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Editorial

Introduction: 50 Years of Konstanz Seminars on Monetary Theory and Policy

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The Konstanz Seminar on Monetary Theory and Policy was founded by Karl Brunner in 1969. Brunner, who was born in Switzerland in 1916 and, at the time, taught at Ohio State University, had accepted a position as permanent visiting professor at the University of Konstanz earlier that year. Upon his arrival at Konstanz, he immediately embarked on a large research project on monetary theory and policy. One of his first hires for this was Manfred J. M. Neumann, who had previously worked for Deutsche Bundesbank. Neumann was charged with organizing the first Konstanz Seminar. Its proceedings were published in a supplement to *Kredit und Kapital (Credit and Capital Markets)* in 1972.[1] We are very grateful to the publisher and the current editors of this journal for accepting our proposal to publish this issue on the occasion of the 50th Konstanz Seminar, which took place in early June 2019.

Upon his arrival in Germany, Karl Brunner was shocked by what he perceived to be a very poor state of macro and monetary economics in continental Europe and in Germany in particular. The gap he saw between US and German academia in this regard was enormous. Brunner's and Neumann's contributions to the proceedings of the first Konstanz Seminar convey a sense of urgency of the need for an improvement in the quality of continental European macro and monetary economics and for a more modern, open academic culture more generally. Brunner thought that the Konstanz Seminar was the best instrument to achieve that. It would serve to stimulate academic debate and state-of-the-art research and bring German and continental European monetary economists up to speed. Thus, Karl Brunner originally intended the Konstanz Seminar to be primarily a teaching institution. The early Konstanz Seminars were marked by three special characteristics that served this purpose:

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[1] *Karl Brunner* (ed.), Proceedings of the First Konstanzer Seminar on Monetary Theory and Policy. *Beiheft 1 zu Kredit und Kapital*, Berlin: Duncker und Humblot 1972.

First, within a few years, Brunner had invited the entire generation of German, Swiss, and Austrian monetary economists born between 1936 and 1946, and many more young economists from Italy, France, and Spain. The emphasis on bringing young researchers to the Seminar has remained a special trait until today.

Second, Brunner brought a large number of researchers from the US, Canada, and the UK to the Seminar to present their latest work to their European colleagues. Apart from the proceedings of the first Seminar, there was never a plan to publish the papers presented. This helped Brunner and Neumann to have the very best ongoing research presented at the Seminar. Long sessions of 75 to 90 minutes per paper, with half of that given to the floor, facilitated intensive and detailed debate. This also has remained a characteristic of the Seminar.

Third, in addition to academic researchers, Brunner invited large numbers of central bankers from the US and European countries, and especially from the Swiss National Bank and the Bundesbank, together with a significant number of journalists. The Konstanz Seminar thus became a forum of open exchange of ideas between academics and central bankers, which was very rare in Germany, Austria, and Switzerland at the time. The Seminars had special sessions devoted to current issues of monetary policy which gave the central bankers opportunities to explain what they were doing and to receive – often harsh – criticism from Brunner and his North American colleagues. These discussions helped the Bundesbank and the Swiss National Bank to design their new monetary policy strategies after the breakdown of the Bretton Woods System of fixed exchange rates. Policy debates with prominent central bankers are still a regular feature of the Konstanz Seminar today.

Karl Brunner was, of course, a monetarist. In fact, it was him who coined the term *monetarism* in a speech given at the Federal Reserve Bank of St. Louis in 1968.[2] One might, therefore, suspect that Brunner was using the Konstanz Seminar to bring monetarism to Europe. But the Seminar was never a breeding place for monetarists. In fact, the version of monetarism, which Brunner had developed together with his former student Allan H. Meltzer in a long series of articles, and which was most comprehensively laid out in their *Matteoli Lectures*, rarely appeared on the Konstanz programs.[3] Several papers devoted to the analysis of the money supply process were presented in the early Seminars, reflecting Brunner's interest in that topic and his emphasis on the relevance of institutions. But, apart from those, the majority of papers reflected what was currently going on at the research frontier. Both Brunner and Neumann were more inter-

[2] *Karl Brunner,* The Role of Money and Monetary Policy. Federal Reserve Bank of St. Louis Quarterly Review July 1968, 9–24, p. 24.

