

Economics as a Public Good*

I. Preliminary Reflections

At least two conditions, in the author's mind, must be met to justify writing an autobiographic essay as the editor has requested. The first one is age. With some tolerance, this criterion can be taken to be satisfied at 65, reached just in time to allow this paper to be included in the series. Secondly, there has to be a message worth getting across. After some reflection, the author managed to put into words what he intuitively felt through most of his life: economics is a public good with a potential demand far from saturation. Those willing to augment its supply can expect to earn a good living, and still maintain their self respect.

Writing about oneself as an economist justifies using some economic jargon. Those who share the author's preference for micro- over macroeconomics and for open over closed economy models will not mind if he addresses the question of how he happened to find his place in the division of labour — interpersonal, intraprofessional, perhaps international — given his peculiar factor endowment and education and the good and bad luck of history in the last half century. It is, of course, the theory of international trade that should guide us to find an answer to this question, the more so if you consider that this theory — as August Lösch remarked — is most suitable for explaining the interpersonal division of labour, not so much the division of labour among entities called countries or economies. However, pure theory is so different from real life that trying to apply it in this particular case turned out to be rather disappointing. Nevertheless, abstract theory helps to raise good questions and it can be used as a guide in selecting facts and recollections.

* Contribution to a series of recollections and reflections on professional experiences of distinguished economists. This series opened with the September 1979 issue of this *Review*.

An economist's "déformation professionnelle" drives him to find (objective) explanations for the observations he made and remembered, the decisions he took and the experiences he gained. Strictly speaking, such a scientific approach to autobiography requires adopting the position of an impartial outside observer. Although this may not be wholly impossible, it has the drawback of producing a deterministic bias. Looking backward in this perspective, the author tends to see himself as a kind of pricetaker who always responded to given circumstances and changes: developing some talents and neglecting others — almost mechanically; adjusting his product mix to perceived changes in the structure of demand — quite opportunistically; exploiting some market *niche* — like a trader. This is surprisingly akin to what Latsis calls "situational determinism".¹

Adopting this approach has, of course, the great advantage of providing for modesty in presentation. Moreover, it is in line with much of recent psychological teaching: aren't we the product of our environment, the slaves of that giant monster called society which then naturally has to bear responsibility for our failures as well as for any achievements? Many economists tend to fall into the deterministic trap by praising the invisible hand: suppliers are seen as selling what their customers are prepared to buy and to make a profit to the extent that the demand curve happens to be sufficiently far on the right. If something goes wrong, they will be said to suffer from a deterioration of their terms of trade or from a deficiency of effective demand. Surely, there are enough macroeconomists around to support such determinism. It implies that the system cannot move ahead or expand without an external driving force — a goddess of history, a government development plan, a budget deficit. This, however, is a view of the world which the author does not share. As some readers may know, he considers himself a Schumpeterian and finds it necessary to stress the importance of suppliers' activities along the following lines: competition is monopolistic rather than atomistic; opportunities are given but can also be opened up by innovations, product innovations as well as process innovations; tastes are usually taken as given but are often waiting to be discovered and, if already there, to be cultivated up to high levels of sophistication; potential supply certainly needs complementary demand, but supply can create its own demand through

¹ LATSIS, SPIRO J., "A Research Programme in Economics". In: *Idem, Method and Appraisal in Economics*. Cambridge, New York, 1976, pp. 1-41.

aggressive selling and through the multiplier effects of those autonomous investments that arise from new knowledge and the competitive exploitation of long run opportunities for growth and structural change. The invisible hand, to be sure, is a forceful co-ordinator but what it co-ordinates in a developing world is — apart from passive adjustment decisions in declining industries and firms — a crowd of ambitious plans pursued in active, if not aggressive, competition.

This point has been raised here to indicate the author's personalistic view of economic life in a market system in general, a view which is in contrast to mechanical interpretations that tend to support ideas of central planning and control, fine tuning and industrial policies. The reader will obtain some information about when and where this view developed. But there is also the touchy question of what in his personal life the author has to attribute to circumstances and what to his own endeavours and decisions. The answer is a rhetorical question: who can pretend to have found a solution to the imputation problem when so much complementarity is involved as in this case?

II. Initial Conditions and Early Experiences

Born and brought up in a small textile town in Lower Silesia (then a province of Prussia) I got an early taste of the "social question" from both Grimm's fairytales and the historical folklore of those places that had seen the 1844 uprising of the weaver proletariat. The family background was lower middle class: peasants, petty traders in livestock and agricultural products, craftsmen. The way of thinking was bourgeois, entrepreneurial, sometimes criticized as mercantile or even Jewish, notably by neighbours and relatives rooted in the Prussian tradition. Civil servants in the family were envied for their leisure time and — particularly during the Great Depression — for their income security. Such envious views were also held by my father who was too busy to have enough time for me before 1929, but failed to earn enough income to pay for my education afterwards.

Having had to qualify for a scholarship during my gymnasium years I cannot claim to be one of those who made their way despite a poor performance at school. An idiosyncratic feeling that I owed a great debt to others developed in this period — to be quickly reversed after

1939. Two teachers deserve credit for having sensed my taste for languages and philosophy. On the quest for understanding why the economic conditions of the family had so dramatically deteriorated in the early 1930s and why the queues at the local unemployment office had become so long, I looked for facts, of course without having a theory, and gained reputation as a little expert in contemporary history. Newspapers (at home) made even more fascinating reading than detective stories (under the desk in the classroom).

