Historical Roots of German-French Differences

In the early nineteenth century, Madame de Staël, the daughter of the prerevolutionary French finance minister Jacques Necker and a leading intellectual who attempted to conduct a philosophical debate with Napoleon, wrote a tract, *De l’Allemagne*, in which she tried to explain Germany to the French. She began with the observation that “French and Germans are at two extremities of the moral chain, because the former consider external facts as the motor of all ideas, while the latter think that ideas generate all impressions. The two countries nevertheless are in basic agreement on social relations, but there is nothing more opposed than their respective literary and philosophic systems.”1 After her, a varied range of distinguished literary and intellectual figures have undertaken the same task of trying to explain Germans and French to each other, from Heinrich Heine through Heinrich Mann, François Perroux, Raymond Aron, Jean-Paul Sartre, and Joseph Rovan. On the political level, the great leaders of the mid-twentieth century who remade France and Germany after catastrophe, Charles de Gaulle and Konrad Adenauer, were both fascinated and attracted by the history of the other country. The incompatibility of thought is as striking in economics as it is in other intellectual domains, but no one has really tried to produce an intellectual reconciliation.

This chapter discusses the following questions:

- How did the very different approaches to the economy arise in France and Germany?
- How did cultural differences affect the construction of Europe’s monetary and financial framework?
• What role did the difference between German federalism and a French centralized state structure play?
• Did the German Mittelstand economic structure that contrasted with the French national champions approach make formulating a common economic policy more problematic?
• How do the wage-bargaining processes in both countries differ with a cooperative German model between labor unions and employers and more confrontational labor unions in France?
• What role did the different historical inflation experiences in both countries play?
• What do these countries think of the linkages that connect them to other neighboring economies and to the global economy?

Cultural Differences

That there should be a significant divergence between Germany and France may initially be quite surprising. After all, the two countries are neighbors and have shared many political traditions and outlooks. Their legal traditions are both shaped by Roman law rather than the common law (or precedent-based) system that characterizes Great Britain and the United States. In both France and Germany, the traditions of the Enlightenment and specifically of eighteenth-century cameralism (or state sciences, Staatswissenschaften) laid the foundation for the involvement of the modern state in the economy. In this approach, the state and its high-minded servants were in a unique position to make judgments about the public interest and the long-term public good. What is even more surprising is that the fundamental economic orientations changed dramatically after crisis moments: in particular, the catastrophe of the Nazi dictatorship pushed Germany away from a state-centered tradition toward a rule-based liberalism. On the other side of the River Rhine, in France, traditional liberalism was discredited. France had fallen heavily in 1940, and its political, military, and economic elite had been completely discredited, not merely by the defeat but more enduringly by the subsequent cooperation or betrayal of the French elites. French thinkers became obsessed with economic planning. The reversal of economic cultures in both countries provides an extreme instance of the way that change—or progress—when it
occurs in Europe, almost always takes place in the aftermath of cataclysms and catastrophes.

Cultural attitudes can combine extraordinary durability and extreme changeability. Alexis de Tocqueville, in *The Old Regime and the French Revolution*, referred in 1856 to the French as “a people so unchangeable in its leading features that it may be recognized by portraits drawn two or three thousand years ago, and yet so fickle in its daily opinions and tastes that it becomes at last a mystery to itself.” France was “endowed with more heroism than virtue, more genius than common sense; better adapted for the conception of grand designs than the accomplishment of great enterprises; the most brilliant and the most dangerous nation of Europe, and the one that is surest to inspire admiration, hatred, terror, or pity, but never indifference?” By the twentieth century, a similar paradox existed in Germany, a country of intense intellectuality but also of tremendous brutality and destructive power, where foreign observers felt tempted to trace the origins of twentieth-century disorders back hundreds of years, to Martin Luther, or even thousands of years, to the tribes of the ancient Teutonic forests. In Thomas Mann’s iconic late-life novel, *Doctor Faustus*, in which he analyzed the condition of Germany, the main character states that the Germans are “capable of realizing antithetical principles of thinking and existence.” His friend responds by saying, “A rich people.” And he replies, “A confused people that confuses others.”

Some modern economists try to operationalize their perceptions of long-enduring national character traits into an economic model. Thus a recent attempt to understand the euro crisis tells of the incompatibility of national cultures and in particular the incompatibilities of a culture obsessed with “cheating” (Greece) and a contrary culture obsessed with “punishment” (Germany). The authors then develop a model of the interactions of choices between these two cultures and show that interactions between Greeks and Germans result into excessive “cheating” (by the Greeks) and excessive “punishment” (by the Germans), with a generalized loss of welfare, which is increasing in the degree of cultural heterogeneity, and which cannot vanish rapidly given the inertia of cultural norms. In such circumstances countries may reconsider participation in the union facing either the choice of breaking up and reverting to a national currency equilibrium or
otherwise considering the creation of a fiscal authority that can be endowed with any punish-forgive strategy the players agree to, hence giving a better chance of converging to a superior steady state and with lower transition costs.\textsuperscript{4}

The intellectual exercise raises the question of how and in what circumstances a revolutionary improvement in the institutional framework can change behavior and thus also apparently deeply entrenched cultural norms. To take a famous case from another European country, Poles were held to have a lazy and cheating culture—which the Germans dismissed as \textit{polnische Wirtschaft}—and then Poland ended communism, introduced democracy and a market economy, and within a few years occupied another stereotype, as the hardest-working Europeans. There is a powerful case that simply identifying the particularities of supposed cultural divergences allows a design of institutional mechanisms not just of accommodating but also of changing them.

**Federalism versus Centralism**

*The Roots of French Centralism*

The easiest explanation of the thought divergence of France and Germany follows simply from political structure. Cameralism, the early modern model of the bureaucratic guidance of an economy, might be an appealing philosophy for one state, but it clearly requires some sort of central direction. France, of all modern European countries, most closely resembles the ideal type of a centralized unitary state. (Italy, with great regional diversity of outlooks, social structures, and incomes, also—perhaps mistakenly—adopted the French centralized political model when it was built as a nation-state in the 1860s.) Indeed, historians have seen the centralizing urges of the French state as a long-term feature of continuity that spans deep divides between dynasties and even ideologies, from the \textit{missi dominici} of Charlemagne and the Merovingians, to the \textit{intendants} of the Bourbon Louis XIV, and then to the structure of departments with centrally appointed prefects after the Revolution and Napoleon, and back to the Restoration monarchy, the 1848 republic, the Second Empire, the Third Republic, and so on. According to analysts such as Alexis de Tocqueville and Albert Sorel, the historical function of the French Revolution was simply to finish or
accomplish the task set by the ancien régime. So centralization has a history in France that goes back a thousand years or so.

From the Holy Roman Empire to the Federal Republic of Germany

By contrast, modern Germany has always been a federal system, with the catastrophic exception of the twelve years of the Nazi dictatorship that implemented a policy of unification and centralization, or Gleichschaltung. Before 1806, the German-speaking territories were organized in a loose association of the Holy Roman Empire, with some 350 territorial units directly subject to only a loose and cumbersome imperial judicial system and some notional limits on their foreign policy. Some of these units were quite large states—Brandenburg-Prussia, Bavaria, Saxony, and Württemberg—while the smallest were little towns or even just parts of villages. After the 1815 Vienna Settlement, some vestiges of the old order were kept with a German Confederation, composed of thirty-eight states (again, some of them were still quite small). The German Empire of 1871 was created as a result of the initiatives of Bismarck’s Prussia, but it remained a league of princes, and the three large south German states, Baden, Bavaria, and Württemberg, even kept their own armies. The state structure of 1871 was retained in 1919 in the Weimar Republic, even though many critics argued that it was politically and economically dysfunctional. After 1945, the Allies—in particular the United States—rightly insisted on a revival of Germany’s federal tradition. Madame de Staël made this tradition the center of her analysis when she wrote that Germans provided a contrast to Latin countries in which there was “skill in escaping from duties”: by contrast, Germany lacked this souplesse hardie (bold suppleness) and instead was obsessed with the “honorable necessity of rules and justice.”

The German tradition emphasized the idea of the Rechtsstaat, the rule of law, or perhaps more accurately, the rule of rules. German constitutional lawyers love to quote an anecdote about a miller at the time of the eighteenth century King of Prussia, Frederick the Great. When the King wanted to seize his mill, the miller proudly replied, “Il y a des juges à Berlin.” (There are judges in Berlin.) But the French playwright who popularized this anecdote, François Andrieux, also noted a certain German hypocrisy about rules: the same monarch who was forced by courts to respect the property of a humble miller had no compunction when it came to the law of other countries, and simply sent his troops to seize the province of
Silesia. “On respecte un moulin, on vole une province.” (They respect a mill, they steal a province.)

Federations are mechanisms for preserving differences while minimizing conflict, while central states repress conflict by overriding differences through the assertion of authority. Federations thus need rules as a way of dealing with substantial differences in outlook. In Steven Spielberg’s striking 2015 movie Bridge of Spies, the central figure, the lawyer James B. Donovan, played by Tom Hanks, is pushed by a CIA agent to disclose his conversations with his client, a Russian spy, and then talks to the agent about the differences in their backgrounds: “I’m Irish. You’re German. But what makes us both Americans? Just one thing. One, one, one. The rule book. We call it the Constitution. And we agree to the rules. And it’s what makes us Americans.”

In the French Third Republic (1875–1940), it was often claimed that the education minister, or the president, could look at his watch and know immediately what page every French eleven-year-old was currently studying. By contrast, in Germany, issues such as education and policing but also the promotion of economic activity remained a state affair, and the imperial government kept out of those matters. The resulting contrast is very evident from any map of the two countries’ railroad systems. France looks like a gigantic spoke system emanating from Paris, the political center (and some important economic areas were not well-connected until the middle of the twentieth century: the coal-mining Nord and the ore fields of Lorraine), while Germany has multiple nodes, all connected with each other. That superior German interconnectedness doubtless also constituted an economic advantage.

