal consolidation *by themselves*—through alleged “confidence effects” or so—would always and everywhere automatically look after sufficient domestic demand as no better than plain nonsense. (And unfortunately it is this kind of “wisdom” that has dominated economic policymaking in Germany for more than two decades now; cf. Roloff 2002). Thus, the emphasis in what follows will be on the peculiar macroeconomic policies that Germany and Euroland have had to put up with, especially the policies of the ECB.

In this regard, the key to “stability-orientation” *à la* Bundesbank is the *asymmetry* in approach and mindset. Metaphorically speaking, the ECB acts like a driver who is quick at slamming the brakes, but notoriously abstains from using the accelerator. While, quite obviously, this is not a recipe for smooth driving, it does beg the question why it seems to have worked for the Bundesbank, and quite well for so long.

Essentially, it worked for the Bundesbank because, and as long as, everyone else behaved differently. In particular, the Bundesbank’s peculiar driving style worked fine when nominal exchange rates were stable, Germany’s trading partners’ inflation generally higher than its own, and as the accelerator was applied skilfully “elsewhere in the world economy” (to borrow one of those phrases the ECB coined to pass on the buck). Things worked best under Bretton Woods. The situation was then almost replicated under the “hard EMS” of the 1980s; with the rest of Europe bearing the economic and fiscal brunt of Buba wisdom. In Germany’s case, misconceptions about an—apparently—successful consolidation strategy of the 1980s that was to be replicated at the European level were important too.

In fact, and as an early warning of things to come, the Maastricht convergence process of disinflation cum coordinated fiscal consolidation saw Europe moving towards the brink of stagnation by the mid 1990s. Luckily the U.S.’s “new-era” growth and soaring dollar provided a last-minute external lifeline that allowed EMU to go ahead. Not quite so luckily, today’s international imbalances are also partly rooted in these events.

For the Maastricht Treaty meant the creation of an economic area comparable in size to the U.S. economy, but without a proper demand management regime in place and with certain key policymakers’ mindset firmly predisposed against the use of stabilization policies. Ironically, exporting the Buba “success story” was doomed to failure because it had only worked in the past—and for Germany alone!—exactly for the fact that everyone else behaved

differently. Hence a regime change requiring everyone else too to behave just like Germany was surely asking for trouble. But Germany got itself into deep trouble even before EMU started—namely by severe macroeconomic policy blunders in response to unification. A closer look at those blunders offers some interesting lessons concerning events that have since been unfolding across Euroland.

OF GERMANY'S PRE-EMU HISTORY AND THE UNIFICATION CHALLENGE: MIRACLES AND BLUNDERS, AND A LASTING BURDEN

It cannot be denied that unification presented Germany with a huge economic challenge. With East Germany's capital stock in a pitiable shape, massive public and private investment for years and decades to come was the only way toward narrowing the gap in comparison to advanced economies. Luckily, West Germany was in a favorable economic position as the happy event drew near. After having grown rather sluggishly since the 1981-82 recession as a result of fiscal austerity and Bundesbank restraint, which led to weak demand, slack investment, and underutilized capacity, growth of the former West German economy picked up markedly toward the end of the decade.

It so happened that, in 1989, when the Berlin wall came down, there was noninflationary and broad-based GDP growth due to strong domestic and foreign demand that yielded high employment growth and a balanced budget, together with a trade surplus of 5 percent of GDP. While exports, traditionally relied upon for igniting demand-led growth, performed strongly (and the oil price slump of 1986 rendered a terms-of-trade boon), fiscal and monetary policies too contributed (although belatedly) to the recovery in domestic demand as a result of income tax cuts in 1986 and 1988 (and also in 1990), along with an accommodative monetary stance (in the aftermath of the 1987 stock market crash) that lasted until mid-1989.

In the years 1990-91, the former West Germany's economy coped impressively smoothly with the strains that unification put on its resources (see Bibow 2003). Real GDP grew at a solid rate of five percent in both years, and while producer price inflation remained stable at around 2 percent, and underlying CPI inflation was stable at around 2.5 percent; perfectly in line with the inflation trend during the 1980s. Investment, potential output, and labor productivity grew rapidly, with the result that supply-side growth was both strong and broad-based. Employment growth was evenly distributed and included people previously classified as structurally unemployed. Moreover, the influx of labor from the former East Germany provided

important supply-side relief, so that general labor market pressures were abated. In addition, Germany drew on increasingly underutilized foreign resources; as reflected by the swift swing in the current account (from a 5 percent of GDP surplus in 1989 to a small deficit in the early 1990s).

For one thing, Germany's current account swing confirmed that unification also represented a great chance for Europe to stay clear from the slump that was hitting, for instance, the U.S., the U.K., and Japan at the time. For another, Germany's stellar performance over the four-year period of 1988-1991, during which the alleged structural paralytic grew at a 4-5 percent annual pace without any significant rise in *market-determined* inflation, produced the very evidence to put the structural ("eurosclerosis") myth to rest (that was much en vogue during the 1980s too). Miraculously, it would have seemed for lack of any profound structural reforms, Germany enjoyed an employment boom just at a time when—for once—domestic demand grew strongly too.

This lucky situation, which had come about by historical accident, was not to last however. Clearly the order of the day was to sustain growth and investment. But the Bundesbank was determined to slam the brakes, and slam them hard too. With Helmut Schlesinger at the helm, the Bundesbank pushed real interest rates up to 5-6 in 1991, a level that was bound to crash Western Germany's economy. Subsequently, with Hans Tietmeyer at the helm, the Bundesbank even surpassed its own historical record when it eased interest rates in an extraordinarily slow fashion. From early on, though, the Bundesbank mounted its pressure on the government to cut the budget deficit (Akerlof et al. 1991, Smith Owen 1994, von Hagen 1994).

