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Domestic Preferences and External Constraints: The Bundesbank between Internal and External Pressures

by Ton Notermans
Graduate Student
Dept of Political Science, M.I.T.
and
CES, Harvard University, 1991

This paper provides an important reassessment of the factors that affect macroeconomic policy-making in the European nations. Notermans shows that many of the conventional models based on the power of the left, institutional or cultural variables cannot account for the course of macroeconomic policy. Instead he argues for the critical importance of international economic variables. His analysis attempts to account for both the policies of the German Bundesbank and the failures of neo-corporatism in the smaller European nations.

Abstract

This essay argues that present theories on the determinants of economic policies suffer from a narrow focus on domestic variables and hence fail to give an accurate account of crucial policy decisions. A study of the causes and consequences of German monetary policy since the end of Bretton Woods shows that 1.) The shift to a restrictive monetary policy stance in five small corporatist countries bordering on Germany is a primarily a reflection of their lack of policy autonomy vis a vis the decisions of the Bundesbank rather than the result of a domestic balance of forces in favor of such policies. 2.) The policy of the Bundesbank itself cannot be adequately understood on the assumption of an overriding priority of price stability. Despite its shift to monetary targeting in 1974, the Bundesbank has allowed its targets to be missed in ten of the last fifteen years. It is argued that this failure to adhere to its own targets reflects the fact that the role of the D-Mark as second line reserve currency has frequently forced the Bundesbank to give priority to stabilization of the D-Mark-Dollar rate.

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1 INTRODUCTION[1]

The second Great Depression of the 20th century has led to an intense debate among political economists about the causes of the downturn and the reasons for the large differences in national performance. Concentrating on the latter question, the study of comparative political economy has experienced an impressive transformation from a rather neglected and isolated field to one of the most vibrant and creative areas within political science.[2] Although the ongoing debate has greatly advanced our understanding of the determinants of policy-making in advanced industrialized democracies, it suffers from an excessively narrow focus on domestic sources of policy. While the rapid integration of national economies greatly complicates the process of national economic management, the theoretical frameworks underlying much of the present work in comparative political economy either ignore the constraints emanating from international developments or simply assume that the presence of effective corporatist mechanisms will allow for the successful realization of domestic goals despite external pressures.[3]

The dominant approaches in comparative political economy are wed to a theoretical framework in which macroeconomic outcomes can be interpreted as the intended result of a conscious strategy on the part of economic policy authorities. Consequently they have sought to provide an explanation of policy strategies by pointing to differences in the institutionalization or societal distribution of preferences that shape policy decisions.

Applied to the macroeconomic decisions of the 1970s and 1980s these views, however, only provide a partial, and sometimes misleading, explanation. The main root of this lack of explanatory accuracy is the failure to accord the macroeconomic policy process a

1 I would like to thank the following persons for comments on earlier versions of this paper: Karl Betz, Peter Hall, Richard Locke, Andrew Martin, Simona Piattoni. I also gratefully acknowledge the support of the Harvard Center for European Studies. I remain responsible for the errors in this paper.

2 A few of the more important contributions are: Bruno, M. and J. Sachs, *Economics of Worldwide Stagflation* (Oxford: Oxford University Press, 1985), Calmfors, Lars & John Driffill, "Bargaining Structure, Corporatism and Macroeconomic Performance" *Economic Policy*, April 1988, 13-61, Cameron, David R., "Social Democracy, Corporatism, Labor Quiescence, and the Representation of Economic Interests in Advanced Capitalist Society, In: Goldthorpe, John H., Ed., *Order and Conflict in Contemporary Capitalism* (Oxford: Clarendon Press, 1984), Garrett, Geoffrey and Peter Lange, "Performance in a Hostile World: Domestic and International Determinants of Economic Growth in the Advanced Capitalist Democracies" *World Politics* XXXVIII (1986), 517-45. Hall, Peter, *Governing the Economy* (Cambridge: Polity Press, 1986), Katzenstein, Peter, *Small States in World Markets* (Ithaca: Cornell University Press, 1985), Martin, Andrew, "The Politics of Employment and Welfare: National Policies and International Interdependence." In: Keith Banting, Ed., *The State and Economic Interests* (Toronto: Toronto University Press, 1986), Scharpf, Fritz W., *Sozialdemokratische Krisenpolitik in Europa* (Frankfurt am Main: Campus, 1987), Schmidt, Manfred G., *Wohlfahrtsstaatliche Politik unter bürgerlichen und sozialdemokratischen Regierungen* (Frankfurt am Main, Campus, 1982).

3 However, in studies of economic policies in developing countries the idea of external influences on domestic policies has been more readily accepted. See e.g. Haggard, Stephan & Robert Kaufman, Eds., *The Politics of Economic Adjustment: International Constraints, Distributive Politics and the State*" (Forthcoming)

considerable degree of autonomy from the shape and content of domestic policy preferences.[4] In a highly interdependent system, specific national preferences can only be successfully realized if at least a minimal degree of mutual compatibility exists among them. Macroeconomic policies in the open economies of the 1980s have to be thought of as a delicate act of balancing domestic and external requirements. The increasing interdependence of national economic systems requires macroeconomic policy to loosen its ties with the domestic constituency. Much of the political changes in OECD countries during the last 17 years can be interpreted as a reflection of this ongoing process of detachment.

Even though all advanced economies are presently undergoing this process, its form and content are strongly influenced by the specific location each country takes within the international system. Large countries have possibilities for shaping their external environment and hence seem able to protect their established domestic political arrangements. For small countries with highly open real and monetary markets, strategic decisions of large countries frequently become objective constraints which require adjustment of domestic policies and consequently change domestic preferences and power relations.

The German monetary policy stance is widely regarded one of the most notorious examples of the imposition of domestic preferences on foreign actors. Discussions of German macroeconomic policies frequently evoke the image of a country obsessed with the fear of inflation. Especially amongst its European neighbors, the willingness of the *Deutsche Bundesbank* to sacrifice economic growth for price stability has become proverbial during the last few years. Starting from a very favorable position in 1973, German labor market performance has continuously deteriorated. With an unemployment rate considerably in excess of five percent since 1982, Germany has come to join the ranks of countries with veritable mass-unemployment. But instead of reflating its economy, Germany's main preoccupation seems to be that of lowering the already very modest inflation rate.[5]

To illustrate the importance of external pressures for the analysis of national policy-making, this paper will focus on the causes and consequences of German monetary policy decisions during the period 1974-1988. Section two reviews the main explanations of the determinants of macroeconomic policies. Section three evaluates these approaches in the light of monetary policy decisions in five small countries. It will be argued that the presence of Corporatist arrangements does not constitute a sufficient condition for the successful realization of domestic policy preferences. Rather it will be

4 See also Schmidt's view on the state of comparative political research in Schmidt, Manfred G., "Einführung." *Politische Vierteljahresschrift*, Sonderheft 19(1988), 3-35.

5 "Germany today holds the world economy hostage with an obsessive refusal to cut interest rates." Dornbusch, Rudiger, "Unemployment: Europe's Challenge of the '80s." *Challenge* Sept.-Oct. 1986, 11-18, p. 18.

shown that the need to adjust to the German monetary policy decisions has seriously destabilized Corporatist arrangements in several countries. Section four provides a critique of traditional explanations of German monetary policies and tries to develop an alternative explanation for the course of German monetary policy during the period 1974-88. Contrary to traditional views, this section will try to show that the policy decisions of the *Bundesbank* cannot be viewed as a simple reflection of an almost obsessive fear of inflation. Instead, it will be suggested that, although the Bundesbank has more room for maneuver than the central banks of its small neighbors, the special position of the D-Mark as a second line reserve currency has frequently forced monetary policy to override domestic concerns. In general, therefore, the monetary policy stance of a specific country does not only reflect domestic preferences, but also is a reflection of external developments.