But the news became more and more puzzling. Brüning was a statesman with a Ph.D. in economics, like Stresemann before him, but he had no inspiring message, while Hitler was shouting and his Nazi followers were marching on the streets as if unemployment and poverty could be overrun by brute force. Was there no academic discipline to supply an answer, no profession of experts to speak up in public? Apart from unemployment, people were concerned about inflation, which apparently had wiped out my grandparents' savings a decade before. But if inflation had been the consequence of war, as was sometimes argued, how could it be a danger at a time when almost every politician talked about disarmament? Public opinion, it seemed to me, was profoundly disoriented. I remember hearing people saying that the country needed a strong man for action, no matter what kind of action he would initiate. In retrospect, there are good reasons to believe that world history would have taken a less disastrous course had good economics been forcefully supplied as a public good. Even as a youngster one could sense the vacuum.

The last three years in school were economically less distressful. This improvement encouraged a pious believer in the virtues of unselfishness and community spirit to become a rebellious young man who was proud of being called a sceptic. Nietzsche's writings, perhaps a bit misunderstood, nourished protest against the collectivist idealism propagated and shamelessly exploited by the Nazis. And a first love romance made me glorify the individual's role in the family. We would, of course, do better than our parents; and I would develop my intellectual muscles to avoid my father's mistakes, earning envy rather than the pity which some people had impolitely extended to me in our poorest years. Instead of a priest or preacher, I now wanted to become a columnist or lawyer to shock and challenge conventional wisdom. My increasingly individualistic beliefs were strongly confirmed when in April 1939 I was drafted into the compulsory German labour service ("Reichsarbeitsdienst") where collectivism and coercion served as

substitutes for intelligence and motivation. The trade balance with these people was adjusted on the export side; in their own words: "Giersch works slowly".

University life was tantamount to liberation. At Breslau in 1940, law proved to be attractive to begin with, thanks to a young professor's praise for a beginner's unconventional argument for an esoteric case. Economics, inspected during the second term, turned out to be dull, except for Günter Schmolders' eloquent lectures on economic policy. Business administration, considered for pecuniary reasons, lifted the student's self-confidence to an unhealthy extent. The final choice came about by circumstances: Kiel University, which offered itself as an intellectual resort after I had been drafted into the Navy in 1941, did not offer a degree in B.A. but, thanks to the Kiel Institute, first class courses in economics, notably from Walther Hoffmann and August Lösch. I exploited this opportunity for two terms owing to a special agreement that allowed me to render military service on the premises of the very Institute for which I was to assume responsibility 27 years after my Diploma Examination in 1942.

When the journey with the Navy, at the end of the war on a submarine boat, ended in a prisoner of war camp in England the half-baked economist became a self-appointed lecturer. He taught what a spontaneous social process could be seen to bring about even in limited freedom: bilateral exchange, a market for goods and services including cultural activities, money as a creature of the market, specialisation for a better living and self-esteem. In the best English liberal tradition, Colonel Vickers, the Commander of the camp, took it on his own to open up trade with the outside world: labour services were exported against food to raise the standard of living beyond the initial subsistence level. Watching this experiment before the background of past experiences in the German labour service while reading Adam Smith's *Wealth of Nations*, one of the few books of the camp library, was to become crucial for my view of the world.

One person noticed it at the time: the British Intelligence Officer (Mr. Rossitter alias Philipp Rosenthal, the Chinaware manufacturer) who, after a lengthy interview on political and philosophical questions, decided in favour of my early release in October 1946. The cigarettes that served as a store of value on my passage to Northern Germany turned out to be vital for my parents who as refugees had to live on the 1,000 or so daily calories the official rationing system could provide. After two months of search unemployment, mainly spent in full trains

and railway station waiting rooms, I was hired by Walther Hoffmann to serve as his assistant at Münster University.

III. Between Theory and Practice

Luck was on my side as Hoffmann was fully occupied in reconstructing the university beyond economics; he gave me full freedom to organise his seminars on Barone and Walras, on Viner and Hicks, and on Lange's and Lerner's economic theory of socialism. At last, I understood the allocation problem. Müller-Armack's seminars on the "Social Market Economy", a term that was to become the trademark of West Germany's economic miracle, proved disappointing for lack of rigour, but they acquainted me with the importance of private property and the limitations of redistribution.

The dissertation on the question of how West Germany could arrange for the compensation of property losses caused by bombing and evacuation had been conceived already in the prisoner of war camp; it was submitted to and accepted by Hoffmann and Müller-Armack in late 1947.² The basic idea was that any redistribution to correct past war hazards could best take the form of a once-for-all change in the property distribution rather than that of a protracted interference with the process of income formation, exemplifying the principle "redistribute now, grow later". Contrary to the author's ambitious expectations it made no impact whatsoever on the vivid public policy debate. A private discussion of the issues with Friederike Koppelman was more rewarding: it first led to a partnership in preparing for the oral Ph.D. examination and later to a most happy marriage for hitherto more than three and a half decades.

The German currency reform of 1948, together with Erhard's courageous decision of lifting most price controls, came close to a controlled experiment of liberalisation. It demonstrated that sound advice — given by leading members of the economics profession — could have a high social productivity. The profession which had failed to prevent the Great Depression now showed capable of living up to my

² GIERSCH, HERBERT, *Der Ausgleich der Kriegslasten vom Standpunkt sozialer Gerechtigkeit*. Recklinghausen, 1948.

childhood's nebulous expectations. My career decision appeared justified.