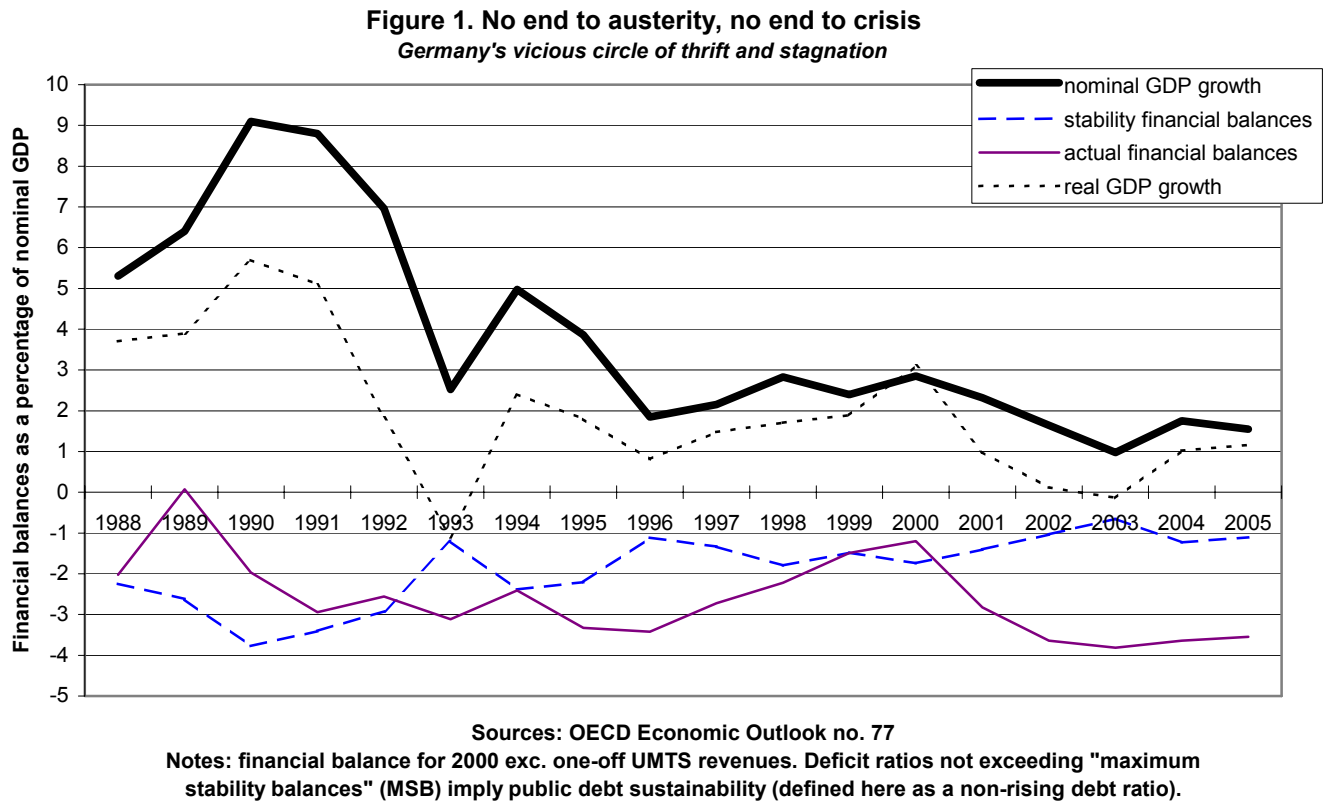
It is true that from 1989 to 1991 the German government deliberately relied upon borrowing to take up almost the whole of unification's fiscal brunt. By 1991, an overall budget deficit of €44 billion (a deficit ratio of 2.9 percent) had replaced a budget that was balanced in 1989. Starting in 1992, the government began to introduce a series of new fiscal measures aimed at cutting its borrowing requirements. Between 1992 and 1995 a cumulative fiscal tightening occurred that was far in excess of initial borrowing requirements. According to Heilemann and Rappen (1997), by 1995, the total effect of expenditure savings and increases in taxes and social security contributions was sufficient to finance almost the whole of *gross* fiscal transfers amounting to €92 billion. Paradoxically, as it might have seemed, Germany's deficit ratio did not decline, but rose instead, reaching 3.4 percent in 1996.

As we know today, Germany has yet to emerge from the debt trap it seems to have fallen into in the aftermath of its unification. After a last-minute dash below the Maastricht three percent hurdle in 1997 due to a U.S. sponsored export boom followed by a brief spurt of growth in 1999-2000, Germany has breeched the three-percent limit of the Stability and Growth Pact in every year since 2002—and is currently expected to continue doing so until 2007. Accordingly, for years to come, Germany is expected to cut its structural budget deficit by at least 0.5 percent of GDP per year *no matter what*. This follows from the rules of the Stability and Growth Pact as currently interpreted, and it abides by the fiscal wisdom that has guided fiscal policy in Germany and much of Euroland since the early 1990s. This wisdom asserts that one should never worry too much about possible negative demand effects of fiscal consolidation (so-called Keynesian effects). But trust that fiscal consolidation will stimulate domestic demand instead (so-called non-Keynesian effects).

From the beginning the “German view” (cf. Hellwig and Neumann 1987, Fels and Flöhlich 1987, Bibow 2004d) has been a rather dubious story at best. Of course “non-Keynesian effects” may arise in situations of financial crisis to the extent that the announcement of fiscal austerity leads to sufficiently sharp falls in interest rates. And, of course, dwarf economies like Ireland’s, for instance, may be lucky enough to get away with a pro-cyclical fiscal squeeze while relying on net exports to keep the economy afloat. By contrast, in cases like Germany’s, sufficient interest rate falls can only be delivered by monetary policy to begin with, while freeloading on net exports is hazardous as it assumes that trade partners may be complacent enough in allowing their trade positions to deteriorate correspondingly. Clearly, then, in Euroland’s case even more so than in Germany’s, the latter is not a viable option at all, so that the whole burden to compensate public thrift campaigns clearly shifts to monetary policy alone.

In view of popular myths about the “burden of unification” that allegedly still plagues Germany today it is important to get the record straight here. It is undeniable that unification destabilized former East Germany’s economy; even though the event may just have been the trigger of ultimate wreckage of what was wrecked anyway. In any case, large-scale public transfers were an *inevitable* consequence of this—the price to be paid for this historical responsibility. Transfers were needed both to cope with the resulting unemployment as well as for building up a first-world capital stock. The fact is that Western Germany’s economy coped smoothly with this challenge initially: through strong, non-inflationary growth. Another fact is that Germany could easily rely on foreign support too, since it started out from an intolerably

large current account surplus and foreign resources were abundantly underutilized anyway. Finally, another key fact is that Germany's public finances remained on a sustainable course initially. There was thus no reason to panic. To sustain investment and growth was the order of the day.



In this context, it should always be remembered that even a permanent deficit of 3 percent of GDP can be sustainable at a non-rising 60 percent debt ratio, namely as long as nominal GDP grows at five percent (Domar 1944, Pasinetti 1998, Bibow 2003, 2004a). In actual fact, Germany was lucky enough in having a significant margin left *after* the fiscal brunt of unification had hit the budget. Figure 1 summarizes how Germany subsequently maneuvered itself into a debt trap, namely by crushing GDP growth. To test whether or not the particular parameter constellation prevalent in any year would have implied a rising debt ratio, the “stability financial balance” is defined here as the deficit ratio that is indefinitely sustainable given the actual rate of nominal GDP growth and actual debt ratio for a particular period. As long as the actual financial balance does not exceed the stability financial balance this implies

sustainable debt dynamics in the form of a nonrising debt ratio. Correspondingly, the concept of the “sustainability gap” may be defined as the difference between actual and stability balances.

The point is that Germany’s fiscal troubles were not a direct consequence of unification (i.e. transfers to the East), but of plunging GDP growth in the West. Since 1993 a rising sustainability gap has opened up as Germany’s consolidation efforts *no matter what* did not reduce the deficit ratio, but slashed the GDP growth rate instead.

Importantly, starting out from a balanced budget and a debt ratio of 40 percent in 1989, there was no need for GDP growth to continue at five and nine percent in real and nominal terms, respectively. My argument does not presume the perpetuation of the four-year miracle that had debunked the structural myth of the 1980s. Rather, the sad fact is that over the course of the 1990s, GDP growth was actually crushed to zero and below two percent in real and nominal terms, respectively. This came about not due to sudden structural problems or external shocks, but as a consequence of remarkably inept macroeconomic policymaking. While the Bundesbank inflicted a long span of ultra-tight money that lasted from the early until the mid 1990s, Theo Waigel turned the fiscal rudder hard right in 1992, embarking on that fateful path of senseless public thrift campaigns from which Germany has never strayed since. Together, these macroeconomic policies massively and persistently destabilized *Western* Germany’s economy.

Puzzlingly, as it may have seemed, even as domestic demand was crushed and stagnation set in, inflation proved rather persistent: staying “above 2 percent” until 1995. This was due to a phenomenon that I dubbed “tax-push inflation” (Bibow 1998) and of which more will be heard momentarily. At this stage, the important point is that while wreckage in the East and a corresponding “burden of unification” was quite inevitable, this second burden in the West was not. As a consequence, however, EMU started with united Germany being in particularly poor shape.