2 ALTERNATIVE EXPLANATIONS OF MACROECONOMIC POLICIES

Studies in comparative political economy have traditionally explained cross-national differences in macroeconomic policies with reference to either one of the following three basic approaches: the Power Resource Model (PRM), the institutional approach, and the cultural explanation. In its basic version, the Power Resource Model holds that differences in cross-national policy preferences reflect the relative strength of organized labor versus capital. Authors in the institutional tradition picture policy making processes as taking place within institutional structures that have an autonomous effect on the specific ordering of preferences. The cultural explanation, instead, stresses the importance of nationally specific cultural and historical factors in shaping cross-national differences in policy preferences. The exact mechanisms through which the explanatory variables influence the macroeconomic policy stance however depend on assumptions about the stability of the unemployment-inflation trade-off and the openness of the economy.

Early comparative studies typically started from the assumption of a stable trade-off between unemployment and price stability. In such a framework, the PRM explains the absence of expansionary policies by the weakness of leftist parties. Serving the interests of their respective core constituencies, leftist governments will pursue more expansionary policies than conservative governments.[6]

Partly reflecting the criticism to which the assumption of a stable Phillips curve had become exposed amongst economists, Manfred G. Schmidt, in a pioneering study, argued that the extra-parliamentary rather than the parliamentary distribution of power

6 Hibbs, D.A., Jr., "Political Parties and Macroeconomic Policy" *American Political Science Review* LXXI (1977), 1467-1487.

was to be considered the main explanatory variable.[7] Since governments cannot directly control the behavior of economic actors, any policy might be obstructed if it runs counter to the views of those actors. More specifically, expansionary demand policies aimed at full employment might lead to accelerating inflation if trade unions are not willing to moderate their wage demands. Successful macroeconomic management will therefore occur in those countries where the organized left is both strong enough to give full employment policies a high priority, and at the same time is willing to exchange full employment for wage moderation.

Even though the argument that successful macroeconomic management requires concertation between the government and the trade unions has become widely accepted, the interpretation of effective concertation mechanisms as a reflection of the strength of the organized left has been questioned. Schmidt himself, in an effort to account for the success of Switzerland and Japan, has pointed to the importance of "dominant sociocultural and political norms", thereby de facto substituting a cultural explanation for a power resource approach.[8]

Cultural explanations of macroeconomic policies imply a criticism of a central assumption underlying much of the (empirical) research in comparative political economy, namely that political tendencies across nations are sufficiently similar to warrant comparisons. Especially within a PRM framework, it is assumed that the functional position workers occupy within a capitalist economy makes them perceive their interests in similar ways and therefore makes cross-national differences between Social Democratic parties relatively unimportant as compared to their similarities.[9] Cultural explanations, instead, point to the specific, historically grown national culture as the primary factor explaining cross-national policy preferences. In contrast to Power Resource and Institutional approaches, the cultural approach mainly addresses substantive differences in national policy outlook without inquiring under what conditions policies can be successful.

From an Institutionalist standpoint finally, it has been pointed out that the institutional logic of the Central Bank will lead it to prefer policies that promote price stability.[10]

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7 Schmidt (fn. 2). See also Cameron (fn 2).

8 Schmidt, Manfred G., "The Politics of Unemployment: Rates of Unemployment and Labor Market Policy." *West European Politics*, 7-3 (1984), 5-24. See also Katzenstein (fn. 2).

9 Castles and Mair rank the major parties from 17 OECD countries on a single left-right scale. Their ranking seems to confirm the PRM assumptions. As they admit however, the inter-national comparability of the left-right ranking is not seriously tested but rather assumed. Castles, Francis G. & Peter Mair, "Left-Right Political Scales: Some 'Expert' Judgements," *European Journal of Political Research*, 12(1984), 73-88.

10 Alesina and Epstein & Schor provide some evidence for the view that the presence of an independent central bank coincides with lower inflation rates and/or more restrictive monetary policies. Alesina, Alberto, "Politics and Business Cycles in Industrial Democracies" *Economic Policy*, No.8 (1989), 55-98, Epstein, Gerald & Juliet Schor, "*Macropolicy in the Rise and Fall of the Golden Age*," (Mimeo, Harvard University, 1987)

Scharpf[11] has argued that the presence of a social democratic government might well lead to the coexistence of expansionary fiscal policies and restrictive monetary policies in case the government has no direct control over the bank. Effective policy concertation hence requires a non-autonomous central bank.

Since the conditions for successful macroeconomic management - especially social democratic strength and corporatist unions- were mainly found in small countries, the upshot of the debate was that small countries actually have a larger potential for realizing domestic preferences than big countries. Whereas in the latter countries expansionary policies might have to be aborted because the escalation of nominal wages leads to balance of payments problems, smaller countries might be able to avoid this kind of stop-go policies.

3 MONETARY POLICIES IN FIVE SMALL EUROPEAN COUNTRIES

The view that smaller countries potentially enjoy a larger degree of policy autonomy is frequently not confirmed by historical facts. Although the five small neighbors of Germany are invariably ranked as medium- to strong corporatist countries,[12] an analysis of their monetary policy strategy rather suggests that their autonomy has been severely limited by the decisions of the German authorities. Applied to the monetary policy decision of the five small neighbors of Germany, neither approach can give a satisfactory explanation.

In general, three phases can be distinguished. During the first years after the first oil price shock, macroeconomic policy generally corresponded to domestic preferences. As these policies increasingly came into conflict with the requirement of external balance, a phase of "muddling through" set in, which was defined by the unresolved tension between external constraints and domestic policy preferences. By 1983 this tension got resolved in all countries in favor of the external equilibrium. Depending on the specific domestic power relations, the political destabilization that accompanied the switch to balance of payments oriented policies was more or less severe.

In the medium term all five countries de facto have chosen a strategy that gives preference to the stabilization of their currency within the EMS, thereby linking their monetary policies closely to the strategy of the Bundesbank. Even though, at the beginning of the crisis the respective countries had rather different policy preferences,

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11 Scharpf, Fritz W., "Economic and Institutional Constraints of Full-employment Strategies, Sweden, Austria and West Germany, 1973-1982," In: J. Goldthorpe, Ed., *Order and Conflict in Contemporary Capitalism* (Oxford: Oxford University Press, 1984), and Scharpf (fn. 2).

12 For an overview of the different rankings of countries according to their degree of corporatism see, Dell'Aringa, Carlo & Manuela Samek Lodovici, "Industrial Relations and Economic Performances," *Review of Economic Conditions in Italy*, 1 (1990), 55-83

the period from 1978 to 1982 saw the adjustment to a strategy of stabilization of the exchange rate. In each case the incompatibility of the domestic policy preferences with the policy stance of the Bundesbank created cumulative external disequilibria which forced a readjustment of policies.[13]

In Belgium, the initial policy reaction to the first oil shock was restrictive. But after the center-right coalition resigned, mainly because of trade union opposition to their economic policies, macroeconomic policies became expansionary. Instead of promoting employment, the expansionary policies created large budget and current account deficits and led to a loss of confidence in the B-Franc. In order to counter downward pressures, interest rates had to be raised constantly thereby increasing the ineffectiveness of expansionary policies. It was the threat on the part of the Bundesbank and the Dutch Central Bank to stop supporting the B-Franc which led the Belgium government to shift to more restrictive policies and opened the way for a new center-right coalition in 1982. [14]

Denmark's situation in many respects was similar to that of Belgium. In contrast to Belgium, however, the Danish government decided in 1976 to leave the *Snake* in order to be able to support expansionary macro-policies by devaluation. Rather than reducing interest rates, the policy of more flexible exchange rates further disrupted confidence and required even higher interest rates than in the case of Belgium in order to prevent a flight out the Krona. In 1982, after the Social Democrats had been ousted, the new government decided to join the EMS and announced a hard currency policy.[15]

Switzerland was the first country in which the incompatibility of domestic preferences and external pressures led to an adjustment of policy strategy. Contrary to both Belgium and Denmark, Switzerland had embarked on a more restrictive policy stance than Germany right after the end of Bretton Woods. The international role of the S-Franc, the weakness of the organized left and the fact that the costs of unemployment mainly had to be born by foreign workers, account for the choice of a strategy that aimed for a zero inflation rate. Under such circumstances, the S-Franc gained in attractiveness relative to the D-Mark. The revaluation of the Frank against both the Dollar and the D-Mark accelerated dramatically in the fall of 1978 when the Swiss National Bank, contrary to

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13 On the influence of German monetary policies on the larger European economies, see, Giavazzi, Francesco & Alberto Giovannini, *Limiting Exchange Rate Flexibility. The European Monetary System,* (Cambridge: M.I.T. Press, 1989).

