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Introduction

October 18, 2010, was a day that changed European politics. German chancellor Angela Merkel had traveled to the Normandy seaside town of Deauville to discuss the European crisis with France's president Nicolas Sarkozy. Press photographs show them in dark raincoats, strolling on the wet and deserted autumnal boardwalk, Sarkozy gesticulating argumentatively and Merkel apparently responding with a look of blank incomprehension. In fact, after a moment in which it looked as if contrasting German and French visions of the world were bound for a head-on collision, they reached a dramatic compromise: Germany would loosen its approach to rules and make concessions to France, if France would in return agree to "an adequate participation of private creditors." Chancellor Merkel—who enjoyed substantial public support in her country—believed that banks had been responsible for the unwise extension of credit and should bear the cost of it. An end had to be put to the bailout mentality that had followed the global financial crisis of September 2008, including the failure of Lehman and the rescue of AIG. The basic elements in the Franco-German agreement had been achieved, and kept secret, two weeks before, during an informal conversation between the two leaders at the margin of a NATO summit in Brussels.

Other European leaders were stunned when they learned of the outcome on their mobile devices. The head of the European Central Bank (ECB) immediately thought that the agreement was a mistake, and US treasury secretary Tim Geithner was enraged by the proposal, warning European policy makers that "if you're going to restructure Greece, . . . you have [to have] the ability to in effect protect or guarantee the rest of Europe from the ensuing contagion."[1] Markets shared this sentiment. Immediately

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after Deauville, interest rates on periphery government bonds shot up. Germans welcomed the imposition of market discipline on the periphery in Europe, while French commentators viewed the spike in rates as unjustified from a fundamentals standpoint—a pure liquidity effect.

The Deauville episode first of all made clear that differences in the German and French visions of appropriate economic policy were at the heart of the difficulty in finding a response to Europe's financial crisis. The incident also highlighted how much power in Europe had shifted away from the European Union's institutions in Brussels, the Commission and the European Council, and toward two big nation-states—countries that found it hard to talk a common language.

The euro crisis has led to the outbreak of a war of ideas in the European continent and to a seismic shift of power within Europe. Starting with fiscal problems in one of Europe's smallest economies, Greece, in late 2009, a long-simmering battle over the appropriate economic philosophy and future design of the European Union broke into the open. It is a struggle between northern, but above all German, and what are sometimes called southern, but above all French, theories. The debate is not limited to French and Germans: Finns, Austrians, and sometimes Slovaks and Poles behave as if they are more Germanic than the Germans, and France is often seen as a champion of a Mediterranean Europe. The clash played a part in the debate that pushed Britain to vote for Brexit. But in practice, the clash is often treated as if it were a war of ideas fought out across the River Rhine. Italy is divided between a north that looks intellectually and economically like Germany and a south in which there is more sympathy for French-style theories. The French and German positions outlined here should be understood as *ideal types*, a concept developed by the sociologist Max Weber to better understand problems, debates, and institutions by thinking in terms of sharply differentiated features. Weber, and every good subsequent analyst, knew well that reality was messy but thought that conceptual clarification could bring a greater realization of the roots of social peculiarities.[2]

It is this war of ideas that lies at the heart of our book. Our main aim is to provide an explanation of the long-term historical, intellectual, and cultural roots of the contrasting German and French economic philosophies. One might think that each country exclusively fights for its own material interests. Such a narrow perspective overlooks an even more important

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aspect: interests are interpreted through the lens of ideas, or visions. Some countries have developed their own economic traditions and schools. Given their historical paths, different countries in Europe follow different economic philosophies and derive different policy descriptions for how to respond to crisis events. Previously, these differences were always taken for granted but glossed over and never thoroughly discussed. The European integration process—arguably one of the most successful peace initiatives in history—was characterized by a tendency to be Panglossian in the face of crisis. Indeed, differences between countries were often so ingrained in national policy makers' thinking that mutual incomprehension ensued. Policy makers even used the same word for different concepts. As an example, "economic governance" for Germany meant convergence around a common stability culture, while for France it meant common initiatives to direct economic development. Similarly, Germans interpreted the euro as an improved version of the old Exchange Rate Mechanism—built around the virtues of the Deutschmark—while the French saw the euro as a new global currency and conduit for more effective Keynesian stimulus policies.[3]