OF BUNDESBANK LEGACIES AND ECB BLUNDERS WITH NO END

No doubt the Bundesbank’s legacies confronted the ECB with a formidable challenge. After the monetary overkill in response to German unification, followed by very sluggish interest rate cuts, which had left Germany in the doldrums by the mid-nineties, the Bundesbank proved all too keen to hike interest rates in October 1997. By that time Germany was barely emerging from stagnation—thanks to U.S.-sponsored export growth. When only a little later Germany was then

hit by the Asian and Russian crises, the Bundesbank exemplified the peculiar tradition referred to above: it simply refused to cut interest rates; much in contrast to central banks like the U.S. Fed and the Bank of England. And on top of its failure to ease, the Bundesbank's communications even invited DM appreciation—in time for the euro to start from what was soon seen as too high a level, and with Euroland's supposed economic powerhouse dubbed the “sick man of the euro.”

Fragility at the core was not the only challenge though. Another was divergence. The interest rate convergence process granted Euroland's periphery a nice boon to public finances, as the interest burden shrank. In addition, sharply falling interest rates in traditional high-interest-rate countries boosted asset prices and domestic demand. Some parts of Euroland thus experienced robust domestic demand growth in the late 1990s, while Germany became ever more reliant on net exports (Bibow 2001b). Both fragility and divergence have since become worse, as will be discussed further below. Before, however, we need to address the ECB's role in bringing about the current EMU crisis.²

Indeed, the bank's performance since it took over its monetary reign from the Bundesbank is best described as a series of policy blunders that pushed inflation up and GDP growth down. The first blunder consisted of a clash between the ECB and financial markets, which resulted in a marked depreciation of the euro. The second featured the bank's refusal to cut interest rates and boost growth, which resulted in a productivity slump that pushed up unit labor costs and core inflation. And the third blunder witnessed the ECB's continued refusal to cut interest rates so as to stimulate a recovery, which saw fiscal policy, constrained by the Stability and Growth Pact, shifting into reverse gear, prompting increases in indirect taxes and administered prices; apart from further destabilizing the euro zone. This series of policy blunders pushed inflation up and left Euroland in a very fragile shape when the dollar's depreciation prevented the world's second largest economy from free-riding on external demand yet again.

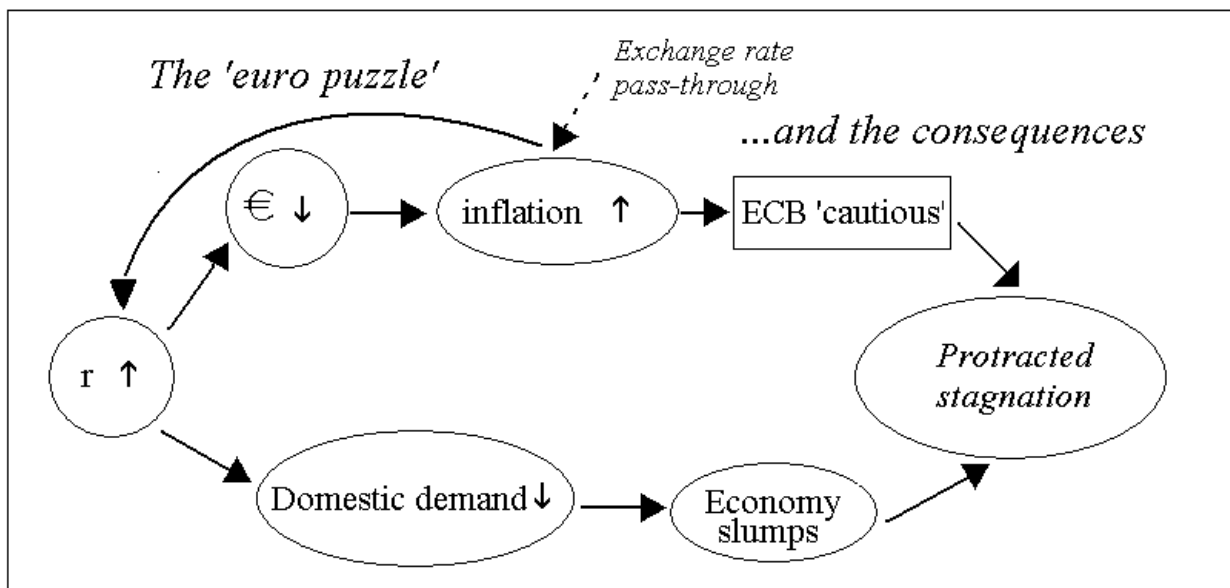
As to the euro's plunge, the ECB's role was one of acting as a two-fold propagation mechanism as the bank's words and deeds provoked market opposition. I can be brief on the bank's confusing words. Its first president was legendary for his gaffes. No less important was that Mr. Issing's monotone “price stability above all else” anthem was way out of tune with the climate in financial markets at the time. The climate was one of growth enthusiasm, with

² See Bibow 2004c for a more detailed analysis of the ECB's record.

inflation risks not seen as any serious threat. So when the ECB backed up its confusing words with all too clear actions, nearly doubling interest rates within less than a year, the markets simply took fright, preferring policymakers that were perceived as more growth friendly.

Interestingly, the risks and foreseeable consequences of *euro-weakening interest rate hikes*³ were clearly spelled out by no other than the European Commission, vigilantly observing in its 2000 review of the EU economy: “To the extent that the depreciation in the euro is due to cyclical divergence between the euro area and the United States, a rise in interest rates in an attempt to support the currency could even backfire if it was perceived as stifling the euro-area recovery. The risk of creating an even more unbalanced growth pattern with weak domestic demand and higher export growth would be serious” (EC 2000: 71). Similarly, the BIS’s Annual Report (2001: 89) observed that: “On balance, market participants may have considered the Eurosystem’s monetary policy stance to be excessively tight inasmuch as it may have negatively influenced the outlook for euro area growth.” Meanwhile the OECD (2001: 106) referred to a “countervailing impact of interest rates on exchange rates via growth expectations” and an “unpleasant monetary policy dilemma” (118). Notice that the ECB managed to push inflation up while choking domestic demand through its aggressive hikes, as Box 1 summarizes.⁴