The suspicion of centralizing principles in a federal state means that the Federal Republic of Germany insists more on the principle of parliamentary approval of legislation and also on checks through legal review by a supreme court (Constitutional Court, Bundesverfassungsgericht). A constant irritant to Germany’s partners in the European Union throughout the euro crisis was the German government’s worry about the need to obtain the approval of the Bundestag for each of the rescue packages. Critics also then subjected the government case to a complaint before the Constitutional Court. By contrast, controversial legislation can be implemented in France by decree law, even though critics will then denounce the failing democratic legitimacy. In 2015, a package liberalizing economic measures (the law Macron) was pushed
through by decree after 111 hours of parliamentary debate and 82 hours of committee hearings demonstrated the strength of opposition within the ruling Socialist Party: the government could simply use the provisions of the Constitution (Article 49-3) on the vote bloqué, provisions that have been used fifty times since 1958, including twenty-eight times by the reformist center-left government of Michel Rocard, who was French prime minister from 1988–1991. Germans by contrast associate decree laws of this type with the constitutional subversion that had undermined the interwar Weimar Republic and led to the Nazi dictatorship.

Banking and Finances

The federal emphasis that marks modern Germany is also evident in differences in the financial systems. The French banking system is highly concentrated. In the postwar economic upswing, the big three deposit banks were nationalized, and their investments were carefully coordinated by the French Treasury so as to accomplish the goals of economic planning. A great deal of German banking remained—and remains—regional, despite the prominence of some big universal banks: between 1870 and 1945, these were called the Berlin banks, or sometimes Great Banks (Grossbanken), and after 1949 their successors relocated to Frankfurt (Deutsche Bank and Commerzbank). These existed alongside a well-developed system of cooperative banks and also of savings banks, which were grouped together through wholesale regional banking establishments (Landesbanken), until recently owned by the regional states.

A federation requires a stricter legal framework to balance the interests of different regions and to ensure that one does not ruthlessly triumph over the other. There need to be tighter mechanisms to control fiscal activism at the center. This is especially true of financial matters and of fiscal policy. Transfers within Germany are regulated by a complex arrangement called the Finanzausgleich, the terms of which are so contested that it cannot be frequently reformulated or renegotiated.

The question of federalism also affects the outlook on monetary policy. In European perceptions in the postwar world, the dollar was manipulated and instrumentalized as a tool of US policy, with “benign neglect” (in the late 1960s) or “malign neglect” (in the late 1970s) forcing other countries to carry the cost or the burden of American policies. The dollar was a “can-do” currency, in this view. The French response was to devise
ways for Europe to develop its own capacity to respond by affecting the external valuation of its currency. Germans were skeptical and preferred to think of their currency as limiting rather than enhancing the room for maneuver: currency was a “cannot do that” instrument. Their view followed from the monetary character of a federation: federations need to restrict money creation because it could affect incomes in a disparate way.

Monetary instability in the past decisively helped to threaten or even to blow apart fragile political systems. The monetary authority never simply agrees to convert every outstanding obligation into money. Instead, it will decide that some industries, or some banks, or some political authorities need to be kept going for the good of the general community and that their debts should as a consequence be monetized. Those industries, banks, and political authorities that are not so privileged are inevitably resentful and see the central bank’s actions as an abuse of power. In federal systems, in particular, those businesses and political authorities far removed from the center of the federation are most likely to be excluded from the monetary stimulus and hence inclined to be alienated.

Hyperinflation in early 1920s Germany fanned separatism in Bavaria, the Rhineland, and Saxony because these remote areas thought that the German central bank and the central government in Berlin were discriminating against them and privileging the capital and its interests. The separatists were radical, on the left in Saxony and on the far right in Bavaria and the Rhineland. The scar created by the memory of inflation is particularly acute in Germany, but it is by no means a purely German phenomenon. There are also more recent cases of federations eroded by inflation. In late 1980s Yugoslavia, as the socialist regime disintegrated, the monetary authorities in Belgrade were closest to Serbian politicians such as Slobodan Milosevic and to Serbian business interests. The Croats and Slovenes wanted to get away. In the Soviet Union, inflation appeared as an instrument of the central Moscow bureaucrats, and more remote areas wanted to break away. Hyperinflation thus fueled the national tensions that broke up federal systems in the Soviet Union and Yugoslavia.

The response to German hyperinflation in the 1920s was the institution of a new banking law that protected the central bank (Reichsbank) from government intervention. The 1957 Bundesbank Law also guaranteed the autonomy of the new central bank’s monetary policy. In consequence, there were spectacular conflicts when Chancellor Konrad Adenauer in the
late 1950s or Helmut Schmidt in the late 1970s attacked the Bundesbank for acting as a brake on growth (in other words, for behaving as an independent central bank is supposed to behave).

In France, until the mid-1990s, there was a general consensus that in a unitary republic an independent central bank was undesirable because it would escape from the control of the central political authority that directly reflected the will of the people. In the early 1990s, the Treasury director Christian Noyer (who later became governor of the Banque de France) stated that central bank independence was incompatible with France’s republican traditions in that the Republic was “one and indivisible.” Centralized states such as France or Japan (which as he pointed out had an excellent record in fighting inflation) exercised political control over central banks, while independent central banks were fundamentally suited to federal states such as Germany, Switzerland, and the United States (and hence also, presumably, although he did not point this out at the time, the European Community or European Union). But it was those models—largely the German and perhaps also the US one—that offered the most promising blueprint for how to construct a new European Central Bank.

**Mittelstand versus National Champions**

*National Champions*

The question of federalism has had an impact not just on the structure of the state but also on the kind of economic organization. The French economy is dominated by large, highly competitive international companies. There are more French firms among the 500 largest firms in the world than German firms: in the FT 500 list for 2014, twenty-eight French versus twenty German (*Forbes* gives a narrower difference on the basis of a slightly different methodology, thirty-one French versus twenty-eight German). The large firms have a close relationship with the government, and the government sees the promotion of their interests as a general public interest. There is a long history, from at least the nineteenth century, of French firms struggling to capture political rents, of businessmen entering politics to influence legislation, of family businessmen encouraging their daughters to marry state officials to extend their control, and of producers defining their businesses as central to national identity. Such behavior created a tradition. An infamous modern example occurred when the French
government intervened to protect the large food business group Danone from a foreign takeover as a strategically vital company on the grounds that food was an expression of France’s cultural identity.

Germany also has large internationally competitive firms backed by the government. There was the same sort of rent-capturing behavior in the nineteenth century: the giant electrical firms Siemens and AEG moved their headquarters and a great deal of their production to Berlin, not for resource reasons but simply because it was the new seat of the German government. But Germany also has a substantial sector of small and medium enterprises (SMEs) that are generally referred to as the Mittelstand. The small and medium-sized businesses have generally been the incubators in which middle-class dynamism developed and galvanized society as a whole. This is as true in the immediate past of Europe as it was in the pioneering days of the Industrial Revolution or in the European Middle Ages. In recent years, small (and often new) businesses have been the major creators of jobs. The fortunes of the small business sector have major effects on the economy as a whole. In the United States, between 1980 and 2005, all net new private sector jobs were in companies less than five years old. By contrast, most large companies have tried to rationalize or downsize employment. German statistics also show small and medium enterprises as net creators of jobs in 2000–2005 (with a million new jobs) and large enterprises as losers (a loss of 800,000 jobs).

German Mittelstand

The German Mittelstand is geographically concentrated, above all in the south of the country, in the states of Bavaria and Baden-Württemberg (as well as to some extent in the southern states of former East Germany, Saxony and Thuringia). The historical heart of the German economy in the nineteenth and early twentieth centuries, the Rhine-Ruhr basin, was just as dominated by large companies as France. There thus ensured what the sociologist Gary Herrigel calls “contrasting industrial landscapes.”

Federalism, however, meant that the small businesses had political champions in the state as well as local governments.

As with the development of contrasting economic philosophies, the roots of the contrasting economic structures lie back a long way in time. In Europe, the key to development lay in the character of social space. In
particular, it was the dynamic of urban development that produced a unique chance of mobility. Medieval and early modern Europe had two models of city. On the one side, there were the bureaucratic capitals of a large state, of which Naples was the largest sprawling example. The alternative lay in those cities dominated by mercantile activities, which were often self-governed. In these, order, justice, and harmony, coupled with education and virtue, transformed not only the city but also the surrounding lands. In the famous frescoes of Ambrogio Lorenzetti in Siena’s Palazzo Pubblico depicting the “Effects of Good Government on Town and Country,” there is not only dancing in city streets but the farmers outside the walls are peacefully tilling their fields. The contrasting picture shows crime, disease, and drought undermining community.

City-states in particular offered a magnet for the ambitious offspring of the land. This late medieval political form also provided a model for civic engagement that in the famous analysis of Robert Putnam still had a major impact on the effectiveness of government and of democratic politics in the twentieth century. West European cities had a unique independence that produced a base for innovation. Cities acted as magnets, where people with ideas could discuss, develop, and realize them. Modern business depended on urbanity. Urban centers then connected with each other and provided a quite different basis for trade than the centrally directed efforts at procurement on the part of great authoritarian regimes.

This model of small businesses that constantly interact with each other—as suppliers, purchasers, or rivals—is still a characteristic of the business landscape of Southern Germany, Northern Italy, and Switzerland, with clusters of dynamic export-oriented niche producers. It is a model that other countries have occasionally tried to emulate with the instruments of state policy and state planning, but it is surprisingly difficult to transplant to other terrains because it depends on such a peculiar and deep historical origin.