14 Mommen, André, *Een Tunnel Zonder Einde. Het Neo-Liberalisme van Martens V en VI,* (Antwerpen: Kluwer, 1987), DeVillé, P., "The Dynamics of Inflation and Unemployment in Belgium: Actors, Institutional Settings and Social Structure," In: Baumgartner et al, Eds., *The Shaping of Socio-Economic Systems,* (New York: Gordon & Breach, 1986), de Strycker, Cecille "Die belgische Geld- und Währungspolitik im Laufe der letzten zehn Jahre," In: Werner Ehrlicher und Dieter Duwendag, Eds., *Geld und Währungspolitik im Umbruch,* (Baden-Baden: Nomos, 1983), Platel, Marc, "Martens IV - Eyskens I - Martens V," Res Publica (6-1981).

15 Damsgard Hansen, E., Kaj Kjaersgaard & Joergen Rosted, *Dansk Oekonomisk Politik,* (Copenhagen: Nyt Nordisk Forlag, Arnold Busck, 1998), Thygesen, Niels, "Echange-Rate Experiences and Policies of Small Countries: Some European Examples of the 1970s", *Essays in International Finance* (Princeton University, No. 13, December 1979), Wesseling, Victor, "Stagnatie en Ekonomisch Beleid in Vier Kleine Landen," *Tijdschrift voor Politieke Ekonomie*, Vol. 8 (1985), No.4,37-57.

the Bundesbank, refused to respond to the dollar-slide with an expansionary monetary policy. Despite very low interest rates and the introduction of negative interest rates on some S-Franc assets held by foreigners, the explosive revaluation of the S-franc could not be stopped. In order to stabilize currency markets, the Swiss National Bank eventually had to decide to join the Bundesbank in an expansive monetary policy.[16] Ever since, the Swiss National Banks has tried to prevent pressures in the SFR-DM rate as much as possible, even if this entailed accepting a higher than preferred inflation rate.[17]

In the Netherlands, there has been no serious attempt to deviate from the German monetary policy stance. The weakness of the Social Democrats, the strong international orientation of real and financial markets as well as the factionalism within the Christian Democrats have prevented a consistent, employment oriented policy as opposed to Belgium. The slightly expansionary policies of the late seventies were largely unintended, and were quickly changed after protests from the central bank.[18]

The Austrian case is especially instructive. Austria is considered a paradigmatic case of a country which satisfies all the national preconditions for successful macroeconomic management. Trade unions are strong and centralized, the Social Democratic party has governed alone for most of the time since 1973, there is a strong tradition of consensual policy concertation, and the central bank does not have the autonomy to pursue its own particularisti: goals but instead is strongly tied in with the process of macroeconomic policy coordination.[19]

According to Scharpf[20] and Martin[21], the Austrian strategy during the first years of the crisis, is said to have assigned incomes policy to combating inflation and fiscal and monetary policy to stimulating demand. In Germany, monetary policy is said to fight inflation, fiscal policy stimulates demand, and wage rises are as modest as in Austria. Since fiscal policies and the development of unit labor costs were rather similar in Austria and Germany[22], the difference in unemployment rates must therefore result from a more restrictive monetary policy. Scharpf indeed interprets the different developments of unemployment rates that obtain in the period between the oil crises in this way. The

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16 Notermans, Ton, "Arbeitslosigkeit und Inflation. Belgien, die Niederlande, Oesterreich und die Schweiz 1974-1985," *Center for Economic and Political Studies* (Working Paper B1. Amsterdam, 1988)

17 Hasse, Rolf, "Die Währungspolitik der Schweiz und das Europäische Währungssystem," In: R. Biskup, Ed., *Schweiz-Bundesrepublik Deutschland* (Bern: Verlag Paul Haupt, 1984), Kästli, R., "The New Economic Environment in the 1970s: Market and Policy Response in Switzerland," In: Marcello de Cecco, Ed., *International Economic Adjustment,* (Oxford: Basil Blackwell, 1983), Leutwiller, Fritz, "Institutionen des Währungswesens in der Schweiz." In: G. Hahn, Ed., *"Institutionen des Währungswesens,"* (Baden Baden: Nomos, 1983), OECD, *Economic Surveys, Switzerland* (Paris: OECD, 1987).

18 Braun, Dietmar, *Der Niederländische Weg in die Masssenarbeitslosigkeit (1973-1981),* (PhD Dissertation, University of Amsterdam, 1988), Notermans (1988)

19 See e.g. Schmidt (fn. 2), Katzenstein (fn. 2), Martin (fn. 2), Scharpf (fn. 2)

20 Scharpf (fn. 2, 11)

21 Martin (fn. 2)

22 Scharpf (fn. 11)

expansionary fiscal policy in Austria was successful because it was supported by an expansionary monetary policy, whereas the Bundesbank decided to break the effects of the slightly more expansionary fiscal policy by a very restrictive monetary policy.

Table 3.1: Indicators of Monetary Policy, Austria And Germany

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
CENTRAL BANK DISCOUNT RATES End of Period, in % per annum.																	
AUT	5.5	6.5	6.0	4.0	5.5	4.5	3.8	6.8	6.8	4.8	3.8	4.5	4.0	4.0	3.0	4.0	6.5
FRG	7.0	6.0	3.5	3.5	3.0	3.0	6.0	7.5	7.5	5.0	4.0	4.5	4.0	3.5	2.5	3.5	6.0
VOLUME OF MONEY (M1) (percentage change over previous year)																	
AUT	12.0	6.8	10.9	10.5	6.8	5.9	-6.1	7.4	3.7	3.1	12	4.0	2.2	4.9	10.0	10.2	6.4
FRG	5.0	6.1	14.1	10.0	8.1	13.5	7.2	2.4	0.9	3.2	10.3	3.4	4.1	8.7	9.4	10.1	6.5
GOVERNMENT BOND YIELDS. Period Averages, in % per annum																	
AUT	8.25	9.74	9.61	8.75	8.74	8.21	7.96	9.24	10.61	9.92	8.17	8.02	7.77	7.33	6.91	6.67	7.14
FRG	9.30	10.40	8.50	7.80	6.20	5.80	7.40	8.50	10.38	8.95	7.89	7.78	6.87	5.92	5.84	6.16	7.09

Source: IMF International Financial Statistics Yearbook 1990.

Because a restrictive monetary policy, in the short term, reduces demand through the influence of higher interest rates on investment and consumption, Austria should have had lower interest rates than Germany. The most obvious indicators to look at for evidence are the central bank discount rate and the volume of money. As table 3.1 shows, Austrian discount rates were higher than the German ones from 1974 to 1978, and from 1982 onward there is hardly any divergence between Austrian and German rates. The growth of the volume of money also does not support the thesis of an overly restrictive Bundesbank. Furthermore, long term interest rates in Austria have been consistently above German rates since 1975. In short, there seems to be no clear evidence that the Bundesbank has caused the high unemployment rate relative to Austria by putting a stronger monetary squeeze on the economy than the Austrian central bank.