Box 1. Slamming the brakes - crashing the euro...and more

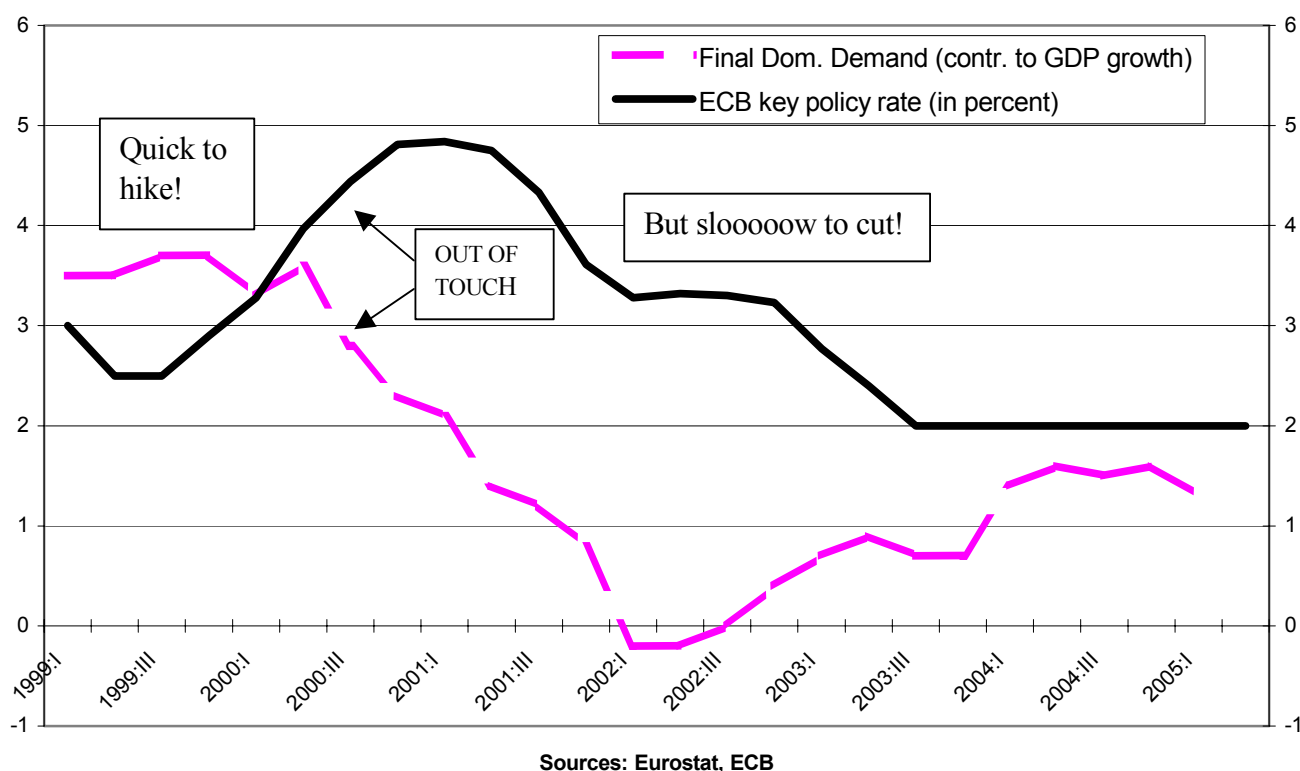


³ See Bibow (2001b, 2002) on the time-inconsistency hypothesis of the euro’s plunge.

⁴ Note that I use interest rates here as shorthand for the whole transmission mechanism of monetary policy rather than the interest-rate channel alone. While some researchers seem to doubt the effectiveness of monetary policy, the ECB’s (2002) research on the transmission mechanism has revealed a strong impact of interest rates on domestic demand, primarily investment.

Inflation *above* 2 percent then seemed to excuse the ECB's subsequent refusal to cut rates as fast as it had hiked them, nicely illustrating the Bundesbank tradition of "quick to hike, slow to cut." Between November 1999 and October 2000, the ECB hiked rates by 225 basis points, nearly doubling policy rates in less than a year. It then stood by as domestic demand, quite predictably, plunged after mid 2000. The ECB's commentaries show that the bank was not just "out of touch" with financial markets, but also with developments in the economy.⁵ As the euro's plunge extended the export boom, domestic demand—seemingly unnoticed by the ECB—tanked (see figure 2).

Figure 2. Asymmetric and out of touch with markets & economy



⁵ For instance, in February 2001, as global growth was clearly slowing and the U.S. Federal Reserve had embarked on fast-track easing the month earlier, the ECB declared: "While this deceleration will have some dampening effects on euro area net exports, the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the fundamentals in the euro area remain broadly favourable" (ECB Monthly Bulletin February 2001: p. 5). Confirming this assessment in the March 2001 Bulletin, the ECB argued that "at this juncture, there are no signs that the slowdown in the U.S. economy is having significant and lasting spillover effects on the euro area" (p. 5).

The trouble is that the ECB's "wait and see" attitude (when it comes to easing) then provoked a severe productivity slowdown and a corresponding rise in unit-labor costs. Facing falling sales business was under pressure to keeping margins up. While the euro's plunge pushed up headline inflation through magnifying the price effects of high oil prices and rising import prices more generally, blunder no. 2 saw to it that core inflation followed suit in 2001.

Of course protracted stagnation and rising unemployment are bound to cause budgetary troubles. And this is where the ECB's blunder no. 3 comes in. A sound monetary policymaker internalizes fiscal policy. Given Euroland's fiscal regime, it was clear from the start that the ECB had to shoulder the bulk of the stabilization burden—or else face the consequences of a destabilized economy. The IMF's head at the time, Horst Koehler, even reminded the ECB of this textbook wisdom, when he explained that monetary policy would be "the first line of defence." Mr. Duisenberg responded that he had never heard of that ("Duisenberg defends holding rates steady." *Wall Street Journal Europe*, 9 October 2002).

As refusing to listen to outside advice is held a virtue at the ECB—and as an always welcome opportunity to "prove its independence" too—it should not be overlooked that it was the resulting protracted stagnation which has caused inflation to stay stubbornly above 2 percent ever since. A conspicuous gap has opened up since 2001 between headline inflation and what may be seen as *market-determined* (as opposed to government-determined) inflation. Rises in indirect taxes and administered prices, reflecting finance ministers' desperate but vain attempts at keeping budget deficits below 3 percent, led to an upward distortion in headline inflation of around 0.5 percentage points by 2004. While, individually, such measures only give rise to one-off price-level shifts, a continuous series of such measures can give rise to a continuous rise in general prices and significantly distort measured *inflation*. In fact, without "tax-push inflation" the ECB would not have failed on its price stability mandate in the last four years.