Of course, there are also straightforward differences in *interests* between European countries, including between France and Germany. But interests are often seen through the lens of ideologies. The difference between European countries is often reduced by some analysts to a simple contest between creditors and debtors based on net asset positions.[4] Since the 1960s, Germany has built up a substantial net creditor position via sustained current account surpluses. France has occasionally had surpluses, but interspersed with substantial deficits. So it might be thought that Germany (and creditors in general) would focus on strict debt repayment, even if it means squeezing the pips out of debtors, and that it would prefer low inflation to increase the real value of nominal debt. By contrast, France (and debtors in general) would be amenable to debt forgiveness, or higher inflation to erode the real value of debt. But this line of argument is open to objections. The net asset position, total claims of a country's citizens toward foreigners, is the sum of net flows. However, net flows mask much larger gross flows and an accumulation of a wide variety of personal and institutional positions: there may be powerful and substantial debtors in the net creditor countries.[5] Equally important, a wise creditor will normally hope that the debtor is prosperous and dynamic so as to be able to repay debt in the

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future. Squeezing the pips may reduce the chances of being fully repaid. A debtor will also be aware that nonrepayment or default will damage future chances of borrowing for productive purposes. So the judgment calls on both sides depend on ideas about the other side: is debt growth enhancing (good) or a sign of profligacy (bad)? These are ideological judgments: as Weber put it in a famous analogy, "Not ideas, but material and ideal interests, directly govern men's conduct. Yet very frequently the 'world images' that have been created by 'ideas' have, like switchmen, determined the tracks along which action has been pushed by the dynamics of interest."[6]

The process of European integration is full of the same kinds of misunderstandings and misinterpretations that often characterize relationships between men and women. According to a popular American psychologist who wanted to provide a "practical guide for improving communication and getting what you want in your relationships," men and women are from different planets.[7] The book was wildly successful, with seven million copies sold. His title was adapted to international politics by Robert Kagan, who argued that Americans were from Mars and Europeans from Venus. "It is time," he said, "to stop pretending that Europeans and Americans share a common view of the world, or even that they occupy the same world."[8] Europe has now discovered that it has its own version of mutual incomprehension.

The basic elements of the contrasting philosophies can be delineated quite simply. The northern vision is about rules, rigor, and consistency, while the southern emphasis is on the need for flexibility, adaptability, and innovation. It is Kant versus Machiavelli. Economists have long been familiar with this kind of debate and refer to it as *rules versus discretion*.

Some more specific policy preferences follow from the general orientation. The rule-based approach worries a great deal about the destruction of value and insolvency and about avoiding bailouts that will set a bad example and encourage inadequate behavior among other actors (economists call this the *moral hazard* problem). The discretionary approach sees many economic issues as temporary liquidity problems that can be easily solved with an injection of new lending. Here the provision of liquidity is costless: A bailout incurs no losses; in fact, the knock-on effects make everyone better off. There are, in this vision, multiple possible states of the world—multiple equilibria—and the benign action of

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governments and monetary authorities can shift the whole polity from a bad situation to a good one. To this, the long-faced adherents of the moral hazard view point out that costs will pile up in the future from the bad example that has just been set.

ECB president Mario Draghi's "whatever it takes" proclamation on July 26, 2012, in London—just before the opening of the Olympic Games—was, after Deauville, the second watershed moment in the euro crisis. Draghi's promise that the ECB was willing to do "whatever it takes" to save the euro later led to the creation of the Outright Monetary Transactions (OMT) program, under which the ECB would stand ready to buy the government debt of distressed countries (under some conditionality). Proponents of the liquidity view felt vindicated that the tide had turned and that interest rates in the peripheral countries significantly declined without any outright transactions taking place. The implicit support of Angela Merkel and German finance minister Wolfgang Schäuble was crucial to the effectiveness of Mario Draghi's promise. However, conservative Germans challenged the ECB's OMT program in the German constitutional courts and the European Court of Justice. For them, interest rates had subsided only because the ECB implicitly guaranteed peripheral government debt. In the end, the credibility of the measure hinged on the interpretation of whether it was consistent with the German vision.

