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Five Decades of Economic Policy Debate

Fifty years ago, in January 1966, the Hamburg Institute for International Economics (HWWA) published the first edition of *Intereconomics*, a new monthly review of international trade and development, and I had the honour of writing the first editorial for the journal. Germany's domestic economy and exporting proficiency were both very successful, and so it seemed natural that the HWWA, at the time one of the leading German research institutes for economics, should publish an English-language journal covering economic and social policy issues. The director of the HWWA, Heinz-Dietrich Ortlieb, a professor of economics, was interested in selecting the most important studies out of the flood of economic and political information, partly created in the research divisions of the HWWA, and sending them to theoretical and practical economists. The journal was to serve as a bridge between theoretical discussions and practical needs.

Now, five decades later, we can state that the creation of *Intereconomics* was a brilliant idea, as it has become one of the most important English-language economic journals in Germany. Beginning in 2001, the journal shifted its focus to European economic policy issues. In 2007 the German National Library of Economics (ZBW) assumed responsibility for publishing the journal, and in 2009 the journal formed a mutually rewarding partnership with the Brussels-based Centre for European Policy Studies.

In 1966, its first year of publication, and continuing into 1967, economic developments were taking place which can teach us how to deal with economic downturns. The German economy was entering the first recession of its post-war history. While GDP for all of 1966 remained positive, in 1967 the recession produced negative growth of 0.3 per cent. This was a terrible thing after nearly 20 years of GDP growth rates of around five per cent. The unemployment rate rose to 2.2 per cent in 1967 and to a peak of 3.2 per cent in 1968. Until that time, unemployment rates of only about 0.5 per cent were normal, and consequently the German people were shocked. In October 1966 *Intereconomics* took up this problem and published articles by two well-known economists, Andreas Predöhl and Hans-Jürgen Schmahl. They dealt with the question of whether Germany was facing an imminent economic crisis on par with the Great Depression. Schmahl's reassuring conclusion was revealed in the title of his paper, “No Real Parallel to 1929”. One reason for this optimistic diagnosis was the advance of the economic theory developed by the English economist John Maynard Keynes.

After the world economic crisis of 1929, Keynes diagnosed a lack of demand as a cause of most economic downturns. In such cases, according to Keynes, the state has to invest through deficit spending in order to fill this lack of demand. Goods will then continue to be produced because there is still a demand for them. In 1966 and 1967, the Keynesian theory represented the mainstream in economic thinking. In Germany the minister of trade and commerce followed Keynes's theory and introduced an investment programme. Consequently, the recession in Germany was quickly overcome.

Nowadays, a lack of demand continues to be the cause of recessions, but mainstream economic thinking, especially in Germany, has unfortunately changed. Monetarist, neoclassical and neoliberal thinking, in the sense of the Washington Consensus, argues that the markets will self-correct and that government should keep out of the economic process; furthermore, wages and social expenditures should be reduced, and the government's budget deficit must be reduced through savings measures. In line with this thinking, Greece, for example, has had to cut workers' wages, to decrease governmental personnel, to reduce pensions, to increase taxes and to achieve a budget surplus. In short, Greece has had to execute an austerity policy.

Numerous prominent economists disagree with this economic policy. Paul Krugman argues that it is wrong for governments to save money during a recession. Joseph Stiglitz calls austerity policy a recession policy. Amartya Sen thinks that this policy is poison for Greece and will make it difficult to carry out the necessary institutional reforms. Robert Solow emphasises that whenever actual production remains below potential production, the reason will be that the total demand is too low to buy the potential output. Robert Shiller also criticises the anti-Keynesian policy. Ignoring the profound insights of these distinguished economists is reckless, all the more so since it can be shown that they speak the truth.

The change in economic thinking of the present mainstream is based on a misunderstanding of the developments that began in the mid-1970s. At that time, two things happened simultaneously which economic theory had said was impossible: low growth and high inflation, i.e. “stagflation”. The German GDP rate had slumped from 4.8 per cent growth in 1973 to -0.9 per cent in 1975, and the unemployment rate had increased from 1.2 per cent to 4.7 per cent. Between 1980 and 1982, GDP growth again slumped from the already low rate of 1.4 per cent to -0.4 per cent. While German GDP increased thereafter, the unemployment rate continued to rise, eventually reaching 9.3 per cent in 1985, despite the government’s attempts to reduce it by introducing large investment programmes. Parallel to the rise in unemployment, the inflation rate increased to more than seven per cent in 1973 and was still around 6.5 per cent in 1981. Furthermore, the attempt to stimulate GDP growth and lower the unemployment rate through the investment programmes increased Germany’s debt burden from about 20 per cent in the years before the recessions to 30 per cent in 1979 and 40 per cent in the 1980s, which in Germany at that time was considered very high.

It seemed to many observers that the Keynesian policy did not work. Opponents of the Keynesian theory took this opportunity to declare that Keynes was wrong, and an ever-increasing number of economists supported this opinion. However, they failed to see three facts. Firstly, these recessions did not arise from a lack of demand, as Keynesian theory entails. The real reason was the shock of the oil price explosions in 1973 and 1979-80. Thus, it was not a demand-side but rather a supply-side problem, which primarily had to be fought on the supply side. Secondly, this supply-side problem was seriously aggravated by the wage policy of the trade unions, which had tried to compensate for the inflation through correspondingly high wage increases. They pushed through a 12 per cent increase in 1973 and an additional 11 per cent increase the next year. The impact of the oil price shock and the wage developments on the inflation rate in Germany led the Bundesbank to raise the interest rate drastically. The explosion of costs and the restrictive monetary policy reduced production and increased the unemployment rate. The effect was the simultaneous arrival of high unemployment, low growth and high inflation. Thirdly, although the government was initially willing to stimulate the economy via investment programmes, anxiety about the rising debt burden soon led the government to counteract these expansionary measures. A systematically procyclical fiscal policy was misguidedly pursued for decades.

The truth is that the Keynesian theory and policy did not fail in the 1970s. Joseph Stiglitz is correct when he argues that the Keynesian theory is still valid at its core. Applying this logic to current events, it seems clear that Greece should not be forced to continue imposing austerity policies. Dealing with the disastrous Greek economy will be a vital task for *Intereconomics* in the future, as the economic problems facing that country – as well as many others in Europe – are not yet close to being solved.

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