Having read Keynes' *General Theory* with Herbert Timm in another prisoner of war camp against the background of Schacht's full employment policy after 1933, I was disappointed to hear Joan Robinson expound a vulgar Keynesianism in a guest lecture at Münster University. It was like Hamlet without the Prince of Denmark: a theory and a policy of full employment without wages. Macroeconomics was further discounted by reading of American stagnationists who visited Germany to recommend expansionist policies, erroneously assuming that we had Keynesian unemployment rather than the classical variety arising from the influx of refugees and the physical destruction of the capital stock. The relevant price was also conspicuously absent when Tinbergen lectured about the dollar shortage without mentioning the exchange rate. My training had surely not been the very best, but none of my teachers had ignored relative prices.

In these circumstances, Wassily Leontief who lectured at Harvard University's Salzburg Seminar to my surprise turned out to be an equilibrium economist. At least he was fully aware of the importance of substitution processes not captured by input-output analysis. The whole class was excellent as some names may indicate: Odd Aukrust, Gerard Debreu, L.M. Koyck, Göran Ohlin, Bob and Barbara Solow. An equally fascinating experience was the subsequent academic year (1948/49) as a British Council Fellow at the London School of Economics where I was most impressed by Lionel Robbins, Friedrich A. Hayek and James Meade among the Full Professors and by William Baumol, Graeme Dorrance, Terence Hutchison, Alan Peacock, and Ralph Turvey among the younger staff members. William Hutt and L.M. Lachmann as visitors enriched the Austrian flavour of the place, and so did Gottfried Haberler and Friedrich Lutz when they passed the L.S.E. on their summer trip from the U.S. to the European continent. How lucky to meet all these great men so shortly after the war.

Due to my interest in international economics, I found myself in Meade's seminar which offered a synthesis of macro- and microeconomics, Keynesian and classical thinking, positive and normative theory, planning and the price mechanism. The master showed how rigorous reasoning can go along with human kindness and fairness, embodied in a scholar whom I admired and still admire as the prototype of an English gentleman. A paper written in the spirit of August Lösch on the

locational consequences of a customs union³ was my modest contribution to what still appears to me the best seminar I ever attended. The choice between Hayek and Laski — the political antipodes at the School — was easy for a young economist of my experience and persuasion, but I failed to grasp Hayek's economics, notably his theory of capital and growth, and the relevance of the hotly debated "Ricardo effect". Among the giants then teaching at the L.S.E. I only missed Popper but nobody told me about him and his work. When a group of leading German economists visited the Oxford Institute of Statistics in March 1949 I was invited to act as an occasional interpreter during the conference. What struck me most was a remarkable international difference in the level of sophistication showing how much human capital Germany had lost under the Nazi rule.

Back home in Münster where Friederike had temporarily replaced me as Hoffmann's assistant we married to start a race in which she would get our first child while I would complete the habilitation thesis on growth and employment that I had begun in London after having discovered Harrod's and Domar's seminal papers. She lost; but my product, although pleasing the faculty, was much inferior in practice. While our son Volker should become an applied economist pushing development in a structurally backward region, my study failed to reach the publication stage. Having moved to Paris to work for the OEEC (Organisation for European Economic Co-operation) I was struck by the contrast between the economics required in the real world and the empirically empty formal structures I had endlessly turned around in the tradition of what Leontief called "implicit theorising". Incidentally, it was on Leontief's recommendation that the Paris job was offered to me.

The group of economists in the OEEC, led by Cairncross and subsequently by Reddaway, included Juist Faaland, Koht Norbye, Jack Parkinson and Maurice Fg. Scott, all analytically well trained and much more versed in the art of interpreting current facts and figures than most economists I had met (except Hoffmann and Leontief). When the German balance of payments went into deficit after the outbreak of the Korean war my nationality made me the first choice for serving a working group of Erich Roll's Economic Committee charged with finding out the deeper reasons and the possible cures. As many of the

³ GIERSCH, HERBERT, "Economic Union Between Nations and the Location of Industries". *Review of Economic Studies*. London, Vol. XVII (1949/50).

delegates were non-economists, most of the theory they used or were prepared to accept was home made (or "do it yourself economics" as David Henderson recently called it), with no use for relative prices, exchange rates, elasticities, and other terms essential for understanding how markets work. Fortunately, Cairncross together with Per Jacobsson had previously been on a mission to Germany and established the authoritative conclusion that the economy was basically healthy. Therefore, the detailed work for which Bonn supplied all information the working group could think of, did actually no harm. In retrospect, this "German striptease" turned out to be an ideal preparation for my later work in the German Economic Expert Council (1964-1970).

After this year at the OEEC it became evident that work in an international organisation — despite an astronomical salary — was less attractive than academic freedom, except for short periods to sense urgent real world problems. On the other hand, after the first term of teaching at Münster University I asked myself whether, without continuous worries about economic life and public policy, my lectures would not become dull, running quickly into the diminishing returns of abstract theorising. There is, after all, only a limited set of interesting theorems one can derive from a few behavioural assumptions without engaging in a "jeu d'esprit" that pleases one's professional curiosity and pride but leads the student to believe that this world is full of paradoxes, anomalous reactions, and market failures waiting for a wise government. This is perhaps the appropriate place to apologise to my first students for having taught them economics without sufficient knowledge of the economy. My subsequent endeavours to bridge the gap were facilitated by the OEEC inviting me to work for them temporarily in 1952 and for another year in 1953, that time as head of a division to push what is still an unachieved task, *i.e.* the liberalisation of invisible trade.