Civic engagement, as in the Siena painting, depends on a spontaneously emerging social order. Where it is ordered from above, by a large bureaucratic state, the initiative tends to be stifled. The quest for the general good produces resources that invite the capture of rents by the politically well-connected. In that sense, the model of a dynamic middle stratum, preserved through mechanisms for self-government, is bound to be constantly vulnerable.
In continental—or more accurately in German-speaking—Europe, the productive layers are dignified with a label that seems to imply their universality: Bürger. The French rendition (bourgeois) captures the depth of meaning less adequately than the German term, although it is often used in an international discourse (many English-language indexes of historical books contain entries of this type: “middle class, see bourgeois”). Bürger can have a universal meaning (citizen or citoyen) as well as a socioeconomic one, or one that refers to educational attainment. But in each case, the central meaning is clear: a Bürger is someone who is capable of self-determination, who can see the fruits of his own economic, political, cultural, or social efforts. A Bürger is not a being that is at the blind mercy of impersonal forces; rather, the Bürger makes a world on the basis of a forceful and dynamic imagination. A Bürger is above all someone who takes responsibility for his or her own actions.

Collaborative versus Confrontational Labor Unions

Soziale Marktwirtschaft

Labor relations substantially differ across European countries. A key problem historically lay in the extent to which workers were prepared to see themselves as Bürger, with an interest linked to the general good and in a cooperative relationship with employers, or alternatively as citoyens, struggling for the general good of the republic against the particular interests—and the vices—of employers. Both sorts of identification can be seen as a kind of responsibility: but the former is to a concrete present reality, while the second is to an abstract notion of what the future might become. One of the remarkable transformations of Germany after 1945 was from a country where labor relations had been highly conflictual into one where labor was institutionalized as part of the overall social system, the Soziale Marktwirtschaft, through works councils and codetermination at the enterprise level. France, by contrast, continued with a basically conflictual pattern.

The extent of political and economic responsibility is directly affected by the way labor movements are organized: that helps to shape the way they see themselves. A feature of the bad political economy of Germany’s interwar democracy was the existence of multiple trade unions that competed with each other and used bargaining strategies aimed at maximizing returns for their members. The case is a perfect example of the logic of
collective action as explained by Mancur Olson: each collective bargaining unit looks for gains for its members at the expense of the overall community. The outcome is costly for society as a whole. The best solution is to simplify the organizational structure so that there are fewer actors who are more aligned with the general interest.

That organizational simplification occurred in West Germany after World War II. There were now generally single unions that covered an entire industry, and they were not linked to a particular political party or worldview. In addition, codetermination brought worker representatives into the upper-level board (supervisory board, Aufsichtsrat) of German companies. In the particularly politically sensitive heavy industries—coal and steel—after the law of 1951, workers had half the seats on the supervisory board; in other industries, a law from 1952 provided for a third of the supervisory board being composed of employee representatives. In 1976, the principle of half the representatives was applied to all German businesses employing more than 2,000.

**Competing French Labor Unions**

By contrast, in France, the labor movement was split both before and after World War II into communist and noncommunist unions. For most of the time, by far the strongest and most organized of the union federations was the CGT, which was close to the Communist Party. The different unions competed against each other: in particular, the noncommunist unions organized in the CFDT, and the Force Ouvrière needed to demonstrate that they were not just patsies of the bosses. They generally saw their interests as fundamentally opposed to those of the factory owners, not aligned with them. In the words of the famous French workers’ anthem, Eugène Pottier’s “The Internationale,” written in the aftermath of the Paris Commune of 1871,

> No saviour from on high delivers,  
> No faith have we in prince or peer.  
> Our own right hand the chains must shiver,  
> Chains of hatred, greed and fear.  
> E’er the thieves will out with their booty,  
> And to all give a happier lot.

As a result, rhetoric escalated, and there is a substantially more antagonistic history of labor relations. It is filled with symbolic actions to
demonstrate the principle of noncooperation: radicalized workers, for instance, liked to demolish statues of business pioneers (the result is that there are hardly any such monuments left in France).

The way the unions organized and negotiated affected economic and monetary policy. The German government, especially after the 1960s, saw the setting of guidelines for pay settlements as part of its responsibility. From 1974, when the Bundesbank moved to monetary targeting, its representatives also insisted that a major part of setting the monetary target was to give employer and worker representatives a sense of how the economy was developing and, consequently, of what would be an appropriate wage settlement. As the economist and Bundesbank president Axel Weber put it, Germany “did not deliberately opt for strict monetary targeting proposed by Milton Friedman, but rather carried out a pragmatic policy of monetary targeting.” 14 Karl Klasen, the president of the Bundesbank at the time monetary targeting was introduced, explained, “On the one hand, monetary policy has in large part a psychological effect, and on the other hand the central bank needs above all to ensure that it contributes to the realization of fundamental objectives (employment, stability, etc.).” 15 As a consequence, American monetarists often treated the German practice with some contempt, thinking that it was more about talk or suasion than about creating a firm limit on the volume of money circulating. But later, when it became clear that the Friedman approach to monetary targeting had “consistently failed,” in the phrase of Lars Svensson, Friedman started to cite the Bundesbank experience as “the first and most successful application of his ideas.” 16

Even in the 1970s, European officials tried to recommend the German mode of social relations as a model for the rest of Europe. For instance, Commissioner Wilhelm Haferkamp, the (social-democratic) German vice president of the Commission responsible for economics and finance in the 1970s, spoke of how “The establishment of normative projections of monetary growth as in Germany had a positive effect on the behaviour of economic actors and represented a useful concept which should be adopted on the Community level” as a means to promote “a better cooperation between the social partners and the government.” 17 Monetary policy is a key part of the story of inducing an ethic of responsibility in Germany—and in prompting a renunciation of the theatrical politics of conflict and struggle.
Historical Inflation Experiences

Monetary policy can be a testing point for the principle of responsibility. How far can the interaction of powerful social actors—trade unions, employers, the government—force monetary authorities to provide an accommodative response? And does a bad memory help to shape an economic culture? The most dramatic and famous inflationary experience of the twentieth century occurred in Germany after World War I, although other Central European countries, including Austria, Hungary, and Poland, had similar experiences at that time, and the Hungarian inflation after World War II was more severe as measured by the extent of the loss of value of the currency.

The monetary disorders of the early 1920s—the Great Inflation—had a profound and long-lasting effect on Germany. But the reason why is not obvious to many modern observers, who point out (correctly) that almost no Germans alive today have experienced the Great Inflation and that there are even relatively few whose parents had a direct experience. It is often puzzling to outsiders why an event that is now so distant should have had so traumatic an impact. In addition, does the historical record not show that the economic event that immediately preceded the interwar collapse of democracy and the dictatorship of the Nazis was not the inflation but a catastrophic deflation?

It is undoubtedly true that by November 1923, the German currency, the mark, had fallen to one-trillionth (1/10^{12}) of its prewar value (the Hungarian forint depreciated to 1/10^{23}). Contemporary accounts of the Great Inflation emphasize the extent to which the devaluation of money destroyed every normal expectation. In the last stages of inflation, prices changed several times a day. Shopkeepers followed the foreign exchange rates and immediately adjusted their charges. Vast amounts of paper money were needed to make even single purchases. In the longer run, inflation destroyed German savings, wiped out the capital of corporations (including banks), and made the economy of the unstable democratic Weimar Republic vulnerable to yet more shocks. It also had a dramatic effect on popular and political psychology.

The constant alteration of prices, the immiseration of large swathes of the population, and the dramatic story of fortunes made and fortunes lost as a result of speculation made ordinary Germans vulnerable and neurotic.
The rapid movement of prices made it appear that every transaction was some sort of a swindle: customers rushed to buy goods before the announcement of a new exchange rate of the dollar and blamed traders if there were no goods in the shop. Because it played along with very old, established clichés about Jewish dominance of finance, the inflationary uncertainty fueled anti-Semitism. Later on, some shrewd observers such as the scientist and writer Elias Canetti reached the surprising conclusion that it was the Great Inflation that made the Holocaust possible by creating a world in which large numbers simply seemed unreal and incomprehensible. Bureaucrats simply wrote down impossibly big sums without thinking of the human consequences.

The early 1920s were not the only German experience with inflation. In the early 1930s, it was in part fear of inflation that made the deflation and the economic crisis so severe. Then, within a few years, monetary and fiscal expansion enabled Hitler’s rearmament. The effects on prices were suppressed through price controls, and the effects of the repressed inflation appeared instead in increasing shortages and in quality deteriorations (so that shoes, for instance, wore out in months rather than years). The aftermath of Hitler’s inflation only became fully apparent after World War II, when part of the process of monetary reform was to cancel the “monetary overhang” and write down monetary assets by a factor of ten.

In the 1960s, such German economists as Egon Sohmen gave persistent warnings about the international inflation generated by the United States, especially through its financing of the Vietnam War. French economists were even louder on the same theme: Jacques Rueff in particular, the key adviser in de Gaulle’s stabilization at the end of the 1950s, provided the clearest indictment of irresponsible dollar politics, and it was French politicians who took on the task of criticizing America’s “exorbitant privilege.” When, however, inflation took off internationally in the 1970s, Germany was one of the first countries to try to break inflationary expectations rather than accommodate them, while France was more accommodative and in the second half of the 1970s had rates of inflation two or three times higher than those of Germany. France no longer had the political structures that supported a sound money culture: the explosion of revolution in 1968 had the effect in France—but not on the other side of the Rhine—of unleashing a fragmentation of the left and the labor movement and a competition to take up radical stances.
Economic thinking is shaped by historical experience. As this chapter details, the experience of dictatorship, World War II, and military defeat played a special role in influencing the development of economic traditions in Germany and France. The differences stretch from questions such as how to arrange competition and macroeconomic planning at home to the preferred arrangement of the global international monetary system. These differences are related to but do not clearly fall in the classic Keynesian-Austrian divide.