The historical inaccuracy of Martin's and Scharpf's views betrays a theoretical inconsistency in their underlying model. Like Switzerland, Austria never joined the EMS de jure. However, since Austria de facto pegged her currency to the D-Mark, and even had a higher increase in unit Labor costs[23], shė could not have maintained a consistently more expansionary macroeconomic policy than Germany. If Austria had

23 See e.g. Scharpf (fn. 11),table 11.4, p. 276

chosen a consistently more expansionary fiscal policy, the resulting trade deficit, budget deficit, and inflation rate would have forced her to continuously raise interest rates in order to maintain the parity with the D-Mark.

In the late seventies, monetary policy was made more expansionary in order to counteract an unexpected rise in unemployment. The experiment was however abandoned quite soon after the negative interest rate differential with respect to Germany had led to the loss of about one third of the official reserves. As Scharpf correctly notes, the stable relation of the Schilling to the D-Mark was considered "sacrosanct"[24]. This however only means that macroeconomic policies are dominated by external considerations.

It is this similarity of strategic choices of five different countries that most powerfully testifies to the inaccuracy of the traditional approaches in comparative political economy. If countries as far apart with respect to central bank autonomy and power resources of the organized left as Austria and the Netherlands, or with widely different cultural backgrounds as Denmark and Switzerland, all come to choose similar medium term monetary policy strategies, the assumption of the primacy of domestic preferences must be considered untenable.

4 GERMAN MONETARY POLIC /

4.1 Traditional Explanations

If the above argument is correct, the societal ordering of policy preferences cannot be considered a good predictor of the macroeconomic policy stance. Since an approach that explicitly takes international linkages into account cannot assume that each country potentially has the same policy options, the policy experiences of five small countries do not automatically point to the general incorrectness of these approaches. One could think of a modified model that includes the assumption of hierachical relationships between states. The domestic preferences in countries at the top of the hierarchy could be seen to severely constrain policy options for countries at the bottom. It could be argued that, considering the relative size of their economies, our five small countries had no choice but to avoid macroeconomic conflicts with the FRG.

In two very illuminating publications John Cornwall has recently developed such an hierarchical model.[25] For Cornwall the recession is the result of the lack of Corporatist

24 Scharpf (fn. 2), p.88

25 Cornwall, John, "Inflation as a Cause of Economic Stagnation: A Dual Model." In: J.A. Kregel, Ed., *Inflation and Income Distribution in Capitalist Crises* (New York: New York University Press, 1989), Cornwall, John, "*The Theory of Economic Breakdown,*" (London: Basil Blackwell, 1990)

arrangements in the large OECD economies. Since these countries were unable to control inflation by effective tripartite concertation, they had to resort to restrictive aggregate demand policies. Under fully flexible exchange rates this might have had no effect on the small corporatist countries. Three developments, however, have made exchange rate policy a rather ineffective instrument. Import- and export price elasticities have generally become lower, reflecting an increasing differentiation of markets for final goods. Real wage resistance makes real devaluations impossible since the rise in import prices under those circumstances will lead to a rise in nominal wages. Even Corporatist countries are characterized by real wage resistance. Devaluations may destabilize incomes policies through their negative effect on real wages. Furthermore, because of the internationalization of capital markets, isolated expansionary policies, especially if accompanied by devaluations, are likely to provoke destabilizing currency speculation. Consequently, macroeconomic performance in corporatist economies also deteriorated in the 1980s despite their effective incomes policies.

A weakness of Cornwall's approach is that it does not provide a satisfactory explanation for the restrictiveness of German monetary policies. Whereas expansionary policies to combat unemployment in the majority of OECD countries have been heavily constrained by their precarious current-account position, the German economy has consistently shown one of the most favorable balances on external trade. Indeed, the latter part of the 1980s has seen the rise of the relatively small German economy to the position of biggest exporter in the world, even outperforming Japan. German monetary policies cannot be explained by current account problems, rather Germany is a textbook example of a country that should reflate its economy.[26] Moreover, as already pointed out, analyses of the wage setting process do not lend support to the view that German trade unions are more aggressive than those in corporatist countries and that macroeconomic policies hence would not have had the option to remain expansionary in the medium term anyway. As Scharpf convincingly argues, German trade unions, despite their lower degree of centralization, have been willing and institutionally able to moderate wage demands at least to the same extent as the Austrian OeGB.[27]

It seems therefore that an explanation of German policies has to refer to an exceptionally strong preference for very low inflation. Three explanations for this preoccupation with inflation can be distilled from the literature. First, the preferences of the whole German electorate are heavily skewed in favor of anti-inflationary policies. Second, restrictive policies are a reflection of the relative weakness of the organized left. Third, the restrictive monetary policy is a result of the autonomy of the Bundesbank.

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26 The German current account actually *improved* in response to the first oil crisis. Only during the years 1979-81 did the current account show a deficit.

27 Scharpf (fn. 2)

Cultural explanations argue that the German population attaches a higher priority to price stability than most other OECD countries.[28] The general aversion against inflation is said to rest predominantly on two historical experiences: the hyperinflation of 1921-23 and the inflation of 1945-48. In both instances wage earners, pensioners and small savers were disproportionately affected by the redistributive effects.[29]

It is not at all obvious that German history unambiguously points to the need to prevent inflation. Since the high unemployment of the 1930s played an important role in bringing Hitler to power, it might just as well be argued that the most important lesson to be learned from history is that full-employment needs to be preserved at all costs. If it were correct that expansionary policies are prevented by a widespread fear of inflation, then it must be explained what forces have reproduced this sentiment throughout the years and at the same time have suppressed alternative "lessons". A cultural explanation therefore only seems to be valid if it is based on a power-resource approach that explains why certain interests have privileged access to the institutions that are instrumental in the reproduction of societal ideology.[30]

But even if the German public has a strong aversion against inflation, it is not clear to what extent this constrains economic policy. The constitution of the FRG has been devised with the specific aim of shielding parliament and government from institutionally unmediated popular sentiments. The absence of plebiscitar' provisions is a visible expression of this aim.[31] Looking at the rearmament of 1955 and the recent deployment of cruise-missiles, it can be argued that the German government is very well capable of pursuing policies that are disapproved by a considerable majority of the electorate.

More important, there is no clear evidence that the German public or even the government, is uniquely concerned with maintaining price stability. During the sixties, when the memories of the two inflations must have been alive more vividly than today, German inflation, on average, was higher and unemployment rates were lower than in the USA.[32] Rather than promoting a revaluation of the D-Mark in order to be able to pursue a consistent anti-inflation strategy, German governments have frequently tried to

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28 "The inflation rate is one of the major yardsticks with which the large majority of the voters evaluate the government's economic performance. *'Control of inflationary pressure is thus part of the political orthodoxy in West Germany and an imperative for every government, regardless of its partisan composition and irrespective of the kind of economic philosophy to which it adheres.*" Schmidt, Manfred G., "West Germany: The Policy of the Middle Way," *Journal of Public Policy*, 7-2 (1987), 135-177, p. 148, Emphasis in the original. Also: Fels, Gerhard and Hans-Peter Fröhlich, "Germany and the World Economy: a German View," *Economic Policy*, 4, April 1987, 178-195.

29 Schmidt (fn. 28), p. 148

30 This argument relies heavily on: Martin, Andrew, "Ideology and Interests in West German Macroeconomic Policy," (*Mimeo*, Cambridge, 1988)

31 Some states (Länder) however do allow for non-binding referenda.

32 Average annual increase in consumer prices 1960-68, USA: 2.00, FRG 2.54. Source: OECD Economic Outlook, 24, 1978.

delay revaluation as long as possible. And even the Bundesbank, until the mid-sixties, did not support a revaluation strategy.[33] The president of the Bundesbank, Blessing, in 1960 even threatened to resign if the government would revalue the D-Mark.[34]

The refusal to pursue a consistent anti-inflation strategy, however, has not led to massive popular protests. The SPD won the national elections in 1972, even though its minister of finance, Helmut Schmidt, had declared during the campaign that 5 percent inflation is to be preferred to 5 percent unemployment.[35]

Contrary to cultural explanations, the power resource approach assumes that the anti-inflationary bias of German monetary policy is not based on a general aversion against inflation but simply reflects the fact that the SPD never managed to gain a hegemonic position comparable to the Swedish or Austrian Social Democrats.