After another year of teaching (both at Münster and, on a vacant chair, at Braunschweig's Technical University) I was appointed professor (of political economy) at the recently established University of the Saar in Saarbrücken, then part of the French economy. Still under the age of 34 I had every reason to praise the invisible hand. It had allowed me, despite Hitler's war and the 15 months as a British prisoner of war, to achieve the professional goal of my life without a loss of that truly non-renewable resource called time. The signals given by the invisible hand had been opportunities: stimulating personalities to learn from, job openings to be considered as challenges. Some tempting opportu-

ities that might have become blind alleys could be rejected: offers to join the German federal ministries of economic affairs and economic co-operation in 1950 and to accept an isolated chair at a Technical University in 1955. Of course, there had also been luck at work: in choosing a subject which turned out to benefit from a high income elasticity of demand and in gaining an undeserved terms of trade advantage from the heavy war losses of my age cohort. Even the fact that the place of my birth and my youth had become inaccessible was, in retrospect, a great advantage: being a refugee I had full freedom of choosing the location with the best long-run prospects. At least in my subjective accounting, the flow of income began to contain a substantial rent element. The problem was how to justify it in the coming years.

The Saar University's department of economics hardly existed at the time; and when the Referendum of October 1955 brought the Pro-German parties to power they uttered their intention to close down what they called an "offspring of French cultural imperialism" and to give the country's daughters and sons comfortable scholarships for studying at some fine old established German universities. My career as a professor was close to becoming a non-starter. There were very few students around and none of them seemed to qualify for post graduate work in economics. On the other hand, there was also no time for research and writing since everything seemed to depend on strengthening the institution by lobbying for money and co-opting colleagues, by agreeing on new rules and regulations, and by making tedious exercises in self-administration. Professors whom we offered a chair were asking for students, and the few students we had were deeply worried when the professors, usually after a short while of teaching, left for more reputable places. Nonetheless, we had Paul Senf after his term as minister of finance, we had Herbert Timm for more than two years, we got Wolfgang Stützel and Elisabeth Liefmann-Keil, we persuaded Egon Sohmen to join us and we enjoyed the intellectual company of two prominent professors of law, Ernst-Joachim Mestmäcker with his sharp mind on matters of antitrust law and competition policies, and Werner Maihofer who was specialising in social philosophy and later, in the seventies, became a cabinet minister in the Bonn government. Add to this Ralph Dahrendorf in the department of philosophy, and you may grasp the spirit of lively discussions on essential matters of liberalism. Around 1960 the Saar University was sufficiently settled, yet still so vivid that it took me no great pains to turn down tempting offers from German universities with long-established traditions.

My writings in the 1950s essentially consisted of articles on trade and business cycle policy, including a paper on the acceleration principle and the propensity to import⁴ which had grown out of my OEEC experience, and an article on optimum trade⁵ (both translated for the *International Economic Papers*) which came close to introducing monopolistic competition and effective tariff rates into considerations of trade and welfare but failed to make its points sufficiently clear and was also misunderstood by one critic as putting forward an argument for protection. From this time on I made it a habit to have everything intended for publication criticised by the best young scholars around me. Olaf Sievert did this perfectly for the first volume of my book on economic policy, and it sometimes happened that he urged me to rewrite long passages which had fully satisfied their author at first sight. He also deserves credit for having forced me to give up any natural author's pride which often makes team work an unpleasant affair. The intellectual atmosphere which gradually developed in this spirit attracted further competent scholars: Lutz Hoffmann, Klaus Stegemann, Manfred Streit, Gerhard Fels, Juergen B. Donges, and Wolfgang Kasper who all made their way — as did Sievert — to become full professors or find an even more attractive post.

Yale University which invited me as a visiting professor in 1962/63 — thanks to William Fellner, Jim Tobin, and Gustav Ranis — exhibited all the advantages and disadvantages of professional specialisation. The great names apart, it was surprising to learn how much everybody knew within the boundaries of his own field and how little interest he had in going beyond them. By contrast, I still remember an intensive discussion of philosophical and methodological issues, *i.e.* with Paul Streeten and Mike Montias, which made us suddenly aware that we all happened to be Europeans. Of course, this European accent could also be heard from Raymond Goldsmith, Henry Wallich, Robert Triffin, Bela Balassa, and Friedrich Lutz who was also a visitor. The students in my graduate course were hard working and — on the average — technically better than those at home, but they did not match the very best we had attracted to Saarbrücken. A short trip to give a paper in

⁴ GIERSCH, HERBERT, "Akzelerationsprinzip und Importneigung". In: *Weltwirtschaftliches Archiv*, Vol. 70, Nr. 2, 1953, pp. 241-283. (Translated for: *International Economic Papers*, No. 4, London, New York, 1954.)

⁵ GIERSCH, HERBERT, "Das Handelseoptimum. Ein Beitrag zur Theorie der Wirtschaftspolitik". In: *Weltwirtschaftliches Archiv*, Vol. 76, Nr. 1, 1956, pp. 1-40. (Translated for: *International Economic Papers*, No. 7, London, New York, 1957.)

Gottfried Haberler's seminar made me feel that Harvard had a slightly more European touch. Anyway, the U.S., although fascinating in some respects and quite European in some locations in general, lacked the broad cultural background that made Europe a place to live for good. Moreover, as a professor there was no better place for a comfortable living than in Germany. Being determined to return, German rather than English was the language of the three articles on growth policy and on regional and structural policy produced and finished at Yale — without the incisive criticism they needed.