The rules principle emphasizes the importance of solidity—of not living beyond one's means. In the novel *David Copperfield*, Charles Dickens has Mr. Micawber tell David, "Annual income twenty pounds, annual expenditure nineteen nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery. The blossom is blighted, the leaf is withered, the God of day goes down upon the dreary scene, and—and in short you are forever floored. As I am!" The southern or French approach, by contrast, emphasizes social solidarity. Paragraph 21 of the 1793 Declaration of the Rights of Man and the Citizen—the ultimate statement of the ideals of the French Revolution—states that "Public relief is a sacred debt. Society owes maintenance to unfortunate citizens." The southern view also tried to extend the principle of solidarity across national frontiers, a move that the northerners resisted. In general, the rule-based view is concerned with price stability; the discretionary approach embraces the idea of managing the economy.

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Economic Traditions Are Not Written in Stone

Almost all contemporary commentators have recognized the chasm between the two competing ideas. Many treat it as a product of plain stupidity and ignorance on one side: Paul Krugman talked about a "Dark Age of macroeconomics" in which the good lessons of the Greeks and the Romans had been countermanded by the obscurantist barbarians (from the north!) who overrun Mediterranean civilization.[9] The second interpretation is that these preferences represent deep historical traditions, cultures, and memories—so deeply rooted that they cannot be erased by the persuasive powers of superficial rationality and logic. In particular, Germans were so seared by the experience of catastrophic hyperinflation in the early twentieth century that ninety years later they repeat a meaningless mantra.

But wait a moment: Krugman's Dark Age is about the revival in the twenty-first century of the principles of Jean-Baptiste Say, a nineteenth-century economist—from France! In fact, in the nineteenth century, most French (and for that matter Italian) economists were, like Say, classical liberals who mentally inhabited a rule-based world. On the other side of the Rhine, in Germany, economists and politicians did not care much about rules—seeing them rather as a hypocritical device used by English free traders to impose their preferences on a backward continent. In other words, for a long time—basically until the middle of the twentieth century—the French were advocates of laissez-faire, and the Germans were profligates who thought that fiscal spending was the key to prosperity and success. So it cannot be true that the economic cultures are deeply and irrevocably entrenched.

As will be explained later, the German and French view of rules reversed as a result of a historical crisis of unprecedented severity: the Nazi dictatorship, World War II, and the fall of France in 1940. Germans learned that they needed rules to restrict the possibility for arbitrary government action, while the French thought that their political system under the prewar Third Republic had too little fiscal, military, and intellectual flexibility in dealing with the Nazi threat. Later, the new members of the European Union from formerly communist central Europe would learn a similar lesson as the Germans after 1945: good government and the limitation of corruption and political abuse require strict rules.

This book sets out a rather different interpretation of the persistence of clashing economic cultures. First, there are indeed different national ways

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of thinking about economics, but they are changeable when dramatic new circumstances arise. Second, up to now—in the context of a new crisis—rethinking has not proceeded very far. On the contrary, countries are following, on the whole, an approach of "business as usual"—digging trenches around established intellectual and theoretical propositions. The rational business of negotiation strategies developed in the course of the European crisis intensified rather than resolved the clash of cultures. As the relentless logic of events went on, the French appeared ever more French and the Germans ever more German.

The Maastricht Negotiations: Ambiguities and Master Plans

The Maastricht Treaty—the document that provides the legal framework for the euro—lies at the root of the current problems. It assumed too simply that price stability was sufficient to ensure financial stability and that fiscal policy had no role to play in the provision of price stability. It allowed French and German thinkers and politicians to operate with incompatible visions of economic governance. In short, it was about what the treaty labeled "European Union," but the Europeans looked as if they did not really intend or understand the concept of "union."