According to the commonly used indicators, the organized German labor movement is indeed weak in comparison to Austria and Sweden. The social-democratic SPD did not take part in a government until 1966, and during the thirteen years that it did govern it never managed to do so alone.[36] Especially during the later years the small coalition partner FDP had a disproportionately strong influence on economic policies. The trade union federation (DGB) also has a comparatively weaker position than its Austrian and Swedish counterparts. While in Germany, during the period 1965-80 on average 32 percent of the total Labor force was unionized, the respective numbers for Sweden and Austria were 70 and 50.[37]

However, the SPD did govern until 1982 and it is exactly the policies of the late seventies which have strongly contributed to the image of the single-mindedness of German economic policy. For the explanation of the restrictiveness of macroeconomic policies of the SPD, the PRM analysis converges with the views espoused by authors in the institutional tradition, with the exception that the existence of strong institutional constraints to full employment policy are seen as a reflection of the long term weakness of the left.[38] The economic policies of the SPD have been constrained by the CDU/CSU majority in the Bundesrat and the Federal structure of Germany which promotes

33 Riese, Hajo, *Geldpolitik bei Preisniveaustabilität. Anmerkungen zur Politik der Deutschen Bundesbank,* (Mimeo, Freie Universität Berlin, 1988), p.12-14

34 Holtfrerich, Carl-Ludwig, "Relations between Monetary Authorities and Governmental Institutions: The Case of Germany from the 19th Century to the Present," in: Gianni Toniolo, Ed., *Central Banks' Independence in Historical Perspective,* (Berlin: W. De Gruyter, 1988), p147

35 Scharpf (fn. 2), p. 160

36 The SPD was in government from 1966 to 1982. During 1966-69 it was the junior partner in a coalition with the Christian democratic CDU/CSU. During the remainder of the period the SPD coalesced with the small liberal FDP. Since 1982 there is a CDU/CSU/FDP government.

37 Cameron (fn. 2), p. 165

38 Martin (fn. 2), p.221, Also Schmidt (fn. 28)

procyclical behavior on the state (*Länder*) and local levels.[39] The most important factor hampering a consistently expansionary macroeconomic policy stance, in both the PRM and the cultural interpretation, is the independence of the Bundesbank. Since the Bundesbank seems to be uniquely concerned with price stability, it is said to have frequently frustrated the expansionary fiscal policies of SPD governments. Indeed, during the last few years this view has been able to command a widespread consensus amongst scholars.[40]

An explanation for the restrictiveness of monetary policies that relies on the legal autonomy of the Bundesbank, however, suffers from serious weaknesses. First of all, since Uusitalo[41] has shown, that even in the Nordic countries the differences in legal autonomy of the central banks can not be explained by the relative strength of the social democratic movement, the PRM interpretation loses much of its plausibility. More important, however, both the power resource and the institutional interpretations rely on highly implausible assumptions concerning the political coalitions that support macroeconomic policies in Germany.

If Scharpf and Martin are correct in arguing that the DGB is not more aggressive than its Austrian counterpart (OeGB) and therefore full employment and price stability also are compatible policy goals in the German case, then the only thing the restrictive monetary policy of the Bundesbank does is not to fight inflation but simply to increase unemployment by reducing demand. Such a policy can hardly be in the interests of domestic industry. But even the export industry stands to loose from such a policy because in a highly open economy there is no clear distinction between exporting firms and firms operating in the domestic market. Most large exporters also have a considerable stake in the German market.

The only groupings that stand to gain from such a policy are banks with large international operations and capital exporters. Since, as Zysman[42] points out, German banks are heavily involved in German industry, even the big banks do not have an unambiguous interest in such a policy.[43] It would consequently have to be argued that the Bundesbank policy works not only against the interests of labor but is equally detrimental to the interests of most employers. It is very implausible to assume that the

39 Kromphardt, J., *Inflation und Arbeitslosigkeit*, (Göttingen: Vandenhoeck & Ruprecht, 1987), p. 177-78. Martin (fn. 2), p. 213

40 A small selection: Allen, Christopher S., "The Underdevelopment of Keynesianism in the Federal Republic of Germany," (Paper prepared for the SSRC project on *The Diffusion of Keynesian Ideas*, 1987), p. 28, Kromphardt, (fn. 39), p.185 f., Therborn, Göran, *Arbeitslosigkeit. Strategien und Politikansätze in den OECD Ländern*, (Hamburg: VSA, 1985), p.154, Scharpf (fn. 11), p. 281. Scharpf (fn. 2), p. 170. Hall (fn. 2), p. 239.

41 Uusitalo, Paavo, "Monetarism, Keynesianism and the Institutional Status of Central Banks," *Acta Sociologica*, 27-1 (1984),31-50, p.45

42 Zysman, John, *Governments Markets and Growth*, (Ithaca: Cornell University Press, 1983)

43 "One important factor which also shapes the independence of the central bank is the relationship between financial and non-financial corporations. When financial institutions have vested interests in manufacturing, as in Germany, the central bank will be less opposed to fiscal expansion and relaxed monetary policies." Kurzer, Paulette, "The Politics of Central Banks: Austerity and Unemployment in Europe," *Journal of Public Policy*, 8,1 (1988), 21-48, p.30.

Bundesbank could have persisted in its restrictive policy against the opposition of all relevant political forces. And, as has become quite clear from the decision making process concerning the monetary union with the former GDR, the Bundesbank indeed does not have the political power to let its wishes prevail in the face of strong dissenting views within the government. But even if the board of the Bundesbank had decided to completely ignore the prevalent views in the surrounding society, the law regulating the autonomy of the Bundesbank - the *Bundesbankgesetz* - would hardly have remained intact for all this time.

4.2 The D-Mark as a Second Line Reserve Currency

The policy preferences of the Bundesbank are undoubtedly skewed in favor of price stability. Instead of fully exploiting the possibilities for reflation the Bundesbank attaches more weight to the possible inflationary effects than to positive employment effects. An institutional reform that reduces the autonomy of the central bank might therefore be conducive to a less conservative outlook on monetary policy. Indeed, the presence of an institution that has critical influence on economic policies and yet is not under parliamentary control must seem misplaced in any democratic polity. However, in an open economy, democratic control of the central bank does not necessarily also imply the ability to exert democratic control over the conduct of monetary policy.

In spite of its independent status, during the last 16 years the Bundesbank has been confronted with stronger constraints on the conduct of monetary policy than many banks that are more exposed to direct government interference. In the multi-currency standard that took the place of the Dollar standard of the Bretton Woods era, the D-Mark assumed the role of second line reserve currency.[44] At the same time, however, the Dollar has remained by far the most important currency for international transactions. This asymmetry in size, together with the general instability of a multi-currency standard, has repeatedly forced the Bundesbank to take policy measures that were not in accordance with its preferences.[45]

A basic weakness of Martin's and Scharpf's, as well as Cornwall's interpretations is that the generally favorable current account in the case of Germany is thought to signal the absence of external constraints. It is the seeming lack of external constraints which ultimately makes German policy look too restrictive. However, since external constraints

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44 According to the *Financial Times* of March 11, 1991, total international holdings of D-Mark at present are well above DM 800bn.

