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Miracles are Possible —
Or a Classic German Approach to the Current Crisis

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- How can the principles of *Ordnungspolitik* be applied today?
- How has *Ordnungspolitik* shaped Germany's economic policy over the past sixty years?

It is often said, with an ironic undertone, that in times of crisis Americans take action while Europeans talk about institutional reforms. And of course there is a bit of truth behind this without implying that any side is right. When one looks at Germany's approach to handling the current economic crisis, Americans sometimes wonder why the world exporting champion is not taking more action. In order to understand Germany's economic policy one has to understand the foundation and the principles of the German economic model of the Social Market Economy and of *Ordnungspolitik*.

What is *Ordnungspolitik*?

Ordnungspolitik is something uniquely German, without an English translation. Literally translated, it would be something like *order policy*, describing the organization of the markets and the state. It describes a constitutional framework and policy for the state to shape the economic environment, and economic interaction among people and between people and the state. Following the definition of the *Initiative Neue Soziale Marktwirtschaft* (Initiative for the Renewal of the Social Market Economy), *Ordnungspolitik* covers all institutions, laws, rules, and policies that enable the economy to organize according to the principles of markets and competition. Predominantly, it is a policy that strives to guarantee competition and the freedom of the individual for his economic activities.

For a sound Ordnungspolitik what matters most is to draw a reasonably clear line between the sphere of the state and the sphere for the activities of business. Besides setting a general framework, the state has only limited objectives within a market economy. It should only interfere through regulation or by its own economic activities into markets if these do not function properly (i.e., providing public goods, external effects, natural monopolies, cartels). However, in a social market economy the state may interfere to change market results, mostly via its social policy and redistribution. By doing so the state is in conflict with the goals for efficiency and growth. Too much redistribution and too much regulation weaken the economy and the effectiveness of markets. It is up to *Ordnungspolitik* to balance the various government policies, in order to assure that neither the state nor other market participants unduly weaken the market mechanism.

A Brief History

The roots of German *Ordnungspolitik* lie in the *Freiburger Schule* (Freiburg School) and will always be connected with the names of Walter Eucken, Alfred Müller-Amack, Franz Böhm, Hans Großmann-Doerth, and of course Ludwig Erhardt. In the early 1930s, Eucken, Böhm, and Großmann-Doerth studied and taught the problems of a free society with private power at the University of Freiburg. In today's academic language one would probably call their collaboration an interdisciplinary research of lawyers and economists. In 1937 this collaboration led to a publication series *Ordnung und Wirtschaft* ("Order and the Economy"), which is recognized as the birth of the *Freiburger Schule*. Some members of this School not only discussed academically the rules of an economy that is based on individual freedom, but also took part in the intellectual opposition to the totalitarian Nazi regime. After the war many became involved in politics and the government of the emerging Federal Republic of Germany.

In 1948 Ludwig Erhardt was appointed Director of the Administration for the Economy of the United Economic Area (Bizone), what would later become West Germany. On 20 June 1948 he then implemented Germany's currency reform from the *Reichsmark* to the *Deutsche Mark* in the western zones of Germany. Without coordinating with the military governments he liberalized the price control mechanism as well as the associated rationing and government control of the economy. This day marked the beginning of the German Social Market Economy and was followed by the *Wirtschaftswunder* (the economic miracle) that made Germany the world's second biggest economy until the end of the 1950s.

Ordnungspolitik is led by seven constitutional principles that are mentioned in Walter Eucken's book *Grundprinzipien der Wirtschaftspolitik* (Basic Principles of Economic Policy), published posthumously in 1952. These constitutional principles are:

1. The basic principle of a <u>functioning pricing system</u>. Politics should avoid all measures that distort relative prices through i.e., subsidies, tariffs or non-tariff trade barriers, monopolies, etc.
2. With the <u>primacy of monetary policy,</u> price stability should be achieved. This principle is also the lesson learned from the hyperinflation in 1923.
3. The principle of <u>open markets</u> in order to avoid the establishment of monopolies or cartels. This principle includes the necessity of free trade.
4. The principle of <u>private ownership</u> defines property rights and acts as an incentive for market participants.
5. The <u>freedom of contract</u> is a prerequisite for competition though it is limited in the view of the Ordoliberals (those who believe in *Ordnungspolitik*), since it may not be abused to reduce competition.
6. The principle of <u>liability</u> is an incentive for market participants because only if they can be held accountable for their contractual agreements will they act responsibly.
7. A <u>steady economic policy</u> engenders people's trust in the existing economic order. Steadiness reduces risk in the decision-making process for entrepreneurs, investors, and consumers. Like the primacy of monetary policy, this rule is based on Europeans' historic experiences in the first half of the twentieth century.

As one could expect from a democracy, Germany frequently violated these principles in its economic policies over the last sixty years. However, especially in the beginning of the Federal Republic of Germany, the *Freiburger Schule* was very influential in shaping institutions such as the *Bundesbank* and policies such as the competition law with the creation of the Federal Antitrust Agency. The primacy of monetary policy is also a founding pillar for the European Central Bank, supporting the Bank's independence and its goal to guarantee nothing but price stability.

The Current State of *Ordnungspolitik* in Germany and Abroad

It is apparent to match those principles of *Ordnungspolitik* with the current policies that are supposed to help us out of the present recession. Even at first glance it is obvious that those principles seem to be of little guidance for Germany's or other nations' approaches.

1. Functioning Pricing System

In order to increase demand for new cars the German government introduced a “cash for clunkers” scrapping program, giving car buyers €2,500 for every car older than nine years when buying a new one. By doing so, new cars became relatively cheaper compared to other goods, thereby artificially distorting the relative price system.

2. Primacy of Monetary Policy

Expectations are high that inflation will increase in the years to come, given the huge expansion of monetary supply by central banks in order to revive capital markets and stimulate investments, in combination with distrust in the ability of central banks to neutralize this additional money when the economy does pick up again. When compared to other nationas, German have been more hawish on price stability since the introduction of the Deutsche Mark. The German public demands that inflation must be kept under control, thereby reducing the ECB’s and the finance minister’s room to maneuver.

3. Open Markets

Many stimulus plans include protectionist measures that are designed to protect domestic industries from foreign competitors at a time when global demand is shrinking. Instead of keeping markets open such policies are deliberately designed to do just the opposite—but by doing so, governments are making the same mistakes as their predecessors during the Great Depression. Germany may be less guilty of this protectionist tendency, as evidenced by the scrapping rebate example mentioned above. The government pays the “cars for clunkers” rebate for every new car, regardless of where it was built; neither does the German Chancellor publicly ask consumers to buy only German cars.

4.-6. Private Ownership, Freedom of Contract, Liability

We are facing a deep recession which has and will further lead to many bankruptcies of private companies. This puts governments under pressure to help those companies that are in the public eye (usually large firms) in order to save endangered jobs. Typically such governmental actions violate the principles of ownership, freedom of contract, and liability by socializing the risks that come with free enterprise while the opportunities remain private. These government interventions are then followed by further interventions, causing a domino effect when, for example, the freedom of contract is limited, *ex-post*, by limiting management compensation for companies in which the government intervened.

7. Steady Economic Policy

Saving one bank and letting another fail is not a steady policy and drastically increases uncertainty in markets. The same is true for ad-hoc laws that are designed to nationalize banks that were saved with taxpayers’ money, as it happened in Germany. While the supposedly systemic risk might make it necessary to violate the principle of a steady economic policy in the financial sector, there is no reason why it should not hold true in the goods and services industries. A world without Chrysler or Opel does not mean people have nothing left with which to travel from point A to point B.

At the sixtieth anniversary of the founding of the Federal Republic of Germany, *Ordnungspolitik*, the *Freiburger Schule*, and the principles of the Social Market Economy are frequently cited by politicians in keynote addresses—but when it comes to policymaking, these references are at best a rough guide, if not totally ignored. In academic circles the ideas of *Ordnungspolitik* are often replaced by sophisticated econometric models, and the rule-based political economy approach is left for those fields in which we lack sufficient data or models. However, the myths of the economic miracle after World War II, of Ludwig Erhard and the Social Market Economy, and the stable, reliable Deutsche Mark are an instrumental part of modern Germans' national identity. These myths still play an important role in shaping public opinion and therefore economic policy today. And there is good reason why they should.