For some, Europe had now become a new sort of political entity, a postmodern, twenty-first century state in which the traditional principle of national sovereignty no longer applied. The treaty looked like a detailed and helpful itinerary to "ever-closer union." But others believed that Maastricht was simply a treaty arrangement that could be broken if conditions changed. Customary international law includes a clause known as *rebus sic stantibus*, things being as they are, that allows treaties to be broken if fundamental conditions change. There was also another ambiguity about Maastricht: all members of the European Union, with the exception of the United Kingdom and Denmark, which negotiated opt-out clauses, were committed to joining the currency union when the accession criteria were met. The result was that there was a European Union that was separate in terms of membership from the narrower euro area. That separation gave rise to a debate about multispeed Europe. In 1994, in the immediate aftermath of Maastricht, two German Christian Democratic politicians, Karl Lamers and Wolfgang Schäuble, issued an influential paper setting out the idea of a Europe of "varying geometry" that relied on a "hard core" provided by France and Germany.[10]

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For many politicians, especially for former German chancellor Helmut Kohl, economic aspects did not play a major role in the origins of the euro area. Rather, the currency union was a high-minded European political project that went way beyond economic realities. It was needed to stop the recurrence of war between France and Germany. Proponents of the "peace project theory" ignore that one does not need a currency union to improve relations with neighbors. Even worse, a malfunctioning currency union may even lead to civil war, as the American economist Martin Feldstein had warned in the late 1990s.

The debate about interests produced a much more sinister view of the origins of the euro—a conspiracy theory about a vicious, deep-seated German master plan. Because Germany typically has a lower rate of wage inflation than France and much lower rates than the Mediterranean countries, a locked currency would guarantee increased export surpluses, at the price of misery elsewhere. In this manner, a German grasp for European economic primacy would succeed at the end of the twentieth century and in the new millennium where a similar German military plan had failed one century earlier. Some of the earliest exponents of the notion that the currency was a German instrument of dominance were British, notably the former UK chancellor of the exchequer Denis Healey, but now this same notion is circulating widely, above all in Southern and peripheral Europe. In the euro crisis, Southern Europe began to talk incessantly about German hegemony. Italian prime minister Matteo Renzi complained that "Europe has to serve all 28 countries, not just one."[11] This view seems implausible, as lending and subsequently plunging one's neighbors into national bankruptcy is not a good way of building any kind of stable prosperity.

A mirror image of the idea of a German master plan is provided by the equally often-expressed claim that the euro was the price that France exacted in 1990 for its agreement to German unification. President François Mitterrand, according to this version, wanted to put an end to a Europe that was controlled monetarily by the Bundesbank. He thought that a monetary union would go hand in hand with a "*gouvernance économique*" in which France could project and extend its statist orientation to encompass the whole of Europe. Monetary union, in short, would be the Trojan horse that would carry French thinking into the heart of all of Europe. So in the euro crisis, German commentators started to talk about a dictatorship of Southern Europe or to complain that the ECB had been taken

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over by Southern European government officials. But this view is also implausible, as in fact Germany continues to be at the center of European policy debates.

In the end, the story of monetary union is one about dealing with imbalances and fiscal and monetary adjustments in the least politically costly way possible. As such, the monetary union reflected—and failed to resolve—many of the differences in economic philosophy between the French and the German sides. These differences came to the fore in the recent crisis.

Structure of the Book

We therefore examine in part II, "The Ghost of Maastricht," the major battlegrounds and ideological difference in economic thinking that had resurfaced again. They had already played a major part during the Maastricht negotiations in the late 1980s and early 1990s, and the global financial crisis rekindled the intra-European debate. The different visions of the economy, the clash of a preference for rules with a preference for discretion, affected the way the interests of the different countries were presented in policy debates. The creditor and debtor countries played a strategic game: both reckoned that the other side could not have an interest in letting the system collapse, and so a game of not yielding and moving closer to the brink looked plausible and attractive. In this way, the interaction of ideas and strategic reflection on interests brought Europe to the edge of the abyss. When it appeared that Germany's constitutional court—which delivered ponderous rulings on whether rescue packages were in conformity with German laws and constitutional principles—was giving the German government a reason for taking a more intransigent line, constitutional courts in Portugal and Greece started their own brand of activism by handing down rulings that austerity measures were unconstitutional.