Overall, this chapter will try to address the following questions:

- At a high level, how do German and French economic philosophies and traditions differ?
- Are these differences written in stone or do the economic traditions evolve or even switch sides over time?
- What events shaped the economic traditions? What role did academic economists, leading newspaper writers and political figures play?
- How do French and German views differ with regard to the international monetary system? When facing the same trade-offs, do both countries choose the same outcome?

Fluid Traditions: Switch to Opposites

In the nineteenth and for the first half of the twentieth century, France could generally be characterized as dominated by economic liberalism (in
the European sense) and Germany as largely statist. Then, quite abruptly, after 1945 the pattern reversed.

Nineteenth-century France had an economic philosophy largely dominated by laissez-faire, as brilliantly expounded by Frédéric Bastiat and Jean-Baptiste Say, while German thinkers elevated the state as the major economic actor. In both countries, there was always a back and forth. But the older traditions have been largely forgotten, to the extent that a recent guide on “how the French think” includes no reference to liberalism, Bastiat, or Say, but simply focuses on French étatisme and planisme.1

The great French classical liberals were reacting against the powerful legacy of Louis XIV’s powerful finance minister Jean-Baptist Colbert as well as against abusive manipulation of money. As Louis XIV’s wars produced increased economic misery, and after the death of Colbert, an alternative liberal tradition developed. Indeed, the Jansenist theologian Pierre Nicole has a strong claim to have been the first modern figure to explain that, in the world of fallen humanity, social well-being depended on mechanisms that harnessed man’s self-interest and not his benevolence. His 1670 tract on The Education of a Prince explained that “Cupidity takes the place of charity to fill human needs, and it does this in a way that is not sufficiently admired, and that charity could not arrive at.”2 This was the worldview of Adam Smith, derived from a theological foundation. The antiliberal view powerfully reasserted itself in very destructive ways, notably, during the bubble unleashed by the Scottish adventurer John Law, who wanted to destroy competition through a new system to “combine the competing interests and make the nation wealthier.”3 By the nineteenth century, liberalism in France had clear enemies: the monetary and inflationary abuses of Law along with the paper money (assignat) financing of the French Revolution.

At the same time, German economists developed Staatswissenschaft, in which state authority solved collective-action issues and then applied that philosophy to an increasing range of economic and social problems. German liberal thinkers had in the early nineteenth century developed the idea of rule of law in a state formed by right (Rechtsstaat), and there was an alternative tradition of thinking about rules as the characteristic component of the well-ordered state. The term Rechtsstaat was popularized by Carl Theodor Welcker (1790–1869), a lawyer and member of the 1848 Frankfurt National Assembly, and by Robert von Mohl (1799–1875),
another lawyer, in his 1844 treatise The Science of Policy According to the Principles of the Constitutional State. Then, however, a reaction set in, and Bismarck’s political practice eroded the principles of a legally ordered constitutional state.⁴ There were a few German Smithians, and Germans invented the concept of Smithianismus. For the most part, British thinking was dismissed as Manchesterism, a form of materialism devised by the cotton masters. One example is Friedrich List’s famous criticism, largely unnoticed during his life, of British free-trade economics as a cynical device for ensuring that Great Britain retained preeminence while trade openness kicked the ladder away for other countries that may want to climb up to advanced industrialism. The German school had a strong interest in institutional design and in the use of institutions to tweak policy in a desirable outcome. Adolph Wagner formulated a “law of increasing state spending” (which he saw as an accompaniment of modernization), and he and his colleagues—notably Gustav Schmoller and later Werner Sombart—acquired a reputation as leftists, or Kathedersozialisten. In the 1930s, a brilliant French economist, François Perroux, produced an analysis of the contrast between French and German thinking, by noting that “the greatest danger lies when the two partners do not speak the same language and have different intellectual and moral values.” In particular, he believed that France insisted on rules and contracts, while Germany had a feudal sense of good faith that was personalized and “mocked contracts and signatures.” “The German does not have like us the sense of the permanent and absolute value of the contract.”⁵

Perroux’s depiction of a strict French insistence on contracts and their enforcement and a personalistic German orientation appears exactly the opposite of modern stereotypes. So it appears that German and French economic thought flipped sides from the nineteenth to the late twentieth century: the Germans moved to more economic liberalism, while the French retreated.

Both the old traditions in both countries were discredited as a consequence of the political catastrophes of the mid-twentieth century. The extent of the catastrophe, on both sides of the Rhine, indicated the necessity of a basic change of course. German writers could see how the prominent role accorded to the state in traditional economic theories might have favored Nazi etatism. By contrast, younger French thinkers blamed the do-nothing noninterventionism of the traditional liberal
school for sluggish economic growth, but also specifically for fiscal austerity and consequently the failure to coordinate a viable defense economy in the 1930s. Thus, after World War II, France reacted against old-style laissez-faire and emphasized the desirability of systematic planning, and Germans recoiled from the idea of the state because its actions were arbitrary.

Of course, interest as well as ideology or institutions may have played a role in making the intellectual or ideological reversal in national thinking. But it is worth pointing out that the switch in attitudes between Germany and France cannot simply be explained by their net debtor or creditor positions. Germany, it is true, was a big debtor in the interwar period, with large current account deficits and capital inflows in the 1920s, when it was mostly in favor of debt cancellation and also ran two large inflation episodes; but it was a creditor in the nineteenth century, when the statist orientation originally evolved. France had substantial current account surpluses from 1992 to 2004.

**German Economic Tradition**

*Hayek’s Critique of a Planned Economy*

The most far-ranging critic of the German or Central European model of statism was Friedrich Hayek, an Austrian who mostly worked in the United Kingdom but toward the end of his life settled in Freiburg, in Southwestern Germany. He was largely without political influence until the 1970s. Hayek accurately identified that the interventionist approach of the Weimar Republic (which had its origins in wartime planning) created a sort of path dependency, in which the answer to failure was not an abandonment of the approach but rather a more radical version. In *The Road to Serfdom*, Friedrich Hayek asserted that Walter Rathenau, the intellectual who devised Germany’s innovative planning regime of World War I, “would have shuddered had he realised the consequences of his totalitarian economics” but nevertheless “deserves a considerable place in any fuller history of the growth of Nazi ideas. Through his writings he has probably, more than any other man, determined the economic views of the generation which grew up in Germany during and immediately after the last war; and some of his closest collaborators were later to form the backbone of the staff of Goering’s Five Year Plan [sic] administration.”
controls looked ineffective, so the Nazis wanted more extensive and radically enforced control. Rathenau’s major collaborator, Wichard von Moellendorff, formulated his view of a new communal economy, or Gemeinwirtschaft, provocatively and concisely: “Up to now in Germany the principle reined: free in economic matters, constrained in intellectual and spiritual affairs. The purpose of Gemeinwirtschaft is to turn that upside down.” In practice, however, the experience of interwar Germany showed that economic constraints also contributed to the erosion of intellectual, spiritual, and political freedoms.

A widespread response to the great financial crisis of 1931 was the imposition of capital controls, which brought the state further into the micromanagement of economic activity. Economic planning, as Hayek recognized, was inherently discriminatory: “It cannot tie itself down in advance to general and formal rules which prevent arbitrariness. . . . It must constantly decide questions which cannot be answered by formal principles only, and in making these decisions it must set up distinctions of merit between the needs of different people.” The issue of arbitrariness applies in a particular way to the actual implementation of capital controls. They were implemented in both Austria and Germany from 1931, that is, before the onset of the political dictatorship (Hitler came to power in January 1933, and Austrian conservatives created the reactionary corporate state, or Ständestaat, in 1934). But the dictatorship provided more means of enforcing controls. Hayek cites the German liberal thinker Wilhelm Röpke, to the effect that “while the last resort of a competitive economy is the bailiff, the ultimate sanction of the planned economy is the hangman.” Hayek might actually, if he had at the time known Hitler’s table talk, have cited the musings of the dictator himself: “Inflation does not arise when money enters circulation, but only when the individual demands more money for the same service. Here we must intervene. That is what I had to explain to Schacht [the president of the Nazi central bank], that the first cause of the stability of our currency is the concentration camp.”

The decision on who should benefit from the allocation of foreign exchange became political and arbitrary. The institution invited a political process of rent-seeking, and it was those who could develop the closest contacts with the regime who benefited most. The allocation of scarce raw materials was in fact the basis of Nazi economic planning and also an
initial instrument in the application of anti-Semitism: Jews were discriminated against as far as access to imports of raw materials, and their businesses suffered as a result.

**Ordoliberalism**

A softer version of the Hayekian critique of the old German tradition was deeply influential in Germany and had a major political impact. Known as *Ordo-Liberalismus* (or sometimes as the Freiburg School), and chiefly expounded by Röpke and Walter Eucken, it developed the emphasis on the state that was characteristic of the old German historical school, but altered the emphasis. According to the new doctrine, rules needed to be formulated in general terms and the state’s actions should be confined to the enforcement of such general laws, for instance, the laws on competition and against cartels, which had been an important part of the older German tradition of business management. Unlike Hayek, who more and more insisted on the spontaneous creation of order and rules, the Ordoliberals emphasized the need for an initial elaboration of an appropriate framework.