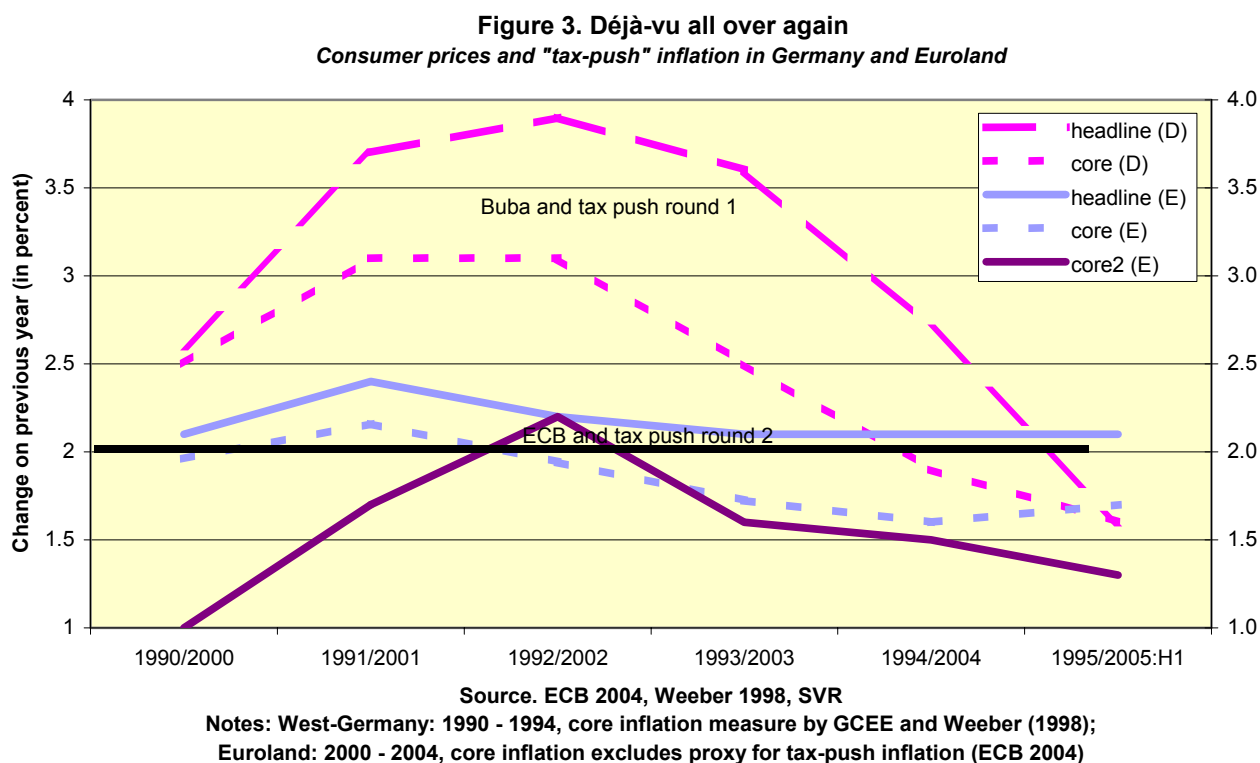


Figure 3 reminds us that the same phenomenon could be witnessed in Germany in the first half of the 1990s (Bibow 2005). At that time too, tax-push inflation was behind the conspicuous inflation persistence in a stagnating economy. Meanwhile, however, the disease has spread across Euroland. In addition, Figure 3 also shows a measure of core inflation (core2) that excludes energy, food, alcohol and tobacco, apart from administered prices. After its recession-driven peak in 2002, underlying inflation in Euroland has declined sharply (reaching 1.2 percent by mid 2005); reflecting “historically low” wage inflation. No doubt this would make any properly cautious central bank’s deflation alert flash red.

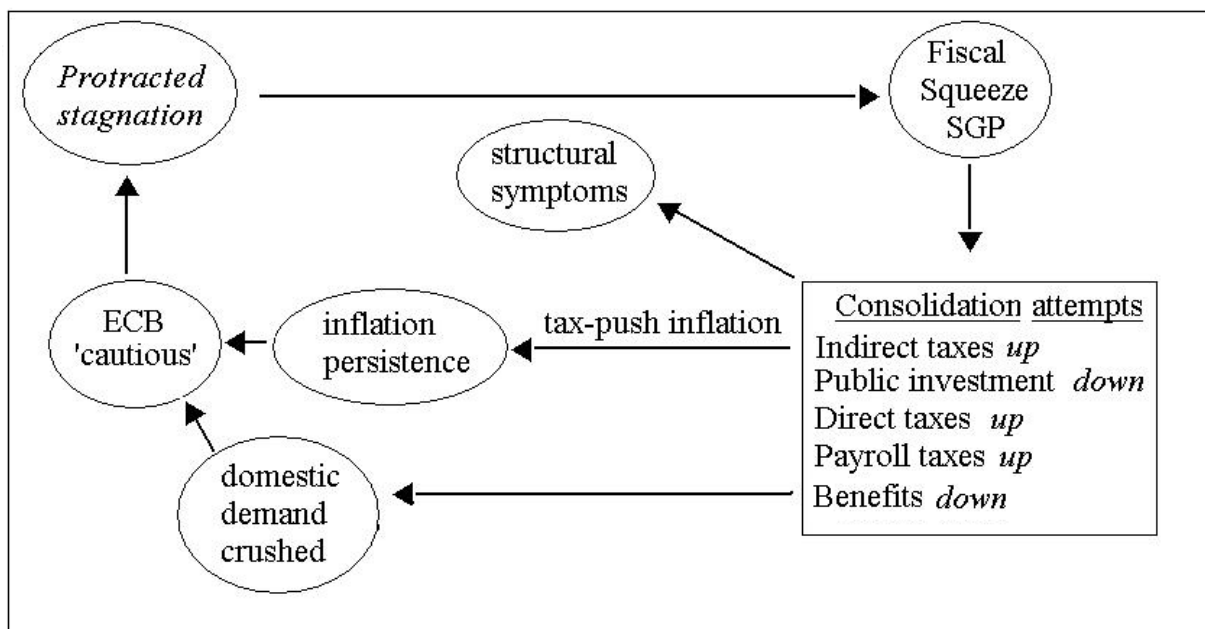
HOW THE MAASTRICHT REGIME HAS PLAYED OUT—SPREADING THE “GERMAN DISEASE”

Box no. 2 summarizes the actual play-out of the Maastricht regime over recent years. At the heart of the current EMU crisis is a counterproductive interaction between fiscal and monetary policies, featuring tax-push inflation as the key symptom in a macroeconomic policy blunder that has left the euro area stranded in stagnation. Courtesy of the ECB, Euroland has become

stuck in a stability-oriented vicious circle, with headline inflation persistently *above* the set limit of 2 percent due to tax-push inflation.⁶ Notice how Euroland's two key "stability-oriented" institutions, the SGP and the ECB, have thereby shot each other in the foot: as the ECB reneged on its growth mandate and failed to properly counter the symmetric shock of 2000-01, budget deficits of more and more member states began to pass through the 3 percent threshold by 2002; finance ministers' desperate thrift campaigns, in turn, have then not only further destabilized Euroland, but kept inflation above the holy 2 percent threshold ever since, too.

Box 2. No use of acceleration please: getting stuck in a "stability oriented" vicious cycle

Actual play-out of Maastricht regime features tax-push inflation



Much to its own surprise, Euroland is today finding out that emulating the Buba "success story" of asymmetric "management" of domestic demand, while fiscal policy is no longer allowed to take up the slack, actually means the opposite of the promised land of stability and growth. With the exception of Ireland, Greece, and Spain, domestic demand has plunged and seems set for subdued growth or protracted stagnation—the spreading of the "German disease." Accordingly, by mid-2005, there are few countries left which are not struggling with the three percent limit of the SGP, excessive deficit procedures having been initiated against Germany,

⁶ I focus here on the short-run aspect of stagnation cum inflation persistence. While this vicious circle itself can easily cause hysteresis, as another popular measure, Euroland's senseless thrift campaigns feature cuts in public investment, which cause even more clear-cut long-run damages.

France, Italy, Portugal, and Greece. Public thrift for years to come is in the pipeline across Euroland. And according to the “German view,” but the German view only, this will continue to stimulate domestic demand growth.

While this may seem to contradict popular excitement about President Bush’s “irresponsible” tax cuts since 2001, in truth, Germany’s as well as Euroland’s fiscal positions are already in a worse state than the U.S.’s; despite—or because of—thrift no matter what. Recall that the sustainability of public finances crucially hinges on GDP growth. As Figure 1 above shows, in Germany’s case, public finances are on track for a continuous sharp rise in the debt ratio. In 2003, when Germany’s nominal GDP growth crumbled to barely 1 percent, the country’s (close to) four percent deficit ratio implied a steady state debt ratio of 400%! Even at slightly higher nominal GDP growth, courtesy of the rest of the world, Germany’s fiscal position remains in the doldrums; particularly as privatization revenues, which have helped to close many a hole en route so far, are set to dry up by next year.