Part III, "Maastricht's Stepchild," explores the problem of dealing with financial instability—an important omission in the Maastricht Treaty. It outlines the shift in the financial architecture and how the banking union tries to reduce financial instability in the monetary union. Prime examples of the dangerous dynamics of financial stability in the context of monetary union are Spain and Ireland—two fundamentally fiscally sound countries thrown into crisis by their own banking systems.

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The third watershed moment in the euro crisis, after Deauville and Draghi's London speech, was the European debate over Cyprus in the spring of 2013. The German discussion was dominated by the perception that a great deal of the liabilities of the Cyprus banking system consisted of the assets of Russian oligarchs, which constituted a possible criminal or even security threat, and hence required no special protection by European governments. For Berlin, there was little that constituted systemic risk in the Cyprus situation, and German officials complained that "if Cyprus is systemic, then everything is systemic." By contrast, many policy makers in France, but also in Italy and Spain, feared that penalization of Cypriot depositors might lead to a bank run in other countries (including their own).

The Cyprus crisis changed Europeans' attitude toward bailouts. The new chair of the Eurogroup, the Netherlands finance minister Jeroen Dijss-elbloem, spoke of the Cyprus approach as offering a "template." Even outside Europe, it looked like an attractive solution to the problems created in the wake of the financial crisis. For instance, the influential governor of the Bank of Canada Mark Carney deduced that his country should move away from bailouts, and in May 2013, Canada launched a "bail-in regime." In Europe, the bail-in principle was integral to the proposals for banking union. Critics argue that this undermines the transaction role of money, as demand deposits should remain informationally insensitive (one shouldn't need to worry about their value), and argue instead for stricter and higher equity cushion for banks. As the proposals on a banking union were elaborated, an ever-decreasing number and type of assets were liable to the bail-in procedure. The bail-in principle suffered another hit in late 2015 and early 2016. Italian banks had sold risky subordinate bonds to Italian retail investors with little financial knowledge. As some banks ran into trouble, these investors lost large parts of their retirement savings, leading to social hardship; tragically, one pensioner even committed suicide.

While parts I to III focus on the German-French differences, part IV collects various other perspectives on the crisis. Chapter 12 examines Italy, one of the six founding members of the European Economic Community. Italy largely stood on the sidelines of the Franco-German debate and long stood as an example of the problems of inadequate economic integration in a common political area. Its historic North-South conflict was a microcosm of tensions within the currency union—and perhaps an indication

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that fiscal transfers alone are incapable of resolving these problems. In terms of economic philosophy, Italian economists were split between the major schools of thought outlined above as "German" and "French." Postwar Italy was initially made by such economic liberals as Luigi Einaudi, an economics professor who became the first postwar president of the Banca d'Italia and then (in 1948) president of the Italian Republic. Einaudi's emphasis on the importance of rules had a clear similarity to the thought of the German Ordoliberals. Keynesianism was at first represented by two famous Italian economists who had fled from Mussolini's Italy: Piero Sraffa at Cambridge University in the United Kingdom, who tried to combine Keynesianism and Marxism, and Franco Modigliani at the Massachusetts Institute of Technology (MIT) in the United States, one of the architects of the neoclassical synthesis.