IV. Open Advice

Back home, an important task seemed to be waiting. Numerous pages, perhaps too many, in my 1960 book⁶ had been devoted to economic forecasting and to counselling on economic policy matters. As a follow-up, the "Verein für Socialpolitik", the German Economic Association, had asked me to organise a workshop on economic diagnosing and forecasting (1962) and on normative economics and policy prescriptions (1963). This apparently made me a candidate for the newly established Council of Economic Experts, long favoured by Erhard, the Minister of Economic Affairs, as an institutionalised ally against the business lobby that had direct access to Adenauer, the Federal Chancellor, but also supported by the social democratic opposition to the extent that they saw economics on their side. What made the Council attractive to me was its guaranteed independence of both organised interest groups and — contrary to the U.S. — of the government administration. Other members of the profession who raised their voices in the preparatory stage (when I was at Yale) thought this independence to be unwise or unworkable. That apparently improved my position on the list of candidates for the five places to be filled: three by independent professionals and two by practitioners with links to business and labour. When those chosen for appointment met for the first time I came to the conclusion that I had to decline. It is true

⁶ GIERSCH, HERBERT, *Allgemeine Wirtschaftspolitik*, Erster Band: Grundlagen. Wiesbaden, 1960.

that the honorarium offered was attractive, but fearing that the two practitioners would at best offer only a small marginal product and considering that one of the other two professionals was not keen on playing an active role I felt incapable of providing the 50 per cent input that would fall upon me. And would the profession not attribute to me 100 per cent of the blame in the most likely case that the whole enterprise turned out to be a failure? For these reasons I wrote to the Minister of Economic Affairs (the successor to Erhard who in the meantime had become Chancellor) that I had to decline. After all, there was still Raymond Goldsmith in Paris waiting for my co-operation to build up the OECD Development Centre.

A ministerial envoy came to Paris (the person who had taken the job offered to me in 1950) to apply moral pressure for a whole evening. Flattered and depressed at the same time, I persuaded myself that I had to do the job, given my childhood's traumas and dreams and my understanding of economics as a public good. A renewed decision to decline might have proved good for the family but bad for my self-respect. If there was a rent element in my income, this was a good chance to compensate for it. But how would we avoid the disaster that others predicted, including Erich Schneider on the occasion of the 50th anniversary of the Kiel Institute in a private conversation on the very day when the names of the "five wise men" were made public? Writing reports was a task not new to me; but giving them a profile and still getting them approved by the other four would be the real test. Years ago I had read Edwin Nourse's account of his time in the U.S. Council of Economic Advisers under the programmatic title "Economics in the Public Service".⁷ It would be on these lines that we could succeed: sticking to the objectives laid down in the law (price level stability, high employment, and balance of payments equilibrium to be achieved simultaneously with adequate growth) and adhering to the scientific norms prevailing in the profession. But something more would be needed. When the students assembled with torches in front of our home to appreciate my declining offers from other universities I summed up my mixed feelings in paraphrasing Alfred Marshall's dictum that one could not be a good economist and have the reputation of being a good patriot. The implication was: economics as a public good may not find popular support in the political arena.

⁷ NOURSE, EDWIN G., *Economics in the Public Service*. New York, 1953.

So it happened. Supported by Olaf Sievert and Gerhard Fels we managed to produce the first Annual Report (by November 1964) roughly approximating our standards. Fortunately for the coherence of the group, we felt obliged to produce a short forerunner which was sent to the Government in June, calling for exchange rate adjustments to fight imported inflation, a message never acknowledged by the recipient and hence forcefully repeated in the Annual Report.⁸ The latter (which was to be published and submitted to Parliament under the law) thus contained a substantial portion of dynamite given West Germany's loyalty to the Bretton Woods System and the fact that — after the introduction of convertibility on capital account — this system had become more and more rigid with respect to exchange rate adjustments. In these circumstances, the Government when publishing the Report heavily criticised the Council for exhibiting an unrealistic preference for exchange rate flexibility. The media and the business community shared the Government's judgement and the profession — with the exception of Karl Schiller and a few others — remained silent. It thus appeared that we had lost the battle. Chancellor Erhard remarked that we had given stones to a public in need of bread, and one of the leading commentators made the point that the economics of the ivory tower had turned out to be a disservice to the public. Unfortunately, Fritz Meyer of Bonn University gradually withdrew from the Council's work for health reasons so that I was becoming the only ivory tower economist in the group.

The ado about exchange rates distracted the public's attention from another important price variable which we also stressed in our first report: the wage rate. In long discussions the Council member close to organised labour could be convinced that maintaining both full employment and price level stability required wages rising roughly proportional to labour productivity with due allowance to be made for changes (i) in the external terms of trade and (ii) in unit capital costs. Adding the terms of trade argument to the popular but fiercely disputed rough wage guideline helped the spokesmen of organised labour (including Wilhelm Haferkamp, later a longtime E.C. Commissioner) to find themselves basically in agreement with representatives of employers'

⁸ *Stabiles Geld · Stetiges Wachstum*. Jahresgutachten 1964/65 des Sachverständigenrates zur Begutachtung der gesamtwirtschaftlichen Entwicklung. Mainz, Stuttgart, 1965.

associations who in turn were strong proponents of the capital cost argument. On June 17, 1965, the Council reached a kind of tripartite agreement on this norm and submitted the rough outlines of a possible scheme for what the second report called "stabilisation without stagnation".⁹ The idea was that an inflation rate slightly surpassing three per cent in 1965 could be brought down without losses in output and employment if the inflation component in nominal aggregates and prices, *i.e.* public expenditures, wage increases, interest rates, investment budgets, was simultaneously and gradually reduced by — say — one percentage point a year within a scheme that had been agreed upon by the government, unions, and employers' associations and thus should be credible to all of them. The time to implement such a policy framework of rational expectations was highly favourable since the economy could be viewed as being in an inflationary equilibrium. For obvious reasons we were careful not to raise the exchange rate issue at that time but we did not have any doubt that a parallel revaluation would be indispensable to curb inflationary pressures from abroad. In later reports, the focus shifted very much in this direction when we began to stress the point that the German inflation rate was largely determined by the external price level and the exchange rate and that preannounced revaluations could serve the purpose of price level stabilisation without affecting the balance of payments.