Their vision of order includes both a system of general rules and a mechanism by which those rules define the liability (or responsibility) of individuals, and of economic agents. The system fundamentally depends on the accountability of market participants. Any measure that limits accountability or responsibility by promising some sort of contingent rescue would create destructive incentives that would lead to the accumulation of unfulfillable expectations on behalf of the economic actors and unfulfillable liabilities on the part of the government as the ultimate insurer. As a consequence, Ordoliberals worried greatly about *moral hazard*, a term taken from insurance (a well-insured person may not take sufficient care that his house does not burn down). On these grounds, the Freiburg School and its modern successors even worry about the limited liability principle for corporations. “Unlimited liability is part of a competitive system,” Walter Eucken wrote. In his eyes, the problem was that the development of the legal system and the increased complexity of laws tend to subvert the liability principle: “Its destruction by legal policy endangers the functioning of this system.” So too many, and too complicated, laws would breed moral hazard, and the economic agents are given incentives to game the system.

The antitrust thinking of the new German economists also meshed well with the thinking of the US military administration. General Lucius Clay,
the military governor, liked to sum up American goals for the postwar German order as the four Ds: denazification, demilitarization, democratization, and decartelization. The critical document for the initial postwar occupation policy, JCS 1067 of April 26, 1945, required the prohibition of “all cartels or other private business arrangements and cartel like organizations.” One of the German Ordoliberals, Franz Böhm, wrote that there was “no influential and socially strong group” supporting competition “excepting the American occupation authorities.”

Competition law thus became a crucial part of the new German philosophy and, as advanced by Walter Hallstein, the German economist and civil servant who became the first president of the European Commission, also of European law. Ludwig Erhard, the economics minister who pushed Germany’s liberalization program, made the link between competition policy and European priorities explicit. In 1952, at the launching of the European Coal and Steel Community, he stated, “We plan to create a common European market. The aim is incompatible with a system of national or international cartels. If we want to create a higher standard of living through technical progress, rationalization, and an increase in production, we have to be against cartels.”

The resulting vision did not completely remove the state. The Freiburg economists and also Erhard saw their ideal as a middle path between the extremes of an unregulated free market and unlimited state command, and some other economists, notably Alfred Müller-Armack, spoke of a social market economy (soziale Marktwirtschaft). Walter Eucken formulated the philosophy of the Freiburg School as follows: “A genuine, equitable, and smoothly functioning competitive system cannot in fact survive without a judicious moral and legal framework and without regular supervision of the conditions under which competition can take place pursuant to real efficiency principles. This presupposes mature economic discernment on the part of all responsible bodies and individuals and a strong impartial state.”

The German position always remained somewhat ambivalent, and the middle way could oscillate. The rejection of the past was not as extreme as it appeared in some of the Ordoliberal manifestos. Indeed, the economic historian Albrecht Ritschl has argued (controversially) that a large part of the distinctively German and rather corporatist approach to the state-business relationship was inherited from the Nazi era.
Ordoliberalism in Today’s Germany

In the 1960s, the German model incorporated a good deal of Keynesianism, reaching a high point in 1967 with the Law on Stability and Growth. But even the way that German Keynesianism was formulated in terms of a foundation of stability—or a rule-based order—was very characteristic of the German tradition. In addition, in academic economics, Ordoliberalism ceased to be the prevalent tradition and was largely replaced by a US-style neoclassical synthesis. There is virtually no serious academic economist who would today describe himself as an Ordoliberal (and indeed no female academic Ordoliberal); most modern Ordoliberal academics are lawyers rather than economists. Hans-Werner Sinn, one of Germany’s most publicly prominent economists, is often portrayed by outsiders as an extreme case of the German obsession with moral hazard issues, and at his retirement, the conservative Bavarian minister president Horst Seehofer celebrated him as a “Great Ordo-liberal” (which he distinguished from “narrow neo-liberals” and Milton Friedman’s “Chicago boys”); but Sinn himself instead tries to present himself as simply a classical economist.

Some Ordoliberalism survived in think tanks and in the economic research institutes that are a feature of the German intellectual landscape and constitute a bridge between academia and politics. In particular, the Hamburg Weltwirtschaftsinstitut and the Cologne Institut der Deutschen Wirtschaft have been quite consistently Ordoliberal in outlook, while the Berlin German Institute for Economic Research (DIW) has long been Keynesian. The German Council of Economic Experts (Sachverständigenrat), which was set up by Ludwig Erhard in 1963, and which is intended to inform and educate the public rather than specifically to advise the government, often thinks of itself as emphasizing microeconomic foundations rather than macroeconomic interventionism and sees itself as embodying the legacy of Ordoliberalism. But in general, Ordoliberalism has a bad reputation, especially outside Germany, with the Financial Times journalist Wolfgang Münchau excoriating “the wacky economics of Germany’s parallel universe”: “German economists,” as he put it, “roughly fall into two groups: those that have not read Keynes, and those that have not understood Keynes.” It would indeed be peculiar if a whole country fell prey to a collective ideological imbecilism.

The traditions of the postwar era certainly exercise a substantial, almost subconscious, appeal to many Germans, and especially to German policy
makers in the Bundesbank and perhaps also the Finance Ministry. It is also conspicuously represented in the economics pages of the major German newspaper the Frankfurter Allgemeine Zeitung (FAZ) and powerfully reinforced by the fundamentally even more liberal Swiss newspaper Neue Zürcher Zeitung. The FAZ is generally considered to be moderately right of center, but even the moderately left Süddeutsche Zeitung devotes space to the German economic tradition. In particular, since 2009, both these large German newspapers have worried about the moral hazard implications of euro rescue measures. Those traditions represent what Keynes famously called “the gradual encroachment of ideas” that rendered politicians and practical men as “slaves of some defunct economist.” As the Bundesbank had a major input in the design of the European monetary union, some commentators speak of the “Ordoliberalization of Europe.”

But there is also something of a political pushback against the residues of Ordoliberalism. German officials in some Berlin ministries like to voice their dissent from alleged “fundamentalists” in the Bundesbank. The government also started to distance itself from the Council of Economic Advisers, complaining that the economists there were too dogmatic and inflexible and were looking “too much through German spectacles” and to taking into account the weakness of demand in peripheral Europe. The Social Democratic Party (SPD) economics minister Sigmar Gabriel pointedly delayed supporting the renomination of the chairman of the economic advisers, Christoph Schmidt. The council had provoked the government by criticizing many of the policies of the coalition government and demanding a return to more Erhard-style market-friendly policies. The SPD’s general secretary complained that the council was proceeding in an unscientific way.

In the course of the euro debt crisis, German critics of the euro and the various rescue packages and measures liked to present themselves as the voice of the economics profession. “Economics professors” in Germany came to have a sort of ideological definition. They were the five professors who conducted a complaint against the Greek rescue package in 2009 (Wilhelm Hankel, Wilhelm Nölling, Karl Albrecht Schachtschneider, Dieter Spethmann, and Joachim Starbatty—only one of these was really an academic professor of economics, and he was retired). They were the 172 professors who in July 2012 signed a letter to the FAZ attacking the
banking union plan.\textsuperscript{23} Or another group of five who together with other groups and with over 37,000 individual complainants organized by the Left Party in 2012 launched a constitutional complaint against ECB bond purchases.\textsuperscript{24} The phenomenon of economics professors even eventually appeared as a new political party: Bernd Lucke (an economics professor from Hamburg) and Konrad Adam (a retired \textit{FAZ} journalist) formed an anti-euro protest party, the Alternative für Deutschland (AfD), which polled surprisingly strongly in the European Parliament elections of 2014. These organized mobilizations of economics professors were not truly representative of the economics profession in Germany, but they wanted to give the impression that they were. Later, the economic professors were forced out of the AfD, which turned in a radical right direction.

\textbf{Ordoliberalism in a European Context}

The lineage from the Ordoliberals of the immediate postwar era to the modern politics of the euro does not only run in a solely German, or national, direction. Some of the background to the reversal of the German stance from etatism to an assertion of the liberal principles of economics occurred on a European level. One of the most interesting attempts to promote new economic thinking on a European level took place in Paris in August 1938. Twenty-six economists and other intellectuals, from all over Europe, had been summoned by the French philosopher Louis Rougier to discuss Walter Lippmann’s 1937 book \textit{The Good Society}. In that book, Lippmann had defended political and economic liberalism in the face of a rising worldwide tide of illiberal antiparliamentary movements based on centralized economic planning: communism, fascism, National Socialism. The meeting included two figures who would be prominent in developing the German approach to Ordoliberalism, Wilhelm Röpke and Alexander Rüstow, although interestingly (and characteristically in the light of the historical moment) none of the participants were described as German: Rüstow was described as coming from Turkey, where he lived in exile, and Röpke as “école autrichienne, Austrian school,” along with Ludwig von Mises. Some of the most influential postwar French economic figures participated, Jacques Rueff, Raymond Aron, and Robert Marjolin.\textsuperscript{25}

After 1945, the development of the European Union lends itself to the kind of analysis that the Ordoliberal school undertook immediately after World War II of the problem of the proliferation of rules and the tendency
to augment or even replace general laws with particular decrees. Designed on Ordoliberal principles, as Bundesbank president Jens Weidmann recently pointed out, because of the need to observe rules in a federal setting, the European Union is vulnerable as a result of the ever more complex rules that after the financial crisis seem necessary to ensure its functioning. As Eucken warned, the elaboration of such detailed rules opens the way to the assertion of particular interests and the undermining of the collective project.