Chapter 13 starts with an outline of Anglo-American economic thinking. Overall, Anglo-American and French philosophies have many parallels, in particular deep roots in Keynesian thinking and an emphasis on liquidity over solvency considerations. Notably, whenever US or UK politicians lectured EU officials about optimal economic policy, they almost always sided with the French liquidity interpretation—favoring big bazooka and bailout solutions. Both the French and the Anglo-American interpretations of the euro crisis stress the importance of fiscal union as a necessary stepping stone for the smooth functioning of a common currency union, although the British and the Americans primarily regarded fiscal union from an outsider's perspective. However, the Anglo-American and French philosophies also differ in important ways. First, Anglo-Americans are more skeptical about the general desirability of government intervention than the French. Both agree that the government can and should intervene in a deep crisis, but the French are more sympathetic toward a government that coordinates economic activity all the time, which includes the involvement of the government in the financial sector. Second, debt in the Anglo-American approach is a contingent construct. That means there is some flexibility in repayment that depends on particular circumstances. In times of hardship, debt is not repaid and bankruptcy laws enable a new start. The Continental European interpretation of debt and the need for repayment is, in contrast, more stringent. Third, French policy makers push for an actively managed international monetary system and see the euro as an alternative to the long-lived

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hegemony of the dollar. For Germany, the UK stance in favor of more trade-friendly solutions played an important role to lean against the more interventionistic French approach. The British referendum on June 23 to exit the European Union, the Brexit, can be seen as the fourth watershed moment of the crisis. It has the potential to untie the United Kingdom with Scotland (and even Northern Ireland) separating. At the same time, it also strengthens the centrifugal force within Europe. Immediately after the Brexit vote anti-European parties in the Netherlands and France called for Nexit, Frexit, and other exit referenda. Europe, and especially Germany, faces a dilemma. One has to be firm toward the UK and uphold European rules in order to avoid other countries asking for special deals—a moral hazard that could threaten to unravel the European Union. On the other hand, Germany has to avoid fueling anti-German sentiment in the current atmosphere of euro skepticism. Chapter 13 also covers the global dimension of the crisis, paying particular attention to the Chinese and Russian attitudes toward the troubles of the euro area.

The economic philosophy of the International Monetary Fund (IMF) is discussed in chapter 14. The IMF is open to debt restructuring to make debt burdens sustainable. The IMF also brought much-needed expertise and external discipline to the table. IMF conditionality and focus on structural reforms aligns with Germany's view. On the other hand, in terms of fiscal stimulus, the IMF took the French view of relaxing fiscal rules and expanding government spending. The IMF was part of the brief and apparently successful interlude of stimulus cooperation in fall 2008 and spring 2009 in the intermediate aftermath of the US subprime crisis. Complacency about government capacity to cooperate led to a resurgence of zero-sum thinking—a style of politics that had last been seen during the Great Depression.

In chapter 15, we turn to the analysis of the European Central Bank (ECB)—the only European institution whose power dramatically increased during the crisis, but an institution (like central banks all over the world) that also fundamentally changed through the adoption of nonconventional monetary policies and a new mandate on bank supervision. A game of chicken in the euro crisis occurred between the ECB and the national governments. The ECB was aware that if it were too generous, national governments would falter and stall in their reform efforts. And the national governments also knew that if they did nothing and there

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were a crisis, the ECB would ultimately have the responsibility of finding some way out: it would be forced to be generous. In terms of debt restructuring, the ECB's economic stance is to resist it. Their main argument is that it would undermine the role and function of money. As a consequence, the ECB also has a tendency to treat problems as temporary liquidity rather than solvency issues.

Our book highlights these differences by looking at the crisis through various lenses: the Teutonic lens and the Latin lens. The aim is to analyze differences in the hope of finding common ground, or at least a better understanding of each other's positions, and thereby possibly speeding up the crisis response.

In the following pages, the three of us discuss how this common language can be achieved. We share different national origins—German, British, French—as well as different intellectual pedigrees: economics, economic history, and public service. The following sections deal with the fundamental economic dilemmas that exist everywhere, have been magnified in the wake of the financial crisis, and are still greater in the complex situation created by a currency union; the long-standing differences in intellectual and political traditions concerning economic life; and the way that the policy discussions are reflected (and their outcomes shaped) by both constraints. When we started this collaborative enterprise, we were convinced that if we could overcome all our differences, such a reconciliation might occur on a European level. We did not want to despair, and we do not think that Europe should either.

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