In two conversations with Erhard — one in Saarbrücken before the submission of the Report and one in a special meeting in Bonn afterwards — we made the case for this policy of rational expectations by pointing out how much could be gained by behaving in a way that allowed relative prices in real terms to remain fairly constant in the process of fighting inflation. Unfortunately, these attempts at persuasion turned out to be in vain: Erhard, by temper not a gradualist anyhow, joined forces with Blessing, the President of the Bundesbank, and with the chairman of the Federation of Industries to decide in favour of what the then Minister of Economic Affairs later called "die gewollte Rezession" (wanted recession), a fall in employment that eventually led to Erhard's resignation in late 1966.

With the second Report the Council had established itself as a "pouvoir neutre" and with the nomination of a professional economist

⁹ *Stabilisierung ohne Stagnation*. Jahresgutachten 1965/66 des Sachverständigenrates zur Begutachtung der gesamtwirtschaftlichen Entwicklung. Mainz, Stuttgart, 1965.

as Minister of Economic Affairs (Karl Schiller), its relationship with the government became as productive as one could hope for. The real test, however, was to come in 1968 when the Council (except Stützel who had been appointed to succeed Meyer) recognised and emphasised the need for a revaluation; in a letter to the Chancellor, the Council warned the Government about what it would have to spell out in greater detail in its forthcoming Annual Report. In a meeting in October with Chancellor Kiesinger, Blessing, Schiller and F.J. Strauß (then Finance Minister) it became obvious that the fear of losing farmers' votes to an extremist party on the right would lead the Grand Coalition Government to introduce import subsidies and export taxes as a substitute for a revaluation. It so happened, just at the time the Annual Report was published. When Schiller tried to defend this half hearted move before the Advisory Council of his Ministry of Economic Affairs (of which I had become a member in 1961), he found himself confronted with a memorandum recommending an immediate revaluation. But the Christian Democrats, influenced by Hermann J. Abs, the most highly respected banker, and by Franz Josef Strauß were determined to defend the old parity at no matter what cost. My feeling was that the profession which had failed to raise its voice in the Great Depression, once again had a historical role to play; this encouraged me to initiate — together with Egon Sohmen — a telephone appeal to German university professors of economics, more than 100 of whom supported our resolution in favour of freeing the exchange rate. It took another five months and a general election (with a change of government) for the market forces to have their way, at least for the time being.

The six years in the Council taught me that economics as a public good makes little impact unless it is persuasively sold in the political arena in competition with the views expressed by organised interest groups. We were happy that this competition took place before the background of a broad political consensus on value judgements. Thus the arguments — at that time — concerned logic rather than ideology, consistency and expediency rather than basic political issues. Hostile criticism addressed to the Council strengthened the team spirit among the members and the small academic staff, except in the case of one member who held strong views about the exchange rate being a fundamental norm rather than the relative price of two monies and who eventually resigned. Whether the experiment of an independent Council would have succeeded if it had begun in the subsequent period of political polarisation is open to doubt.

Apart from drafts for six annual reports and a few intermediate pronouncements of the Council I gave speeches on current issues of economic policy and wrote a few professional articles on wages and exchange rates, including a paper for the 1969 Bürgenstock conference on "Greater Exchange Rate Flexibility" organised by Halm, Machlup, and Bergsten.¹⁰ Exchange rate flexibility, so the paper's argument was meant to run, does not add to existing uncertainties even in a small country; if domestic monetary policy is aimed at price level stability exchange rate changes will merely reflect external disturbances relevant for the international sector and — by making import and export prices more flexible — help to stabilise domestic output in the face of cyclical movements of the world economy. This message was perhaps too strange to find attention and support; but I still happen to believe that even an individual firm can stabilise its output despite the ups and downs in its market if it raises and lowers its sales prices sufficiently and makes its employees accept what I am now calling their "full employment terms of trade". Would full price flexibility be more costly than fluctuations in output and employment? And is exchange rate flexibility not a useful substitute when prices are sticky? The argument, of course, can be generalised: if every country pursued a policy of monetary stability, the world economy would enjoy maximum stability since exchange rates would then merely reflect real disturbances requiring adjustments. Could monetary stability *cum* exchange rate flexibility not have prevented the Great Depression?

V. International Economic Policy Research

In the 1960s I had declined several offers from other universities, including one from Berlin tailored to simultaneously becoming head of the German Institute for Economic Research. But when Erich Schneider asked me whether I would be a candidate to succeed him at Kiel I could simply not refuse in view of my old allegiance to the Institute and

¹⁰ GIERSCH, HERBERT and WOLFGANG KASPER "A Floating German Mark? An Essay in Speculative Economics." In: N. Halm (ed.), *Approaches to Greater Flexibility of Exchange Rates. The Bürgenstock Papers*, Princeton, N.J., 1970, pp. 345-355.

my persistent interest in international economics. As my closest associates and quite a few other junior economists from Saarbrücken were enthusiastically prepared to join me and to fill the vacancies Schneider had deliberately left open in the Institute, I could confidently accept the challenge. Fortunately, this decision was never regretted on my side. It involved leaving the Council after six years but did not change my view of economics and its role in society.