The elements of the German economic intellectual tradition can be summed up as follows:

1. A focus on the legal, moral, and political foundation of free markets in agreed rules, which may be treaties or laws or also common or shared understandings.
2. A strong emphasis on responsibility and accountability. Participants in the market and those in the political process both have a responsibility. For market participants, the responsibility is a financial one—they need to pay the price of failure; politicians are accountable to voters. In short, as a Bundesbank official recently put it, those who have control and take risks also need to face the consequences of their actions.
3. A concern with the potential for moral hazard arising out of lender of last resort activities. The IMF package for Mexico in 1994–5 was heavily criticized by German officials as encouraging reckless behavior on financial markets by increasing the likelihood of future rescue operations.
4. A concern that lender of last resort (LLR) action may corrupt or pollute monetary policy, because a central bank that has an LLR obligation might be force to give financial sector stability priority over price stability.
5. A belief that firm or binding rules are needed to shield monetary policy from fiscal dominance, namely, the view that government, by raising the permanent level of expenditures without at the same time raising taxes, can affect the current and future flows of the monetary base and, hence, of the money stock and of the inflation rate.
6. A strict approach to government debt and to debt ceilings. Germany pioneered an approach that it now proposes to Europeanize, with a 2009 law mandating a deficit limit at the federal level.
of 0.35 percent of GDP by 2016 and an elimination of deficits for states by 2020. German think tanks like the idea of a Europeanization of fiscal rules enforced by some sort of fiscal or debt council.\textsuperscript{30}

7. Growth is not achieved by the provision of additional money or resources but by structural reforms.\textsuperscript{31} Additional money is a sort of trickery, doomed to failure, and analogous to trying to pull yourself out of a swamp by pulling on your bootstraps.

8. A belief that present virtue—or austerity—is rewarded by future benefits.

**French Economic Tradition**

France too began the postwar era by rejecting the economic orthodoxies of its past and by seeking to Europeanize its new priorities. The economist and economic historian Alfred Sauvy characterized the old economics, which emphasized the limitations on government action, as contributing to “Malthusianism,” low growth and stagnation. Low growth and stagnation had weakened France politically, socially, and also militarily. The obsession with balanced budgets had led to a cutting of defense expenditures that made France more vulnerable. The architect of the “super-deflation” of the 1930s, Pierre Laval, was also the man who after 1940 went furthest in the political compromise with Hitler. Malthusianism thus was held to bear the ultimate responsibility for the military collapse of 1940 and the end of the French Republic.

Part of the Malthusian picture had been French unwillingness to take John Maynard Keynes seriously. Keynes was not a popular figure in France, doubtless because of his well-known criticism of the 1919 Versailles Treaty, and in pre-1940 French debates, the role of the state was not seen primarily in terms of macroeconomic stimulus. The new postwar French alternative to Malthusianism particularly emphasized the need for the state to coordinate and plan investment. An unplanned or spontaneous market order was likely to lead to underinvestment and low growth. There was thus a need for *planisme*.

The new concern always sat uneasily with many of the views of the most prominent French economists. Jacques Rueff had gone to London with General de Gaulle but remained an advocate of an enlightened
liberalism as well as of monetary orthodoxy: he pleaded continually for a version of the gold standard. The later Nobel Prize laureate Maurice Allais made his reputation with a 1943 book, *A la Recherche d’une Discipline Economique. L’Economie Pure*, in which he sought to find a solution to “the fundamental problem of any economy”: how to promote the greatest feasible economic efficiency while ensuring a distribution of income that would be generally acceptable. Though it is sometimes claimed that Allais’s approach to capital and time preference laid the foundations for subsequent planning, he always considered himself an economic liberal. He attended the first meeting of the Mont Pélerin Society in 1947, and though he refused to sign the Statement of Aims, he wrote to Hayek that he wished to express his “profound agreement with economic and political liberty.” His dissent was based on the view that land should be held as national property: in every other respect, he was a classical liberal.  

*The Influence of Engineering*

The new French tradition had its roots not so much in high thought, in the works of France’s most prominent economists, but rather in the work of practical economists who were trained in institutions that had been conceived as oriented toward the service of the state. Allais in fact had begun as an engineer trained at the École Polytechnique. The strength of that engineering tradition is the basis of the conclusion of the sociologist Marion Fourcade that “French economists hold more favorable attitudes toward state intervention than practitioners in other advanced industrialized countries.” Among French economic practitioners occurred a confluence of “a ‘sociological’ tradition, which affirmed the need for economists to look for the human act behind any economic phenomenon,” with “a financial technocracy in the form of the Inspection des Finances, as well as various specialized elite corps (Mines, Ponts) in the interests of orchestrating the development of key industries.”

That tradition went back a long way. The Corps des ponts et chaussées (Corps of Bridges and Roads) had been set up in 1716 and organized as a school in 1775. The original intention was to provide an accurate mapping system so as to allow the construction of a national road network for the whole of France. In 1794, a parallel École Polytechnique was established to train “national engineers.” A third mining school (École des Mines) had been founded in 1783. The products of these schools pushed for elaborate
and unified transportation, communications, and eventually also energy transmission systems. They made roads in the eighteenth century, canals and railroads in the nineteenth century, and electricity grids and high-speed train networks in the twentieth century. They habitually disdained economic calculation in realizing their technical vision.

Critics observed that the schools were proud of their complete ignorance of the economic principles of diminishing marginal utility and the time value of capital. The French planning tradition achieved a new momentum in wars: in World War I, when Etienne Clémentel and Ernest Mercier tried to imitate the German war planning approach of Rathenau, and again in World War II. Some historians have consequently argued that the planning approach that dominated the post-1945 Republic was already evolved under the collaborationist wartime Vichy regime of Marshall Philippe Pétain.

Even the brief narrative of the evolution of the French planning tradition makes it clear how much interaction there was with Germany. Frederick the Great in Prussia admired French economic planning methods and tried to promote similar developments. He imported technicians and engineers from France and England. So did other German states, with a famous mining school founded in Freiberg (Saxony) in 1765. The École Polytechnique found many imitators in Germany, from the Technische Hochschule in Karlsruhe (1825) onward. Indeed, Germany came to be more widely regarded as the best practice model of technical education.

*Past Liberal Tradition: Say and Bastiat*

The practical economists or technicians who were produced by the corps and polytechnics were not major economic theoreticians. The theoreticians on the other hand were classical economic liberals. The nineteenth century in France was intellectually dominated by a passionately articulated economic liberalism, with Jean-Baptiste Say (1767–1832) arguing immediately after the French Revolution in his *Treatise on Political Economy* (1803) that it was a “gross fallacy” and “productive of infinite mischief” that “what government and its agents receive, is refunded again by their expenditure.” He went on to establish Say’s Law: “Supply creates its own demand.” The journalist Frédéric Bastiat (1801–1850) became probably the most brilliant expositor of the principles of laissez-faire and the denouncer of the fallacies of protectionism. He radiated an indelible
optimism about the beneficence of economic processes. In his last pamphlet, in the aftermath of the 1848 revolution, he concluded that “legislators and do-gooders [should] reject all systems, and try liberty.” Later, those principles of liberal economics were magisterially expounded by Paul Leroy-Beaulieu at the new School of Political Science (Sciences Po) and then at the Collège de France. The liberal tradition of economics had in part evolved—and Sciences Po founded—as an explicit counterweight to the engineering or technocratic vision presented by the graduates of the professional schools.

Planning

The first “Monnet plan” was already formulated in 1946. Heavy industry and especially steel figured prominently in the national investment plans, and individual businessmen were frightened of appearing as laggards or saboteurs. The result was massive investment and quick expansion. The government was obsessed with targets of production: growing more quickly than German steel and warding off the new and threatening Italian challenge to its industrial strategy. The political scientist Jack Hayward terms the French steel complex one of “industrial patriotism.” The French political class saw big steel mills as modern cathedrals that gave expression to a national revival, “redressement national.” The chief architect of France’s postwar plan, the banker and visionary of European unity Jean Monnet, in Gaullist language, called for “une politique de grandeur pour l’acier,” and indeed he saw some mechanism for extending French control over the continental European steel industry as key to postwar political stability.

Technological specialists would bring France out of stagnation. In the immediate aftermath of the war, there was an intense discussion of nationalization as a way of raising production. The old Colbertist tradition of a state-guided economy was augmented by admiration for the achievements of Soviet planning. French policy makers believed the Soviet Union had both avoided the Great Depression of the 1930s and won the war because of planning. There was an additional moral aspect of this question, a biblical conversion of swords into plowshares: as the left-wing Force Ouvrière argued, “What had made war should now serve peace.” Gigantism itself was sometimes also presented as a response to the new German challenge: Le Figaro, for instance, in 1956, in a gloriously mixed metaphor
referred to a “steel fever on the other side of the Rhine in which France should not let herself be outpaced.” 41 Rueff compared the idea of planning to the author Edmond Rostand’s depiction of the famous cockerel, Chantecler, who believed that the sun rose each morning because he crowed.

Such initiatives at the European Recovery Program (or Marshall Plan) helped to establish a general idea that planning might transform the whole European business structure. What the historian Charles Maier termed the “politics of productivity” demanded a new relationship with labor, which would be mediated through the state. 42 For steel and coal, planning was given a European context by the Schuman plan and the establishment of the European Coal and Steel Community (ECSC). France also Europeanized its preference structure, and many political figures saw the primary desideratum as the establishment of a mechanism for economic governance that allowed Europe to undertake the same coordination as French policy makers had managed to apply on a national level.

The highest achievements of the French tradition were seen in the coordinated nuclear power network built up by Electricité de France and also in some spectacular examples of ingenious but ultimately failed technology. In civilian aerospace, France built the first short- and medium-range passenger jet aircraft, the Caravelle, in the mid-1950s, and then in the 1960s, the supersonic aircraft project that resulted in the beautiful and fast but not commercially viable Concorde. In 1978, France’s telephone company launched Minitel, a sort of predecessor of the Internet, with online videotext linked to commercial applications. France’s high-speed train system, the TGV, launched in 1981, was unique in Europe and only emulated much later by Italy, Spain, and Germany—with the United Kingdom still contemplating such a move.