How *Ordnungspolitik* Can Help Us to Get Out of the Current Crisis

The vast expansion of money, the huge amount of additional public debt, and the countless discretionary government interventions in formerly free markets leave many people uneasy. In Germany, people are turning to the "founding fathers," looking for answers for today's crisis. So what could be an appropriate answer to the crisis in eyes of an Ordoliberal?

When capital markets become global markets, national regulation can be of only limited effectiveness. The regulative framework for banks and capital markets should therefore also become global—or at least should include the major players: the European Union and the U.S. At a time when not only banks but also hedge funds and other financial vehicles move markets, they too should be subject to such regulation. An effective competition control should make sure that market participants do not become so powerful that their failure poses a systemic risk for our economies. The current government support for bank mergers is just the opposite of such a policy.

While a business-owner succeeds—and fails—with his company, this is different with the managers of large public companies. Benefits such as bonuses tied to annual or even quarterly profits, stock-options that can be exercised after only a short period of time, and huge golden parachutes that one receives even after failure, all violate the principle of liability. The rules are wrong when management has an incentive to take big risks and receive a big bonus when the risk goes well—and still receives a huge golden parachute at worst while the taxpayer has to bail out the company and the company pays for the losses. That is a win-win situation for the manager, but not for the taxpayer—nor for the shareholder. While there is nothing wrong with earning a large income, the compensation rules should be an incentive for the long-term well-being of a company instead of rewarding big risk taking without personal liability.

In accordance with the principle of open markets, the vast increase in global output in the last decades was caused by opening up markets within our nations and abroad—the process widely known as globalization. The current crisis puts governments under a lot of pressure from all kinds of lobby groups to shield domestic industries from competition. The arguments they use are plentiful; the two most common (and most obvious) are, first, to protect the local workforce and, second, to avoid allowing fiscal stimuli to leak out of the country instead of increasing demand for domestic goods at home. This kind of protectionist policy deepened and prolonged the Great Depression. Instead of falling in the same trap again, governments should actively work to cut tariffs and bureaucratic red tape so that trade and investments can freely cross our national borders. The gains from a successful completion of the Doha Round are—in the words of the WTO's Director General Pascal Lamy—the lowest hanging global stimulus package.

If it is impossible to reach such an agreement among the 153 member states of the World Trade Organization (WTO) within the foreseeable future, the EU and the U.S. should push for an agreement within the Transatlantic Economic Council (TEC). The

TEC is a promising forum to shape the framework for the global economy since there are only two negotiating partners at the table that represent around 60 percent of global GDP. The OECD concluded in 2005 that structural reforms in the U.S. and the EU to reduce competition-restraining regulations, remaining tariff barriers, and foreign direct investment (FDI) restrictions could lead to permanent gains in GDP in Europe and the U.S. of up to 3 to 3.5 percent. That would be a sustainable stimulus that would not only help in the current situation but would also increase our growth in the long-run.

On a national level it would be in the spirit of *Ordnungspolitik* if governments would stop ad-hoc interventions into markets and instead reshape the rules of the game so that they again benefit the people. Governments should not be the referee and a player at the same time. In the case of Germany there would be plenty to do. The country suffers from high taxes and social contributions. In addition, the tax code and social regulation are so complex that a drastic reform is needed. The vast majority of the German Bundestag agrees to that, but until recently the need to balance the budget was an excuse for not acting. Now is the chance to cut the red tape and increase take-home income. The same could be said about the heavily regulated German labor market. Governments should follow Winston Churchill's motto: Never waste a crisis, and aim for the large and sustainable changes that seem to be possible only in times of crisis. These are such times and they should make us return to our principles instead of throwing them overboard. In the case of Germany this means a return to the principles of the Social Market Economy and *Ordnungspolitik*—principles that could also help lead other nations out of the crisis.

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