With the benefit of hindsight it appears that most of my previous work on growth and cycles, on structural and regional policy, on trade and exchange rates had been conceptual economics rather than empirical research, thus requiring or inviting complementary efforts in the form of a comprehensive research programme. This seemed to suit the Institute's purpose and facilities quite well. However, a conference in 1970, organised to enlist methodological advice from the best outside experts we knew, was not as encouraging as we had hoped for. Thus Gerhard Fels had to become a pioneer in the research on structural change in advanced countries while Juergen B. Donges took the lead of a team to explore the challenges arising from the adoption of outward looking industrial strategies in LDCs.

The results soon became politically as exciting as the work in the Council. In 1972, while Helmut Schmidt was temporarily in charge of the Ministry of Economic Affairs succeeding Karl Schiller, we were prevented from publishing a publicly financed study on the industrial structure and the level and profile of protection in Germany simply because the leader of the textile union had intervened for reasons of job security. Some of the participants in the 1972 congress of the German Economic Association (which celebrated its 100th anniversary) had the occasion to witness a rather vivid conversation with Schmidt about freedom of thought and publication before and after 1945 and the importance of structural adjustment for the first and the third world. Shortly afterwards, the public could indeed take note of the research¹¹ financed by its taxpayers while the Institute — though government supported — could be confident of having asserted itself as intellectually independent.

This was but one additional example that economics — here: information gained by research — is not universally welcome. Some

¹¹ DONGES, JUERGEN B. *et al.*, "Protektion und Branchenstruktur der westdeutschen Wirtschaft". *Kieler Studie*, Nr. 123. Tübingen, 1973.

textile firms actually complained that the Institute's findings had impaired their creditworthiness. This may be an exaggeration but, if true and viewed in due perspective, it demonstrates that information about trends in structural change has the potential social productivity of preventing a misallocation of investible resources. Similarly, we have testimony that an international cross section analysis to assess the medium run prospects of Europe's steel industry had in fact a strong impact on a large firm's decision to change its output mix in anticipation of the steel crisis. But if privately so useful, why is such structural research not in demand as a private good? Part of the answer is: in contrast to the Chicago view, markets in some sense are always in a process of learning, often too slow for the impatient observers from Kiel. In the meantime, the German government has institutionalised tri-annual surveys on structural change to be competitively submitted by the five leading research institutes.

In the field of macro economic policy, the Institute carried some of the Council's thinking on the assignment problem to its logical conclusion, taking into account the new conditions of flexible exchange rates, inflation, and slow growth. Freed from the obligation to support the exchange rate and to care for balance of payments equilibrium, monetary policy could be held fully responsible for determining the domestic price level. With no money illusion left, the Central Bank had virtually no influence on the level of output and employment except in the case of a recession due to a declining income velocity of money. Therefore, the medium run level of employment was seen to be essentially determined by the level and structure of real wages, a point that completely spoiled our relations with organised labour when early warning signals about the "reprivatisation of the employment risk" emitted in 1972 were harshly dismissed by Helmut Schmidt and hence completely ignored by the trade unions in the wage rounds leading to the 1974 wage explosion. Having been publicly attacked as anti-labour in subsequent years I was glad to receive satisfaction from the EC Commission's 1985 economic report¹² which contained the message that wage moderation was a necessary condition for any strategy intended to substantially reduce Europe's unemployment before the end of the

¹² COMMISSION OF THE EUROPEAN COMMUNITIES, *Annual Economic Report 1985-1986*. Brussels, 1985.

1980s. In order to appreciate this message one should know that it was formulated under the responsibility of the German Commissioner who had previously been in charge of economic policy questions in the German Federation of Labour Unions (D.G.B.).

Fiscal policy, in our solution to the assignment problem, is not considered instrumental in determining output and employment except under conditions of a Keynesian liquidity trap as it might develop in a recession as a "secondary deflation" (to use Röpke's term). What fiscal policy really determines is the growth of potential output: (i) the aggregate supply of savings for (productive) capital formation via the budget surplus or deficit, the tax system, and the structure of public expenditures; (ii) the marginal efficiency of autonomous (*i.e.* not demand-induced) private investments via the tax structure and the complementary character of public investments, and (iii) the supply of labour and society's general motivation level via the level and rate structure of direct taxes. In a medium run perspective, the Finance Minister is regarded as responsible for the population's economic mentality and the national economy's dynamism and attractivity on world capital markets. Some commentators tend to view us as modernist supply siders whereas we ourselves simply see us rephrasing old fashioned classical truths, including the emphasis on long-run policies which are conducive to the growth of supply. This at least was behind my separate vote to the 1977 OECD Report "Towards Full Employment and Price Stability",¹³ prepared under the Chairmanship of Paul McCracken.

When inflation accelerated after 1973, I came out in favour of indexation that would allow long-term contracts to be concluded in real terms — on the labour market as well as on the capital market.¹⁴ With respect to labour, this idea was complementary to assigning responsibility for employment to the partners at the bargaining table whereas the introduction of inflation-proof credit instruments was to lengthen the term structure of domestic and international debt and to prevent the flight into what I called "Betongold" ("concrete gold"), *i.e.* houses and apartments built and bought as hedges against inflation. If there were

¹³ MCCRACKEN, PAUL *et al.*, *Towards Full Employment and Price Stability*. A report to the OECD by a group of independent experts. Paris, 1977.