45 See also: Duwendag, D., K. Ketterer, W. Kösters, R. Pohl & D.B. Simmert, *Geldtheorie und Geldpolitik*, (Köln: Bund Verlag), p.283

can only be interpreted to mean the extent to which the currency is subjected to pressures, such a view is correct only if there is a direct relationship between the current account and the de- or revaluation of the currency. Due to the instability of the post Bretton-Woods system, this has not been the case.

From a historical perspective, capital mobility was very low during the Bretton Woods System. In a situation where exchange rates were fixed, inflation was moderate and the Dollar was 'better than Gold', there were not many reasons for large scale capital movements. The stability of the system was undermined when, towards the late sixties, inflationary pressures, especially in the U.S., increased.[46] The increased insecurity and the continuing devaluation of dollar assets brought about by the surge in inflation, prompted an increase of non-dollar assets in financial portfolios. Those currencies were preferred, whose low inflation rate reflected the absence of virulent domestic distributional conflicts. The D-Mark and the Swiss Frank were the main targets for conversion of Dollar assets, but also the currencies of Germany's small neighbors - Austria, Belgium and the Netherlands - were confronted with large inflows of capital. As long as there was a general commitment to stable exchange rates, shifting funds between different currencies was relatively risk free. Consequently the Bundesbank lost its control over the volume of money because of capital inflows.

The Bundesbank, in line with many economic experts, thought that the transition to a system of floating rates would increase monetary autonomy again. After an initial adjustment perhaps, exchange rate changes would be determined by relative differences in the inflation rate thereby leaving the real exchange rate unchanged. The Bundesbank accordingly would be able to devise its policies solely with the domestic inflation rate in mind. The switch to a monetarist strategy in 1974 reflected this view. By committing itself to money growth targets in advance of wage negotiations, the unions would be forced to moderate their claims unless they were prepared to accept higher unemployment. In this way the Bundesbank hoped to prevent a repetition of the inflationary 1974 wage round.

Instead, the generalized floating increased the insecurity about future exchange rates, thereby increasing volatility of capital flows and decreasing the autonomy of the Bundesbank.[47] With the change to floating, expectations of exchange rate changes became a major determinant of capital flows. When transferring assets into foreign currencies under floating exchange rates, account will have to be taken of the expectations of other individuals, and it cannot be assumed that those individuals hold a "correct" model of the economy and know what the long term equilibrium exchange rate

46 Argy, Victor, *The Postwar International Money Crisis*, (London: Allen & Unwin, 1981)

47 Spahn, Heinz-Peter, *Stagnation in der Geldwirtschaft* (Frankfurt am Main: Campus, 1986), p. 267

will be. In a multi-currency standard, therefore, large flows of capital tend to occur that are unrelated to "economic fundamentals" like the current account.[48] In such a system, second-line reserve currencies are especially vulnerable.

German monetary policy, since the end of Bretton Woods has been confronted with a double asymmetry. Large capital inflows (outflows) do not only occur when, for domestic reasons, the confidence in the D-Mark is increased (reduced), but also come about when the relative confidence in the Dollar changes for reasons unrelated to German developments. Whenever the U.S. monetary policy has been expansionary and the confidence in the Dollar decreased, the D-Mark tended to appreciate, whereas there tended to be downward pressures in periods of restrictive U.S. policies. If the Bundesbank wanted to persist in an expansionary policy in the face of restrictive U.S. policies it would cause capital outflows which would lead to expectations of depreciation, which in turn would probably lead to massive speculation against the D-Mark. Likewise, as shown by the Swiss experience of 1978, a second-line reserve currency cannot persist in a restrictive policy if confidence in the Dollar is low, even if appreciation is one of the best means to fight inflation. The differences in size tend to place the burden of adjustment on the side of the second-line reserve currencies. Although the Federal Reserve cannot tolerate a cumulative outflow (inflow) of capital, the small size of the German capital market relative to the US will typically force adjustment on the Bundesbank before the Federal Reserve must take action.[49] As a result the Bundesbank has missed its announced monetary targets in ten out of fifteen years (Table 4.1).

In short, the external constraints on German macroeconomic policy are not primarily determined by developments in the real sector but derive largely from the confidence the D-Mark enjoys relative to the Dollar in the international financial markets. For Germany, this meant that monetary policy could not be varied freely according to domestic preferences; not because of the autonomy of the Bundesbank, but because the Bundesbank could not fully decouple itself from the trend of U.S. policies. Consequently, the stance of macroeconomic policies cannot be considered a pure reflection of domestic preferences, but must be seen as a mixture of foreign (mainly U.S.) and domestic preferences.[50]

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48 See also: Stewart, Michael, *The Age of Interdependence*, (Cambridge, MIT Press, 1983)

49 "This American-West German-Japanese monetary trilateralism, however, is marked by an inherent asymmetry since the United States can be viewed as the elephant in the boat. While West Germany and Japan are more vulnerable to exchange rate volatility than the United States, the United States still has the economic dominance to enforce unilateral adjustment in both other countries, as it did, for instance, when the dollar soared in the first half of the 1980s." Thiel, Elke, "West Germany's Role in the International Economy: Prospects for Economic Policy Coordination," *Journal of International Affairs,* Vol. 42, No.1 (1988) 53-73, p.57.

50 Scharpf recognizes the problem. In discussing the monetary policy of the Bundesbank from 1973 to 1975 he notes: "Furthermore the government might still have been able to win an open conflict with the Bundesbank at that time, but the resulting loss of confidence in the economic press and on the national and international capital-markets could plausibly have had similar effects as in Great Britain in the year 1976." Scharpf (fn. 2), p. 171. My translation.

For those small neighbors of Germany, who have traditionally had very strong monetary and real links with the German economy and who found it necessary to peg their currency to the D-Mark, the rise of the latter to a reserve currency status meant that, for all practical purposes, they too came to experience the constraints of a reserve currency country. As Giavazzi and Giovannini's research on the so-called Dollar-D-Mark polarization shows, until the inception of the EMS a strengthening of the Dollar vis a vis the D-Mark tended to coincide with a weakening of the D-Mark vis a vis the Dutch, Belgian and Danish currencies, et vice versa.[51] After 1979 the extent of polarization for these three currencies is negligible, which can be interpreted to mean that a change in the relative position of the D-Mark now leads to immediate policy adjustments in Germany's small neighbors. The autonomy of macroeconomic policy in Austria, Belgium, Denmark and the Netherlands as well as in German ultimately is not so much hampered by a deficiency in the domestic system of interest intermediation, but is primarily due tot he lack of regulation of international monetary affairs.

4.3 German Monetary Policy 1973-1989

German monetary policy since 1973 can be subdivided into 6 periods:
- A restrictive policy from the spring of 1973 until the fall of 1974.
- An expansionary phase from the end of 1974 to the end of 1978.
- A more restrictive policy from early 1979 until late 1979.
- Tightly restrictive policies from late 1979 until mid 1982.
- A more relaxed policy stance from mid 1982 until early 1984.
- Restrictive policies from early 1984 until February 1985.
- Expansionary policies from early 1985 until 1989.

The decision to devalue the Dollar by 10% on the 12th of February 1973 marked the end of the Bretton Woods System and the beginning of floating of the main currencies. The Bundesbank used its newly-won freedom to administer a severe monetary restriction. The economy had shown signs of overheating since 1972. Instead of fighting these inflationary tendencies through monetary contraction, the commitment to fixed exchange rates forced the Bundesbank to excessively create money. The restrictive monetary policy stance that followed the change to floating would have been much harder to maintain if the speculation in favor of the D-Mark had continued. The change to floating, however, was followed by a reduction in speculative pressures.[52] The reasons for this remain unclear. One plausible explanation might be that speculators initially felt the

51 Giavazzi & Giovannini (fn. 13), p.136

52 Spahn, Heinz-Peter, *Bundesbank und Wirtschaftskrise* (Regensburg: Transfer Verlag, 1988), p.76

need to be more cautious in a radically changed environment. Pressures on the D-Mark were further relaxed when the demand for dollars strengthened because of the rise in oil prices.