The aura around France’s attachment to the plan as an instrument of national revival lasted a long time. France’s planning institution, the Commissariat Général au Plan, existed until 2006, when it was renamed the Center for Strategic Analysis, which in 2013 was renamed the Commissariat général à la stratégie et à la prospective (CGSP). There had already been an attempt to transform the institution in the mid-1980s, but it had been vigorously resisted. At that time, Pierre Massé, an engineer from the École des Ponts et Chaussées and the principal architect of planning in the 1960s, who was also a disciple of the public pricing principles elaborated by Maurice Allais, had complained that “suppressing the plan in the name
of an impulsive liberalism would be giving up the major weapon in the struggle against the dictatorship of the short term.”

Aspects of the older tradition remained in one area: the argument that currency stability was an important objective of policy and that something like the gold standard was a desirable international discipline had a powerful appeal. This case had been brilliantly and persuasively made by Jacques Rueff, who emerged as the economic guru for General de Gaulle; but it was also taken up by the left quite enthusiastically, above all because it could be mounted as a critique of the United States and the manipulation of the dollar in the Bretton Woods era in the interests of American foreign policy. We deal with the international economic aspects of French thinking in the last part of this chapter.

**Contemporary Economic Thinking in France**

As in Germany, most modern French economists have largely moved away from the traditional concerns of both nineteenth-century liberal economists and postwar French politics with planning growth and with dirigisme. Indeed, French academics have made a decisive contribution to the literature on time consistency and the consequent significance of the correct formulation of rules. In that sense, they have done more than the German Ordoliberals to present a version of a system of rules that is really applicable to the complexities of a modern economy, in which competition is not an obvious result of economic activity. Jean Tirole and Jean-Jacques Laffont in particular have been instrumental in developing a new approach to the provision of incentives by regulators, in which the dangers of creating moral hazard play a key role.

The visions of the past influence the way that economics is seen. Most French economists complain—as did the recent best-selling author Thomas Piketty of *Capital*, a dramatic manifesto on how capitalism does not provide a self-sustaining and politically acceptable model of growth—that “economists are not highly respected in the academic and intellectual world or by political and financial elites.” In fact, a popular and intellectual culture exists that sees economists as narrow-minded and soulless technocrats who force a dehumanized concept of rationality on their fellow citizens. Raymond Barre, a European commissioner who then became prime minister from 1976 to 1981, was lauded by the president at the time, Valéry Giscard d’Estaing, as “the best economist of France.” But
“economist” was a dirty word. As the late 1970s were a time of increased inflation and unemployment, the end of the postwar euphoria of les trentes glorieuses, and a period of general disenchantment with the political elites that had until then managed the Third Republic, the concept of economist as ruler looked sinister rather than beneficent. In the 1990s, another economist finance minister, Dominique Strauss-Kahn, also attracted more criticism than praise. A dissident economist who saw himself in the left-wing, critical, and above all political tradition, Jacques Sapir, complained that economists were undermining democracy.47 Bernard Maris, the journalist and economist who was tragically killed in the terrorist attack on the satirical magazine Charlie Hebdo, concluded, “What were economists for, one will ask a hundred years from now? To make people laugh.”48

That kind of critique sat well with a country that was increasingly obsessed with the parallel stories of national decline and triumphant globalization. The approach of modern mainstream French economists does not translate well into the policy debate, which is still dominated by the older and rather eclectic visions of how an economy functions. In general, The French press—notably Le Monde—is committed to the attractions of interventionism. French politicians from every part of the spectrum denounce neoliberalism (though this term was born in Paris in 1938 in the Rougier-Lippmann seminar). Jacques Chirac denounced “Anglo-Saxon ultraliberalism.” Sarkozy criticized “Anglo-Saxon Europe, that of the big market”49 and repeatedly said that it was his mission to assert the values of French and European humanism as an alternative to the international economic system. A powerful statement of the world of French thought—which was presented as a revolution against traditional Anglo-Saxon economics—was the report of a commission called by Sarkozy and cochaired by Jean-Paul Fitoussi (along with two distinguished but left-leaning non-French Nobel Prize winners, Joseph Stiglitz and Amartya Sen), in which the central role of government in the economy was emphasized and a plea made for a more extensive assessment of the role of “well-being.”50

Even economists like to participate in the backlash against modern economics. Distinguished (and numerate) figures such as Edmond Malinvaud and Thomas Piketty complain about the overmathematization of economics. The same sort of public mobilization of economists for a political cause that took place in Germany against rescue packages occurred in
France against the German doctrines and against austerity politics. In September 2010, over 700 French economists signed a widely publicized manifesto for “an alternative economic and social strategy” for Europe, attacking the “false economic platitudes” of “neoliberal dogma.” The manifesto was drawn up by four economists, three of whom worked at governmental research institutes, and the fourth was an adviser to the antiglobalization organization Attac.

The modern French consensus that presidents and economics professors alike shared may be summarized as follows:

1. Rules should be subject to the political process and may be renegotiated.
2. Crisis management requires a flexible response.
3. Constraining the freedom of government to act—and to borrow—would be undemocratic.
4. Monetary policy needs to be used to serve more general goals than simply price stability, such as being concerned with economic growth.
5. The lessons of the Great Depression include the principle that adjustment to international imbalances should be undertaken symmetrically, with surplus countries doing their part.
6. As multiple equilibria are possible, choosing an unpleasant trajectory for the present is likely to perpetuate rather than remove constraints on growth.
7. Present virtue is self-contradictory and self-defeating.

**International Economics**

Another important dimension of economic thinking along which the German and French philosophies differ markedly is international economic relations, in particular as regards cross-border capital flows. These disagreements also flared up during the negotiations preceding the ratification of the Maastricht Treaty in 1992. The German philosophy calls for free trade, fair (or undistorted) competition, and open international capital markets. Capital controls were considered as arbitrary, favoring certain industries, and inviting political lobbying. Thus, a world in which exchange rates are free to move, in which no coordinated
multilateral interventions are necessary to deal with macroeconomic shocks, and in which capital can flow freely is very much in keeping with the German tradition. The French philosophy, in contrast, is much closer to the original Keynesian position (evolved as a response to the Great Depression) of fixing exchange rates, controlling capital flows, and fostering multilateral adjustment via inflationary policies in surplus countries.

**Trilemma**

A useful organizing principle for a discussion of these philosophical differences is the trilemma of international macroeconomics. Basically, this trilemma states that an economy cannot simultaneously have a fixed exchange rate, an independent monetary policy, and allow capital to flow freely; it must pick two out of three (figure 4.1). What kind of arrangement a country ultimately chooses has profound implications for its ability to deal with and adjust to adverse macroeconomic shocks. The German and French philosophies differ notably in their attitudes toward the desirability of capital flows—is one of the apparently desirable goals at the heart of the trilemma actually a desideratum?—and in how different economies, especially those linked together via some kind of exchange rate mechanism, should respond to asymmetric shocks.

![Figure 4.1. Trilemma Depicted as a Triangle](image)
Theoretically, the trilemma tells us that we have to pick one side of the triangle. Practically, Germans picked the capital flow side, while the French had a preference for fixed exchange rates. Along many dimensions, this trilemma is of course a simplification. In practice, as scholars investigating the exchange rate trilemma demonstrated, it is empirically hard to determine a pure policy stance in the trilemma: there are varying degrees of commitment to a fixed exchange rate regime, varying degrees of openness to international capital, and varying extents of monetary autonomy. In practice, there are thus almost no cases where policy is positioned so as to fully abandon one corner of the trilemma, and practical policy stances fall somewhat in between the corner positions. The corners simply represent the boundaries of the possible. The discussion of the trilemma thus serves as a Weberian ideal type rather than an exposition of the world as it actually is. But France and Germany tugged to be in different parts of the triangle.

Economists and policy makers alike have paid special attention to countries with debt issued in a foreign currency, and this was an issue that became a central component of the euro crisis. The fact that debt has to be serviced in a foreign currency puts a substantial constraint on monetary policy freedom, even in a world with floating exchange rates and freely flowing capital. Still, the trilemma is useful as a first-pass organizing device, and history provides us with numerous useful examples of how the underlying trade-offs were resolved in the past.

**Gold Standard**

The gold standard was the dominant international exchange rate system between the mid-nineteenth century and the early to mid-twentieth century, and many modern commentators make analogies between the gold standard and the European currency union, in that both suppressed the autonomy of monetary policy. Under the gold standard arrangement, the central bank of every participating country must stand ready to exchange its currency for gold at some fixed ratio. How do economies in this system deal with asymmetric shocks, say an expansionary demand shock for one country and a contractionary one for another? The answer is the famous price-specie flow mechanism. In a system with gold backing, trade naturally leads to a flow of gold into surplus countries. As long as central banks in the surplus countries do not sterilize the gold inflows, prices will be pushed up. The opposite happens in deficit countries, and so imbalances
tend to auto-correct. In a world where trade deficits can be financed via credit extended from surplus to deficit countries, however, this mechanism does not work anymore as there is no compulsion to adjust. Explicit policy interventions are thus needed to move the price levels in the desired directions. This important caveat illustrates well the importance of capital flow considerations in the analysis of international monetary arrangements.

_Bretton Woods_

After World War II, the gold standard was succeeded by the Bretton Woods system, a system of fixed exchange rates (with occasional realignments) and constraints on capital flows that was explicitly designed to give more monetary policy autonomy. At the heart of this system was the US dollar as its leading currency. All currencies were fixed against the dollar, and the dollar itself traded at a fixed rate against gold. This system was clearly closer to the French than to the German ideal. But France did not like the extent to which it relied on the US dollar, and General de Gaulle famously tried to revive gold as an alternative. Greatly influenced by the economist Jacques Rueff, de Gaulle had repeatedly insisted that a genuine gold standard would work better than the mixed gold-dollar system of the Bretton Woods regime.