In Euroland’s case too, nominal GDP growth has meanwhile fallen way below the implicit Maastricht norm of five percent. In 2005, the land of the euro will be lucky to achieve three percent. At a deficit ratio of close to three percent, Euroland is thus on course for a debt ratio of around 100%! By contrast, while the U.S. may have a higher deficit ratio of around 4 percent, its debt ratio is rising only mildly—thanks to nominal GDP growth of around six percent. As Domar (1944) taught us more than half a century ago: growth is key to public debt sustainability. Europe’s taxpayers are paying a dear price for the ongoing fiscal folly indeed.

But the real trouble is that signs of learning from mistakes have yet to emerge from Frankfurt’s Eurotower, where confusion continues to reign as the ECB’s top officials never seem to tire of congratulating themselves. It is noteworthy that back in 2001 the world’s most independent central bank often excused its conspicuous refusal to cut interest rates by arguing that occurrences in the U.S. were of little importance, since “the euro area is a large economy in which economic developments are determined mainly by domestic factors” (ECB, February Monthly Bulletin, 2001, p. 5). After years of domestic demand stagnation Mr. Trichet appeared to look for help elsewhere when he referred to the following “normal sequence of events” in an interview: “Growth starts with exports, then passes on to investment and then to consumption. That is the normal sequence for Europe in this phase of the cycle” (*Financial Times*, 22 April 2004).

And for a while Euroland even seemed lucky enough to freeload yet again on external stimuli in the first half of 2004. Yet, this free ride was cut short by the euro's sharp appreciation. Beware though in blaming the strong euro (or, external shocks) for Euroland's troubles. In truth, Euroland's GDP growth benefited significantly from net exports in the years 2000, 2001, and 2002. Only in 2003 did net exports leave a dent in Euroland's GDP growth. Over 2004 as a whole the strong euro then merely made sure that Euroland would be left behind the global growth train pulled along by the U.S. and China, and harvest what it had sown itself.⁷ For Euroland's problems are purely homemade: macroeconomic policy inflicted protracted domestic demand stagnation, the German disease, that is.

Once again exemplifying its peculiarly asymmetric driving style and habit for being out of touch with the economy, the ECB adopted what the markets perceived as a "tightening bias" in September 2004 (Financial Times Deutschland 8 September 2004). Just as the export boom was faltering and with domestic demand being as sluggish as ever, the ECB was getting ready to slam the brakes. This peculiar state of affairs continued until April 2005 (International Herald Tribune 5 April 2005). Barely back to a neutral stance the ECB was then not pleased when even the OECD (2005) advised that a 50 basis points cut would be appropriate in view of domestic demand stagnation.⁸

The ECB's position is based on its view that interest rates are "historically low" already and *therefore* cannot be a hindrance to growth—as the bank repeats ad nauseam. It is all too obvious that this view ignores Wicksell's fundamental insight that the absolute level of the market rate of interest is not an adequate indicator of monetary stance. For what matters is its level relative to the equilibrium rate. To really boost growth in a situation of stagnation and unemployment the central bank has to push the market rate well below the level that would merely sustain the current situation. Deliberately kicking the accelerator down, however, is totally foreign to the ECB's mindset. In the ECB's view, "cautiously" releasing the brakes (after slamming them hard for whatever reason) is all it takes to move forward—as price stability *causes* growth (and if not structural problems are surely to blame).

⁷ While net exports' contribution to GDP growth was zero in 2004 overall, the enormous export boom during the first half was probably key to the temporary acceleration of domestic demand at the time.

⁸ The OECD made its position public at the press conference on the release of its Economic Outlook no. 77, in which the organization is free to offer its independent view. It is of some interest that the OECD's explicit call for lower interest rates was not repeated in the annual survey on the euro area. This sparked some speculation that this owed to pressure from the ECB and European Commission, as those being assessed apparently have a say in what the verdict should be (FTD 14 July 2005). We probably have to conclude, then, that the independence of tax-payer-funded central bank politicians has precedence over the independence of tax-payer-funded research.

Curiously, in its efforts to resist outside pressures to ease policy the ECB even argues that doing so would undermine confidence and push bond yields up. Effectively, the ECB thereby admits that Euroland may already be in a “liquidity trap.” This is truly an embarrassing excuse though, since maneuvering the economy under its stewardship into a liquidity trap is generally seen as the ultimate blunder a central bank can possibly commit.

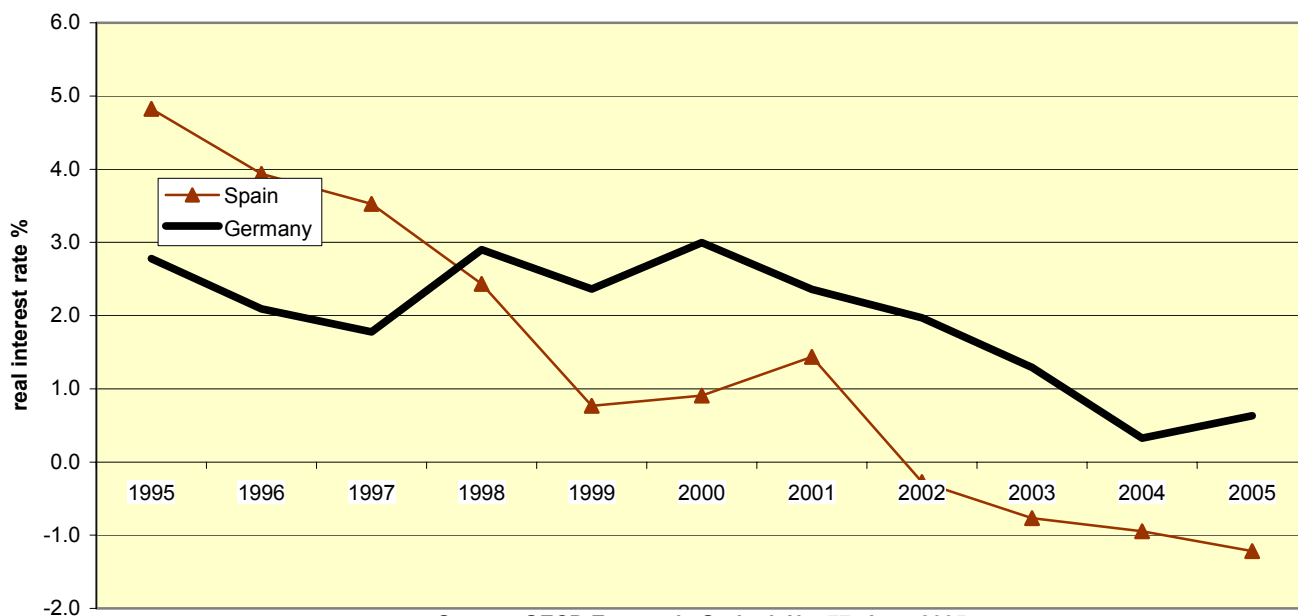
Be that as it may, if it were really true that nominal interest rates cannot fall any further Euroland would have to place its hopes for lower real interest rates on rising inflation (while wage trends and the possibility of more euro strength, if anything, point in the opposite direction). A closer look at Germany’s situation today is in order here, the country that seems to suffer rather more than average under the Maastricht regime.

WHY GERMANY SUFFERS MORE STILL

A key premise and expectation of a German-style EMU was that by exporting Germany’s success model, this would work even better, both for Europe as well as for Germany itself. It is clearly not working for Euroland, and it was shown above that this failure owes primarily to the ECB’s reneging on its obligation to counter the symmetric shock to domestic demand that has left Euroland stranded in protracted stagnation. It also comes as no surprise that exporting the Buba “success story” has undermined its working at home. But why are things even far worse for Germany than for Euroland on average?