¹⁴ GIERSCH, HERBERT, "Indexklauseln und Inflationsbekämpfung". *Kiel Discussion Papers*, No. 32, October 1973.

no inflation-induced distortions and if elements of inflationary expectations in contracts were flexible in nominal terms (to be fixed only *ex post*), it would become easier to achieve "stabilisation without stagnation", even in the absence of a concerted action of our 1965 vintage. We lost the argument in the public policy debate mainly because we failed to make it sufficiently clear that most wage indexation which was actually introduced in periods of accelerating inflation had a built-in time lag and thus made for over-indexation in the deceleration phase.

Once again, it was a point of economics rather than value judgements that led to failure. The smoke of the intellectual battle ground has long disappeared, but the concrete gold in the German landscape is still there, together with a structural crisis of the construction industry. Internationally, the debt problem of developing countries would almost certainly have been less severe had indexation warned the recipients of recycled Petrodollars that there happens to be a real rate of interest which cannot possibly stay at zero (or even below!) before the world economy has attained the final stage of bliss. Next to the theory of comparative advantage, the indexation problem is perhaps the best test for understanding economics.

Depressed real rates of interest during periods of inflation — useful as a short run device for cushioning the cost push of excessive wages in a "Phillips-Curve-Strategy" of fighting classical unemployment with inflation — became to me the clue for explaining why Europe has persistent unemployment despite high rates of capacity utilisation. In 1977, the Institute had convened a conference on "Capital Shortage and Unemployment in the World Economy"¹⁵ designed to draw attention to a — not so uncommon — anomaly which had become familiar to me in the early postwar years. Although we — again — failed to sell a theory, we saw it confirmed in the following years by direct observation at our doorstep: investible funds were diverted to constructing homes rather than plants and jobs, and those remaining funds which the productive sector was able to absorb were used for capital deepening rather than capital widening, for implementing labour saving process innovations rather than pushing product innovations. Years after, the E.C. Commission established the statistical series and presented the calculations to demonstrate how capital had been wasted all over Europe — to the detriment of the unemployed — under the impact of distorted factor

¹⁵ GIERSCH, HERBERT (ed.), *Capital Shortage and Unemployment in the World Economy*. Tübingen, 1978.

prices. Some laymen attending my public lectures seemed to understand better than some professional economists from inside and outside Germany what I tried to make clear: classical unemployment, if fought by Keynesian policies, will merely be transformed into much worse diseases, *i.e.* capital shortage unemployment and, eventually, technological unemployment. The problem with experts is that their model is sometimes too much geared to what fits the facts of the American "économie dominante".

As to the international economy, we organised conferences to critically evaluate the attempts at cartelising supplies and coordinating economic policies, pursued under the temporarily fashionable heading of a New International Economic Order. In a paper for the 1976 F. Marcus Fleming Memorial Conference of the International Monetary Fund, I defended the position that exchange rate surveillance should concentrate on establishing rules for central banks requiring them to preannounce monetary targets and notify the Fund whenever they intervened in foreign exchange markets: "no intervention without notification".¹⁶ When the dollar sharply fell after 1976 I strongly suspected that this was partly deliberate U.S. policy inducing official and unofficial holders of dollar assets to change their portfolio, to "emigrate from the dollar area", to let the "dollar area implode". In the same vein, the rise of the dollar after 1979 was considered as its re-emergence as a strong world currency supported by the home base of an economy which showed renewed dynamism. As to European monetary integration, we favoured either the monopoly approach (create a European central bank) or the competitive approach (let the most stable currency gradually gain dominance) over the old cartel-approach so close to French thinking and to the heart of many officials and politicians that it was actually adopted in the form of the E.M.S. The best research in this field that I happen to know of is the work Roland Vaubel accomplished during his ten (or so) years as one of my closest associates and probably one of the sharpest minds the Institute has hosted since its beginning.

Schumpeter's spirit in the Institute and in my work became increasingly alive after the second period as a visiting professor at Yale (1977/78) which followed the completion of the second volume of my

¹⁶ GIERSCH, HERBERT "Fund Surveillance over Exchange Rates - A Wider View". Paper for the F. Marcus Fleming Memorial Conference of the IMF. Washington, November 1976.

book on economic policy¹⁷ (long delayed because of my Council involvement). The challenge came from Jim Tobin's article "How Dead is Keynes",¹⁸ which irritated me for what my European mind perceived as a misplaced emphasis. Attempts to formulate my position led to a paper on growth, structural change, and employment¹⁹ later to be discussed in the 1979 Kiel Conference on "Macroeconomic Policies for Growth and Stability — A European Perspective". Instead of repeating the message it contained it seems better to mention the titles of the Kiel Conferences in the following years: "Towards an Explanation of Economic Growth" (1980), "Emerging Technologies: Consequences for Economic Growth, Structural Change, and Employment" (1981), "Reassessing the Role of Government in the Mixed Economy" (1982), "New Opportunities for Entrepreneurship" (1983), "Economic Incentives" (1984). With this thrust we hoped to prepare the intellectual ground for a re-acceleration of Europe's growth later in the 1980s, assuming that courageous efforts at deregulation and improvement of the incentive system would cure Eurosclerosis and call forth more innovative activities at the frontiers of economic development.

Kiel

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¹⁷ GIERSCH, HERBERT, *Allgemeine Wirtschaftspolitik*, Zweiter Band: "Konjunktur- und Wachstumspolitik in der offenen Wirtschaft". Wiesbaden, 1977.

¹⁸ TOBIN, JAMES, "How Dead is Keynes?" In: *Economic Inquiry*, No. 15, 1977, pp. 459-468.

¹⁹ GIERSCH, HERBERT, "Aspects of Growth, Structural Change, and Employment - A Schumpeterian Perspective". In: *Weltwirtschaftliches Archiv*, Vol. 115, Nr. 4, 1979, pp. 629-652.