The Bretton Woods regime allowed for occasional realignments, but still—as in any fixed exchange rate system—the adjustment problem always loomed large. Tensions particularly rose in the later stages of the Bretton Woods system, especially in the later 1960s, as Germany increasingly built up trade surpluses that reflected a favorable development of productivity gains as well as the containment of wage costs through a collaborative and collective approach to wage setting. (Trade surpluses would become the hallmark of late twentieth-century German-style capitalism.) By contrast, deficits in Germany’s trade partners reflected either lower innovation or (especially in late 1960s France and Italy) a less disciplined approach to wages in an era of full employment and increased social and political radicalism (reflected in large numbers of days lost in strikes).

At the beginning, in the era of fixed exchange rates and controlled capital markets, even relatively small deficits could not be financed, and they produced immediate pressure on the exchange markets. The deficit countries
then had to apply fiscal brakes in a stop-go cycle. Germany’s partners, notably France, were faced with the prospect of austerity and deflation to correct deficits. This alternative was unattractive to the French political elite because it constrained growth and guaranteed electoral unpopularity. Their preferred policy alternative was thus German expansion, but this course was unpopular with a German public worried about the legacy of inflation and was opposed by the powerful and independent central bank, the Deutsche Bundesbank. Solving the question of the German current accounts in the European setting at first appeared to require some sophisticated political mechanism, and also public debate, that would force French politicians to undertake more austerity than they would have liked and Germans less price orthodoxy than they thought they needed.

By the early 1970s, capital flows had become so large, and the system so unstable, that an answer needed to be found. Again, the German view was that capital flows simply could not be contained and controlled effectively (and, furthermore, any sort of control would invite lobbying and lead to favoritism toward certain sectors). The logical conclusion was that capital should flow freely and exchange rates should be left free to adjust, restoring the balance between countries. The French view was diametrically opposed, calling instead for even more active management of capital flows (through tighter capital controls) as well as inflationary policies in surplus countries. This is the spirit of Keynes, who back in the early 1940s called for the entire international monetary system to be structured so that countries running excessive surpluses would be penalized, while those in deficit were to be supported. The tightening of capital controls was related to the deep-seated French belief that exchange rates, if left to float freely, are excessively volatile, and similarly so are capital flows. Exchange rate overshooting and sizable international capital flows are then argued to actually be destabilizing. French policy makers often expressed a longing for stable rates, and exchange rate stability required more policy coordination. In particular, the inflationary policies in surplus countries were supposed to restore a balance in competitiveness and so restore equilibrium for the wider global economy.

The flipside of such stabilization policies are the destabilizing effects of divergences in inflation between high-inflation debtor countries (under Bretton Woods, Italy, for example) and low-inflation credit countries (for example, Germany). Cross-border capital flows into debtor countries often financed investment in nontradables (in particular in the housing
sector) and consumption (both public and private), thus pushing up domestic wages without improving international competitiveness. Given fixed exchange rates, such divergent trends in wage inflation go hand in hand with a relative loss in competitiveness for the debtor countries; that is, unit labor costs in debtor countries rise markedly vis-à-vis the creditor countries.

Persistent inflation divergences in a system of fixed exchange rates with free capital flows have yet another destabilizing effect, as highlighted by Alan Walters (the economic advisor to Margaret Thatcher) in his well-known “Walters’ critique.” The basic argument goes as follows: Consider two countries in the system, say Italy and Germany, with Italy experiencing an expansionary aggregate demand shock and Germany hit by a contractionary shock. Following the shocks, inflation rises in Italy and falls in Germany. As capital flows freely, and assuming that the fixed exchange rate system is credible, nominal interest rates in Italy and Germany must be the same, so the inflation divergence means that the real interest rate in Italy is lower than in Germany. This low relative real interest rate provides an incentive for Italians to borrow, while the high rates in Germany induce Germans to save. Walters’ original argument then was that this would spur a further economic divergence; output would rise even further in Italy and drop even further in Germany. Taking a more international perspective, we also see that the divergence in real interest rates means that credit flows from Germany to Italy will occur. Interestingly, these patterns very much resemble the buildup of imbalances within the euro area prior to the eruption of the euro-area crisis (with the role of Italy being taken by many periphery economies).

In the end, the Bretton Woods system collapsed; it simply did not incorporate a sustainable and credible way of dealing with the adjustment problem. Afterward, the global exchange rate system started to move very close to the German ideal: free capital flows and floating exchange rates. Later (in the 1980s), this became part of the Washington Consensus (which, interestingly, was also pushed by various French politicians, for example, Jacques Delors), as we discuss in chapter 14.

**European Exchange Rate Mechanism**

In Europe, however, matters continued to look different. European governments felt that volatile intra-European exchange rates would be
detrimental to the European project, and so, in 1978, they launched the European Exchange Rate Mechanism (ERM for short), an attempt to recreate the Bretton Woods system in a European context. The philosophical differences between the German and French sides as regards the adjustment question of course continued. Indeed, the German Bundesbank had always been hesitant about the ERM and so had insisted at the outset on an opt-out should the exchange rate system impose too heavy a cost (i.e., too much expansion) on German monetary policy. In a further nod toward German interests, this rather loose form of exchange rate management still allowed for quite flexible rebalancing. Otmar Emminger, who became Bundesbank president in the 1970s but was a central intellectual presence of the German Bundesbank already before then, had advocated flexible exchange rates in the late 1950s.

In the European Monetary System, the Bundesbank consistently pressed for more regular realignments. In the eyes of the Frankfurt bankers, it was France’s reluctance to devalue in line with changes in labor competitiveness that was placing strain on the system. Abolishing the exchange rate (through the institution of the monetary union) and committing to a notion of price stability provided the only way of resolving this long-standing debate. A case in point is Italy: Every once in a while, Italy would have its target parity vis-à-vis the other currencies in the system adjusted downward. But precisely because such realignments are allowed for, the arrangement cannot be fully credible, and so it remains very much prone to attacks.

With the availability of capital, current account imbalances were sustainable for much longer periods (though, of course, not forever). The effects of movements in capital in allowing current account imbalances to build up to a much greater extent and ensuring that corrections, when they occurred, would be much more dramatic was already noticeable in the 1980s, before the move to monetary union. These forces were, of course, not limited to Europe but also played out on a global scale. As the dollar was soaring in the mid-1980s, American manufacturing came under threat, and so a protectionist backlash appeared possible. In response, the finance ministers of the major industrial countries pushed for exchange rate agreement. At the G7 meeting at the Louvre in 1987, the finance ministers agreed to lock their exchange rates into a system of target zones. In practice, nothing came of that global plan, but then Edouard Balladur, the
French finance minister who had largely been responsible for the Louvre proposal, came up with a tighter European scheme—a first step toward European monetary union. When German foreign minister Hans-Dietrich Genscher appeared sympathetic, Europe’s central bankers were asked by the president of the European Commission, Jacques Delors, to prepare a timetable and a plan for currency union. The Delors committee met between September 1988 and April 1989 and produced its report, long before anyone had German unification in mind.

Large buildups in imbalances convinced Europe’s policy makers that a monetary union was the only way of avoiding the risk of periodic crises with currency realignments whose trade policy consequences threatened the survival of an integrated internal European market. Also, a reorientation of French policy—the adoption of the policy of the franc fort after 1983, a strong French currency with lower inflation—laid the basis for the appearance of convergence after an episode of political and monetary instability in the early 1980s due to a brief experiment in socialist economics by the French president François Mitterrand.

With the 1986 Single European Act, the single common market was also established. Importantly, it included the liberalization of capital flows. Germany pushed hard for a quick implementation, whereas France, unsurprisingly in light of its historical attachment to exchange rate controls, initially wanted to delay freedom of capital as much as possible. In the end, France agreed to implement the capital flow liberalization in 1990, but many blamed the liberalization for the crisis that soon engulfed Europe.

The combination of fixed—but not irrevocably so—exchange rates and free capital flows set the system up for crisis, and indeed in 1992 and 1993, there were two big exchange crises that nearly killed the European Monetary System. The background for these crises was the fiscal stimulus associated with German reunification, which brought with it substantial inflationary pressure in Germany and a tightening of Bundesbank policy. To defend the ERM currency parities, other central banks then naturally also had to tighten but, fearing the associated recession, were generally unwilling to do so.

Speculators realized this fundamental dilemma and bet on it. In September 1992, the British pound was attacked. George Soros, a wealthy Hungarian-born hedge fund manager, sold short more than $10 billion in
pounds. Ultimately, on Black Wednesday, September 16, 1992, the United Kingdom was forced to withdraw from the ERM. A day later, Italy withdrew as well. In July 1993 the speculators also started attacking the French franc. The French and German central banks (under pressure from the German government) spent large sums to defend the French franc, and German interest rates were lowered. Ultimately, on August 1, 1993, the band within which the exchange rate was to stay was widened from 4.5 percent to 30 percent.54

Germans persistently believed that such a union could only occur on the basis of a prior policy convergence. A term that was frequently used, especially by the Bundesbank, was that monetary union could only come as a coronation—the final symbolic act—of an integration that had been prepared by solid policy work. That position was contrasted with the French one, which held that adopting new institutions could quickly force convergence (an approach that was sometimes derided as “rushing fences”).

In sum, one should add the following two international points to our list for the German economic philosophy above:

9. Net exports are considered a gauge of competiveness and a signal of economic health and strength.
10. Germans prefer flexible exchange rates in an international setting with open capital markets.

In contrast, for the French economic tradition, the following two points are more appropriate:

8. Exports that are too high are not a sign of strength but an indication of the application of a beggar-thy-neighbor mercantilist principle.
9. The international monetary system should be multipolar, and effective policy coordination should include the active management of capital flows to stabilize exchange rate movements. Fixed exchange rates are a desirable reflection of states’ ability to impose discipline on disorderly markets.