Figure 4. Germany's competitive advantage turned on its head

While nominal rates converged, real rates did not



Source: OECD Economic Outlook No. 77, June 2005

Note: Proxy used here for real short-term interest rates are the three-month money market rates deflated at national (headline) CPI

Even in Germany, some commentators have by now realized that Germany is today facing higher real interest rates than much of the rest of Euroland; when previously the country used to enjoy the (anchor currency) benefit of generally having the lowest. The German Council of Economic Experts too addressed this issue in its Annual Report of 2004/05. And, as Figure 4 shows, there is no denying the fact that Germany's traditional competitive advantage as to the relative levels of interest rates in Europe was turned on its head; *by EMU*, it seems.

Some commentators are then quick to jump to the conclusion that the ECB's excellent monetary policies are simply less good for Germany than the Bundesbank's used to be. This view is missing the point on two counts. For one thing, the ECB's policies were clearly too restrictive not just for Germany, but also for Euroland as a whole (just as the Bundesbank's used to be inappropriate for EMS member countries as a group, one may add here). For another, if it really were just an incident of the "one-size-fits-all" problem, any excitement would be surprising as the issue was well understood *ex ante*. It was agreed that at any time a common monetary policy is generally more suitable for some regions than for others. Hence the general question was and remains how this diversity in monetary policy impact might best be compensated for, so that it does not lead to divergence.

For the key fact is that the workings of the Maastricht regime together with Germany's chosen response to its troubles have aggravated rather than alleviated those forces of divergence that were to be expected from the "one-size-fits-all" problem.

To begin with, however, an important aspect in the turning on its head of Germany's traditional monetary competitive advantage during the 1990s is that it actually originated from *two* sources. One was the convergence of nominal interest rates towards German levels that started in earnest in 1995. But no less important was another, which preceded it: the ERM crises of 1992-93, which saw a sharp appreciation of the DM against most European currencies; with Germany suffering a corresponding loss in competitiveness and slowdown in export growth. Arguably, this occurrence more than anything else prompted German "supply-side-only" instincts that the proper response to the situation was to restore its competitiveness eroded by these events by a strategy of wage underbidding (euphemistically called "wage restraint" (Lohnzurueckhaltung)).

In this regard, it is common today to refer to the sharp rise in Germany's relative unit-labor costs in the aftermath of unification. And it is popular to then justify the decline in Germany's relative unit-labor costs since the mid 1990s as a reversal of this "shock." A number of points are relevant here. First, referring to all-German data overlooks that much of the rise in unit labor costs over 1990-92 reflected developments in Eastern Germany and does not explain massive job losses in the West during the 1990s. Second, as far as Western Germany is concerned, much of the rise since 1992 was caused by the 1993 recession and protracted investment slump that ensued, depressing productivity growth accordingly. For neither workers nor unions are to blame when macroeconomic policies inflict such supply-side damages (repeated by the ECB for Euroland since 2001). In actual fact, wage inflation in the West exceeded the implicit Maastricht norm of five percent nominal GDP growth only briefly and mildly (peaking at 6 percent in 1991). This had occurred in the context of high productivity growth and after a prolonged period of "wage restraint" during the 1980s. Wage inflation quickly fell back to around 3 percent over 1993-95, and to "historically low" levels thereafter (zero by 2004).

Third, as to the ERM crises of 1992-93, arguably, these—belatedly—merely compensated for the competitiveness gains Germany had accumulated during the "hard EMS" era through its strategy of "wage restraint," delivering relatively lower inflation and sizeable DM depreciation in real terms over the course of the 1980s. Explanations of the ERM crises

feature the fact that real exchange rates no longer reflected fundamentals. And recall that on the eve of unification West Germany had a current account surplus of 5 percent of GDP, much of which had its counterpart in corresponding deficits among its European trading partners.

Arguably, then, there was never any basis for the idea that Germany should set out to restore the competitiveness loss that occurred during the first half of the 1990s. In order to balance West Germany's external position and prevent intra-European imbalances from escalating even further, the deutschmark had to appreciate markedly; as it did in 1992-93. Unification did not change this need for readjustment. Rather, for all-Germany a current account deficit for years or decades to come was to be expected simply reflecting a partial reliance on foreign resources in the rebuilding of the Eastern German economy. (Witness the external positions of the new EU members today.) Obviously, however, this is not at all what has happened. Instead, all-Germany is today experiencing soaring trade and current account surpluses. This implies that (hypothetical) West German surpluses have reached phenomenal dimensions, reflecting that (hypothetical) West Germany's competitiveness is probably the envy of China and the rest of Europe, not to mention the U.S.!⁹

This has not helped Germany all that much though, and relatively high real interest rates are certainly part of that story. Since 1995 wage inflation across Euroland has succumbed to a 2.5 percent trend—as a tribute to German “stability culture.” Hence “wage restraint” 1980s-style does not work any more. So Germany goes for zero today! (And below zero tomorrow?) In addition, as the “German view” on expansionary fiscal contraction has become the norm and procyclical fiscal tightening is applied across Euroland today, Germany can no longer free ride on fiscal laxity elsewhere in Europe to compensate its own austerity either. Hence the German economics profession with its fine memories of the “successful” consolidation of the 1980s is at a loss. Alas, being at a loss does not seem to stop the country from administering itself ever more of the same medicine (Kromphardt 2003).

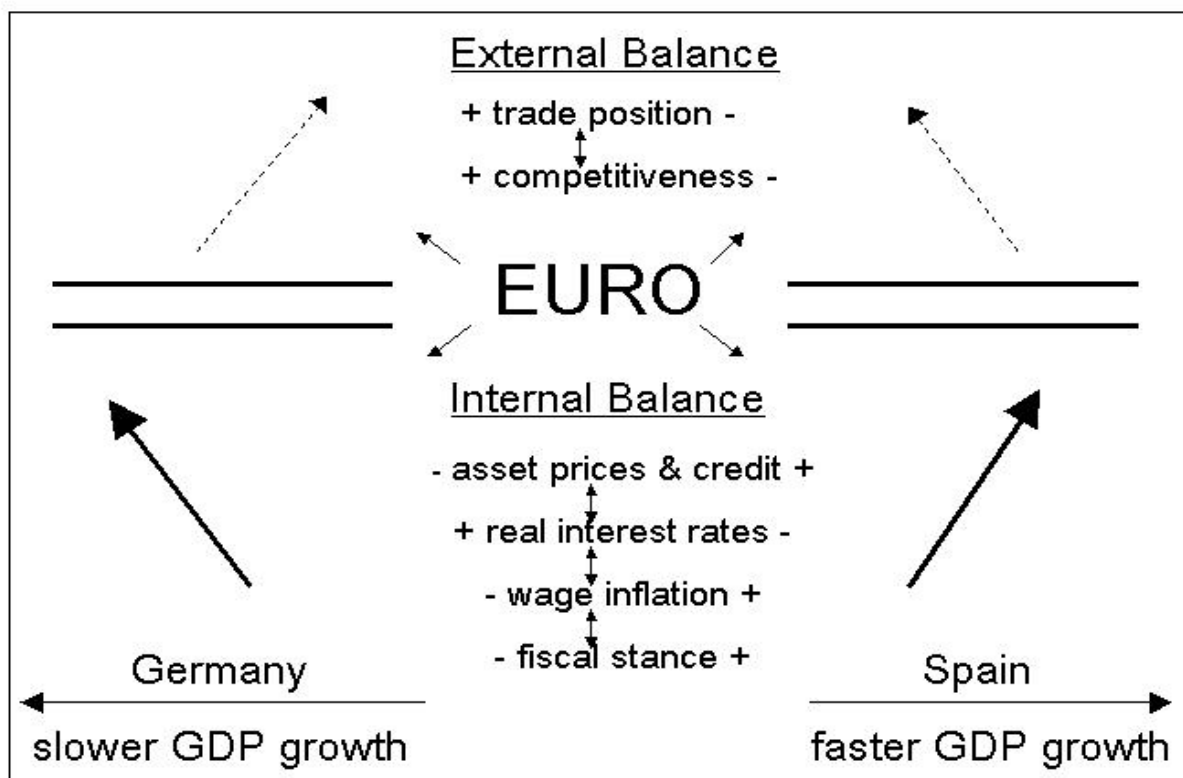
It is the mixture of policies that lack any firm basis in theory or evidence together with certain adverse mechanisms that the EMU regime change has brought about, which are causing havoc in Germany's economy. Above all, the “Instability and Stagnation Pact” (Bibow 2001a) has turned out as an amplifier of divergence. Recall: Given the “one-size-fits-all” problem, the issue was how to compensate those forces of divergence stemming from it. In actual fact, the