In the fall of 1974 the Bundesbank switched to a more expansionary policy, as can be seen from the lower discount rate and the larger growth of the volume of money in 1975. This expansionary policy was continued until 1978 when the discount rate was at a low of 3% and the money growth was allowed to exceed the target considerably (Table 4.1). Viewing the Bundesbank as solely concerned with inflation, the change in policy seems hard to explain. Although activity was starting to decline in the fall of 1974, the inflation rate was still high for German standards (7% in 1974, 6% in 1975). Scharpf's argument that it was the shock of the downturn in economic activity that was responsible for the policy change seems unlikely.[53] The aim of the restrictive policy had been to reduce inflation through a reduction in activity. It seems unlikely that the first signals of the effectiveness of its policy should have prompted the Bundesbank to change its view, especially since the decline in inflation rates proved to be modest.

Table 4.1: Central Bank Money Stock. Targets and Outcomes

	1975	1976	1977	1978	1979	1980	1981
Actual	10.02	9.23	8.97	11.47	6.38	4.89	3.61
Target	8	8	8	8	6-9	5-8	4-7

	1982	1983	1984	1985	1986	1987	1988	1989
Actual	6.11	7.06	4.60	4.50	7.72	8.06	6.79	4.7
Target	4-7	4-7	4-6	3-5	3.5-5.5	3-6	3-6	+5

Note: Figures for 1988 and 1989 refer to M3.

Source: Monthly Report of the Deutsche Bundesbank, Several Issues.

A more likely explanation seems to be the upward pressure on the D-Mark and the development of U.S. monetary policy. Whereas the D-Mark had been weak against the Dollar during much of 1973, the year 1974 saw renewed upward pressures. At the same time U.S. policy moved towards a more relaxed stance as witnessed by the stabilization of the discount rate in 1974 and its subsequent decline. Under such circumstances, the continuation of the restrictive policy would have contributed greatly to the upward pressures. Although this would have eliminated the inflation rate, such a policy would have carried the risk of a strong revaluation. Instead, the Bundesbank opted for an

53 Scharpf (fn. 2), p. 178

increase of the negative discount rate differential with the U.S. and increased money growth. With a short exception in 1976, the D-Mark remained strong and the Bundesbank consequently remained expansionary.

As a consequence, the monetary target was overshot continuously from 1975 to 1978, with the difference between targeted and actual outcomes being especially large in the latter year (Table 5.1). The need to stabilize the exchange rate cast considerable doubt on the significance of the announced targets. As Kloten et al note: "That signal failure (in 1978, T.N.) was widely interpreted as implying that the Bundesbank no longer set any store by monetary targeting."[54]

After the extreme pressures against the dollar and in favor of the D-Mark abated in the early months of 1979, the Bundesbank switched to a more restrictive policy in order to reduce excess liquidity. By mid-1979, however, downward pressures on the Dollar reemerged and capital imports into Germany consequently increased. Instead of easing monetary conditions the Bundesbank decided to aim for the lower band of the monetary target. This decision, that was widely criticized throughout Europe and the U.S., is seen by Spahn as the centerpiece of a risky strategy that intended to put the dollar under pressure in order to force the Federal Reserve on a restrictive course.[55] According to Emminger[56] the switch to more restrictive policies was only made after it had become clear that the Dollar had begun to recover.

Whatever the true intentions of the Bundesbank might have been, it seems clear that a strategy that wanted to force a change in policy in the U.S. might have been completely counterproductive if the Federal Reserve had been willing to let the dollar depreciate heavily in order to safeguard domestic expansion. This must have been especially clear to the Bundesbank since the Swiss, who were in a similar position, only a few months earlier had demonstrated the likely outcome of such a strategy.

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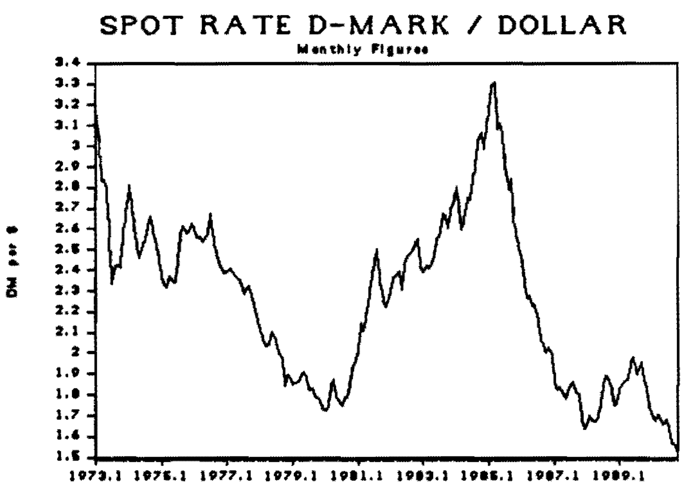
54 Kloten, Norbert, Karl-Heinz Ketterer & Rainer Vollmer, "West Germany's Stabilization Performance." In: Leon N. Lindberg & Charles Maier, Eds., *The Politics of Inflation and Economic Stagnation*, (Washington D.C.: The Brookings Institution, 1985), p.394

55 Spahn (fn. 52), p.94, WZB, "Bundesbankpolitik 1970-1987." *WZB Mitteilungen*, No. 42, (1988), 18-20, p. 19

56 Emminger, Otmar, *D-Mark, Dollar, Währungskrisen* (Stuttgart: DVA, 1986), p. 455



Source: "Statistische Beihefte zu den Monatsberichten der Deutschen Bundesbank. Reihe 5. Die Währungen der Welt." Frankfurt am Main. Several Issues.

It seems likely, therefore, that the Bundesbank assumed that the Federal Reserve indeed would not be willing to tolerate a large slide of the Dollar. By mid-1979, it had become increasingly clear that the Federal reserve would be willing to risk a major recession. Monetary policy in the U.S. had become more restrictive since the fall of 1978. Despite this restrictive policy, monetary growth remained strong as inflationary expectations contributed to a rise in velocity.[57] The Federal Reserve had apparently lost control over monetary aggregates and could only hope to regain it by wielding the big stick of a monetary shock therapy. In this situation the policy of the Bundesbank provided the new chairman of the Federal Reserve, Paul Volcker, with an additional justification for his decision in favor of a monetarist strategy.

On the other hand, it is also clear that the Bundesbank was not willing to ease its monetary policies in order to help U.S. stabilization. The Bundesbank was primarily worried about the excessive monetary growth of the previous year, and it accordingly greeted Paul Volcker's decision of October 6, 1979 to switch to a monetarist strategy.

If the Bundesbank could have foreseen the ferocity of Paul Volcker's monetary shock, it would have been less enthusiastic about the change in policy. The upward pressure on the D-Mark was turned into a strong downward pressure, and in 1980 a veritable crisis of confidence in the D-Mark came about. At first the Bundesbank tried to stem the

57 Axilrod, Stephen H., "U.S. Monetary Policy in Recent Years: An Overview," *Federal Reserve Bulletin*, (January 1985), 14-24.

outflow of funds by a combination of intervention on the currency markets and increasing the discount rate. After she lost about one quarter of her reserves between October 1979 and April 1980, the Bundesbank decided to move to a fully restrictive policy.[58] Although inflation was rising, it should be noted that the Bundesbank admitted that from the viewpoint of the domestic economy the restrictive policy could not be justified.[59]

Hans-Ju' rgen Krupp - former President of the German Institute for Economic Research and main economic advisor of the SPD - however argued that it would not have been necessary for the Bundesbank to tighten her policies. Instead, Germany might have followed the Japanese strategy, letting the D-Mark devaluate strongly in order to gain room for an expansionary policy on the basis of an undervalued currency with expectations of appreciation. However, in contrast to the D-Mark, the Yen did not play a role as reserve currency at that time, mainly because of the still very strict Japanese regulations concerning capital flows. A devaluation strategy with a reserve currency is very risky because it eliminates the main reason why that currency is being held by foreigners, namely its relative stability as compared to other currencies.[60] Under such circumstances a devaluation strategy would not have created room for low interest rates but would probably have required higher interest rates than in the U.S. to restore confidence.

As the pressures on the D-Mark abated and the Federal reserve switched toward a more relaxed monetary policy in 1982, the Bundesbank likewise became more expansionary. In contrast to 1981, the growth of the central bánk money stock was now in the upper range of the target, and in 1983 the target was even slightly overshot. However, this time the monetary expansion was not accompanied by an expansionary fiscal policy stance, as had been the case from 1975 to 1978, thereby leading to a much weaker growth of GDP as compared to the former period.

Strong downward pressures on the D-Mark however reemerged in 1984, which, again led the Bundesbank to reduce monetary growth.[61] Especially towards the end of the year the Dollar surged, but due to the relaxed monetary conditions of the earlier months, the actual monetary growth figure was still within the target range, although at its lower end. After the February 1985 summit meeting, the long rise of the dollar ended.

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58 "The German episode of 1980-81 can be read as evidence that a second-line reserve currency is in an especially vulnerable and asymmetrical position because funds may flow in when the dominant reserve currency is in trouble and flow out again as soon as it recovers - to some extent irrespective of the economic performance of the second-line reserve-currency country; meanwhile, funds will also be liable to flow out in a massive way whenever the second line reserve-currency itself shows signs of trouble." OECD, *Why Economic Policies Change Course. Eleven Case Studies*, (Paris: OECD, 1988), p. 20. See also: Stewart, Michael (fn. 48), p.75 f.

59 Scharpf (fn. 2), p.189

60 Spahn (fn. 47), p. 272

61 Spahn (fn. 52), p.114

In less than two year the D-Mark value of the dollar was more than halved. The Bundesbank now could pursue the expansionary policy it had been aiming for since 1982.

Most remarkable about this "hard landing" of the Dollar was that it was not accompanied by massive capital flight from the U.S.. The reasons for this are unclear. For the Bundesbank, however, it meant that the pressure on the D-Mark was not as strong as might have been expected. Nevertheless, the Bundesbank again considerably overshot it monetary target from 1986 to 1988, thereby repeating the experience of the 1975-78 period.

5 CONCLUSION

Although all OECD economies during the postwar decades have been characterized by a rapid process of internationalization of real as well as financial markets, the resulting policy interdependence has received only fairly little attention in studies of the determinants of economic policy making in advanced industrialized democracies. To some extent, this neglect of external forces impinging on domestic decision making processes is due to the comparative focus of most research. The strength of a comparative approach is that the presence of multiple cases provides for a quasi-experiment which allows us to test the strength of the independent variables and guards against premature generalizations from national experiences. The weakness of the comparative method is that for a useful quasi-experiment to obtain the respective cases must be independent of each other. Furthermore, a comparative methodology focuses on the variation in the independent variables across the cases and is relatively ill equipped to address trends in economic policy making that are common to most or all of the cases.

Although the assumption of policy independence seems valid in many policy fields, it is certainly unjustified in the case of macroeconomic, and especially monetary policies. Consequently, this paper has argued that the contemporary approaches to political economy frequently fail to give an accurate account of policy making processes because of their narrow focus on domestic interactions. What interests come to prevail and what interests get excluded in the decision making process cannot be explained with reference to the extent to which a certain view is institutionally ingrained or can muster strong societal support, but critically depends on whether a chosen strategy is feasible given the choices made by the other national actors in the system. The necessity to establish a minimal degree of coherence between domestic and external requirements, hence, not only accords a degree of autonomy to the macroeconomic decision making process but frequently also alters the domestic distribution of power and the institutional structures.

As a consequence, comparative research in political economy has tended to support over-optimistic views with respect to the possibilities of strategies for renewed growth. Especially the presence of a corporatist coordination of fiscal, monetary and incomes policies is not necessarily a sufficient condition for successful policies. The experience of five small countries during the seventies and eighties has shown that, in case of a conflict between domestic preferences and the German monetary policy stance, the latter has come to prevail, thereby exposing the domestic political arrangements to severe pressures. However, also in the case of Germany, domestic policy preferences were not found to be a good predictor of actual policies because of the special role of the D-mark as second reserve currency. Although the weakness of the left and the autonomy of the Bundesbank did play a role in determining the specific stance of German monetary policies, the primary factor that prevented an effective coordination of fiscal and monetary policies in a strategy oriented towards domestic equilibrium has been the international role of the D-Mark. The reserve currency status of the D-Mark has tended to make coordination of fiscal and monetary policies dependent on swings in U.S. policies. An expansionary U.S. policy creates strong pressures for an expansionary German policy through the pressure on the Γ-Mark that forces the Bundesbank to intervene and through political pressures on the government to increase spending.

To be sure, the sensitivity of the D-Mark to changes in U.S. policies does not plead Germany free of any responsibility for the high unemployment, both at home and and its European neighbors. The historical weakness of the left is undoubtedly responsible for the fact that the commitment to full-employment has never been institutionalized.[62] Active labor market policies, whose potential has been impressively demonstrated in the Swedish case, are quite underdeveloped. Fiscal policy, especially during the CDU-FDP coalition, has failed to exploit the room for maneuver that was opened up by the rapid decline of the Dollar in the mid-eighties. The combination of a SPD government and a less autonomous Bundesbank might indeed have led the latter to be less restrictive in periods of dollar strength and more expansionary in periods of dollar weakness. The point, however, is that, given the role of the D-Mark, a consistently expansionary German macroeconomic policy stance would most likely have not succeeded.

But just as there is reason to be skeptic towards those views that designate the lack of domestic coordination of polices as the main obstacle to growth policies, there is reason for skepticism about the view that, due to the public good character of reflationary policies, the major impediment to renewed growth is the lack of international

62 Therborn (fn. 62)

political coordination. Coordinated reflation cannot solve the problem of capital flows related to substantial differences in inflation rates and hence will fail as long as different economies display a different degree of inflationary bias.[63] Expansionary German policies cannot stop inflationary pressures in the U.S. The distrust in the dollar that inevitably builds up during expansionary U.S. policies forces it sooner or later to use the brake of high interest rates.[64]

Are we left than, with a call to 'dismantle the world economy'[65] in the form of instituting strong capital controls between OECD economies? For the small countries around Germany such a policy would most likely not be beneficial. Apart from the fact that transitional problems associated with the implementation of a regime of stricter capital controls might well be forbidding, these countries have reached such a degree of openness that even under a restrictive European policy regime the costs of dissociation would seem to outweigh the costs of integration. For the EC as a whole the balance of benefits might well point in the other direction. It is a well know fact that the EC as a whole will be more closed in terms of trade and finance than any of its member countries. Given the existing differences in inflationary bias between the US economy and the EC it might eventually be more beneficial to both economies if "Project 1992" were supplemented with extensive controls on external capital flows.

63 See: Cornwall, John (1990) (fn. 25), especially section 10.3

64 Since trade linkages are too small, an expansionary German policy, furthermore, cannot reduce the U.S. trade deficits more than marginally. For an overview of estimated trade linkages see: Helliwell, John F. & Tim Padmore, "Empirical Studies of Macroeconomic Interdependence," in: Jones, R.W. & P.B. Kenen, Eds., *Handbook of International Economics*, Vol. 2. (Amsterdam: Elseviers, 1985)

65 Thurow, Lester, "America, Europe and Japan: A Time to Dismantle the World Economy," In: Jeffrey A. Frieden & David A. Lake, Eds., *International Political Economy: Perspectives on Global Power and Wealth*, (New York: St. Martin's Press, 1987)

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