⁹ Suffice here to mention a peculiar debate on Germany's supposed “bazaar economy,” (Sinn 2005) which deserves the very comment that Keynes spared on the so-called real balance effect: “really too fantastic for words and scarcely worth discussing.”

“stupid” pact means that those in deepest trouble already will face not less but more fiscal austerity to augment their wreckage incurred.

It is thus no surprise that the phenomenon of tax-push inflation is especially prominent in Germany’s case; and bound to gain new impetus with the schedule two-percentage-point rise in VAT in January 2006. A drastic decline in public investment is another. In recent years, Germany’s net public investment has turned even negative. Today the country quite literally lets its infrastructure rot! Given the notorious common place of “today’s deficits as tomorrow’s taxes” that dominates Germany’s economic policy debates and talk shows alike, it is ironic that Germany is proving that there is no better way to burden our children and grandchildren than to inflict senseless public thrift upon us. To describe this absurd situation I propose the following hypothesis: The more we refrain from spending on the right things (like infrastructure, education, research and development) in our desperate attempts at balancing the budget no matter what, the more we end up spending on the wrong things (i.e. unemployment)—without actually borrowing any less, or even more. In fact, by lastingly depressing GDP growth the debt burden is becoming heavier!

Box 3. Partners drifting apart until...



To illustrate what is at issue for Euroland here, compare the cases of Germany and Spain (see Box 3). Just as Germany started as the “sick man of the euro” in 1999, thanks to the macroeconomic policies discussed further above, Spain experienced a domestic demand driven boom, courtesy of the interest rate convergence process. While Germany’s wage inflation has succumbed to its depressed economy and peculiar instincts, with income stagnation causing consumption stagnation, which is further aggravated as relatively high real interest rates depress asset prices and the ongoing fiscal squeeze crushes disposable incomes. Spain’s wage inflation holds up well, with income growth underpinning consumption and investment, which are further stimulated as relatively low real interest rates boost asset prices and the budgetary boon of high growth keeps the stupid pact at bay, or provides even room for tax cuts. Unsurprisingly, intra-Euroland imbalances are soaring: as Germany’s external position improves, Spain’s deteriorates; somewhat alleviated by the fact that Spain is a recipient of EU funds while Germany is a net payer, itself another aspect of the absurdity of the whole situation.

Beware: This comparative analysis is not meant to distract from the key fact that the German disease has meanwhile spread across much of Euroland (with Spain as a rare exception), reflecting the fact that the ECB’s policies were too restrictive not just for Germany, but for Euroland as a whole too. What the analysis shows is that it is the inherent workings of the Maastricht regime together with Germany’s chosen response to its troubles that are making the ECB’s policies even worse for Germany. In fact, fragility and divergence are getting worse across Euroland—thanks to the peculiar design of German-style EMU and Germany’s “stability culture.” And in all this, Germany is still leading the pack, its economy having been turned into a schizophrenic: export champion abroad, zombie economy at home. There are some important lessons for EMU here.

A VICIOUS CIRCLE THAT HAS WRECKED GERMANY AND MAY SINK THE EURO TOO

Watching the spreading of the “German disease” with amazement, the rest of the world sees a rudderless economic giant drifting along hoping for strong enough export currents to pull it along. Since its peak in March 2005, the euro has come back markedly against the U.S. dollar towards a level of 1.20. This easing of monetary conditions seems to relieve the ECB from cutting interest rates. Many observers currently place their bets, once again, on exports as Euroland’s rescue line and motor of growth. The rest of the world cannot be pleased about this

sight, especially in view of soaring global imbalances. Nor can anyone who is really interested in the long-term survival of the euro project. For while external risks keep on growing along with global imbalances, recognizing the fact that Euroland's troubles so far have been purely homemade is further postponed.

In fact, policy debates in Germany and Euroland remain trapped in the dogma of thrift and "stability," which means stagnation and decline stay on the cards and the problems of fragility and divergence are set to get worse. Even international observers seem to have largely given up on any prospect for a belated use of macro stimulus, and place all their hopes on those easily invoked but rarely seen miracles that "structural reform" allegedly unleashes. No doubt Germany's case offers clear evidence that structural reform combined with "anti-demand policies," if anything, undermine confidence and weaken rather than boost growth though.

Just as a prolonged fiscal tightening is in the pipeline across Euroland for years to come, pressures for "wage restraint" seem to be boiling over. The Netherlands is learning the hard way that a repeat of the "Dutch miracle" of the 1990s is hard to come by when German wage inflation is zero. But the view prevails that Italy—recently dubbed the "real sick man of the euro"—sinned in granting itself luscious wage inflation of around three percent for which it will have to endure chastisement in future years.

Truly, wage inflation of three percent is anything but excessive. It corresponds to German-style "wage restraint" of the 1980s, and it is way below the implicit Maastricht norm of 5 percent nominal GDP growth too. It is only made excessive by the wage-underbidding practices of others—the true sinners in this sad game of passing the buck. Essentially, EMU is being undermined today by exactly those policies that 50 years of European integration had anxiously tried to prevent: competitive devaluations.

Yet, as Germany's example has shown, wage deflation drives up real interest rates and triggers other destabilizing forces. If others followed suit, divergence within Euroland might diminish, but fragility would increase. Moreover, if the ECB is right that "historically low" nominal interest rates cannot fall further, across the board "wage restraint" will primarily tend to drive up real interest rates across Euroland. As Keynes taught us a long time ago: nominal wages controlled by social partners are the wrong instrument—the wage unit merely anchors the price level; if it does.

What all this means is that euroization may still turn out as a rather brief chapter in Europe's monetary history (which is often interpreted as a natural response to Germany's

unification). Beware though to blame the mess on the usual suspects—who were always lacking the right “stability culture,” as we (Germans) always knew. In Germany’s case, a sharp appreciation of a new deutschmark against, say, a new lira would merely wipe out the benefits of Germany’s beggar-thy-neighbour policies of the recent past, just as the ERM crises of 1992-93 belatedly compensated for wage-driven divergences of the 1980s. Behind all this lies a thorough misapprehension of why the German model worked in the past, for Germany, that is. The model cannot work for Euroland as a whole—no matter how deafening the structural waffle might still get.

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