[3] *Karl Brunner and Allan H. Meltzer,* Money and the Economy. Issues in Monetary Analysis. Cambridge: Cambridge University Press 1993.

ested in top-quality research than in promoting a certain school of thought. Over the years, many prominent Keynesians presented their work at the Konstanz Seminar, as did proponents of real business cycles and New Keynesian models. Gradually, the Seminar developed an emphasis on open-economy macroeconomics.

In their review of the first 30 years of the Konstanz Seminar, Michele Fratianni and Jürgen von Hagen showed that the teaching mission of the Konstanz Seminar had largely been accomplished by the late 1980s.[4] By that time, papers given by European authors were as likely as papers given by North Americans to be published in top international journals later on. Gradually, the Konstanz Seminar had morphed into a forum of debate and exchange of ideas among equals. Today, we find the best German and Swiss economists on the programs of important economics conferences around the world, and they publish in the leading professional journals. The top German and Swiss economics departments nowadays place their best PhD students in leading economics departments in the US, Canada, the UK, and Asia. The large gap that Karl Brunner perceived has been closed. One cannot claim causality here, but the experience of many German and continental macro economists born between 1936 and 1966 suggests that the Konstanz Seminar helped shape their careers by providing exposure of their work to their North American peers, and, equally importantly, by fostering personal relationships and friendships.

Similarly, the goal of promoting a culture of open debate and exchange of ideas among central bankers and academics can be said to have been reached. Today, that culture is common in many conferences and workshops around Europe and North America. Starting in the 1990s, the Center for Economic Policy Research, under the leadership of Richard Portes, did much to promote and improve the dialogue between policymakers and academics in Europe. Today, we take that for granted. But it was not so 50 years ago. The Konstanz Seminar has likely been influential in laying the foundations in the 1970s and 1980s.

Manfred J. M. Neumann remained the Seminar's main organizer until the mid-1990s, when he handed it over to his student Jürgen von Hagen. 24 years later, von Hagen passed on the leadership to his colleague Keith Kuester, also at the University of Bonn. Thus, the Konstanz Seminar is now in its third generation and thriving. It remains part of Karl Brunner's and Manfred J. M. Neumann's legacy and carries on their spirit of open and honest exchange of arguments for the purpose of finding truth and, in Brunner's words, "systematically applying economic analysis to the social problems of the world."[5]

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[4] *Michele Fratianni and Jürgen von Hagen*, "The Konstanz Seminar at 30.", European Journal of Political Economy 17, 2001, 641–64

[5] *Karl Brunner*, A Fascination with Economics. Banca Nazionale del Lavoro Quarterly Review 1981, pp. 403–426, p. 404.

Karl Brunner's monetary economics was shaped by the interest in the interaction between asset markets and the markets for output and labor, in the consequences of imperfect information for the working of markets, and in the role of institutions for the conduct and results of economic policy. For the past 50 years, these interests have also impacted the research agenda of the Konstanz Seminar. In this issue, we have selected six papers reflecting these topics. Our choice of papers has been guided by two criteria: First, to get a fair view of the breadth of research topics dealt with at the Konstanz Seminar, and, second, to select the most prominent papers as judged by the number of citations they have generated over the years.

Rudiger Dornbusch's paper, "A Portfolio Balance Model of the Open Economy" was presented at the Konstanz Seminar in 1973 and published in the *Journal of Monetary Economics* in 1975. That journal, together with the *Journal of Money, Credit, and Banking*, also belongs to Brunner's legacy. Dornbusch's paper focuses on the interaction of output and asset markets and is thus related to Brunner's and Meltzer's version of monetarism as much as to Tobin's "A General Equilibrium Approach to Monetary Theory" published in the inaugural issue of the *Journal of Money Credit, and Banking* (1969, pp. 15–29). It embeds richer asset structure than the Keynesian IS-LM framework and a wealth-savings relation that creates the dynamics of the model. Dornbusch focuses on a small open economy allowing for international trade in bonds, and works out the long-run equilibrium of such an economy and its adjustment to a number of policy experiments.

The paper by Karl Brunner, Alex Cukierman, and Allan H. Meltzer, "Stagflation, Persistent Unemployment, and the Permanence of Economic Shocks" was presented at the Konstanz Seminar in 1979 and published in the *Journal of Monetary Economics* a year later. By that time, Brunner's and Meltzer's main research interest had shifted from the development of a monetarist general-equilibrium model to the exploration of the macro economic consequences of imperfect information. In contrast to the Lucas "island" model,[6] which builds on the inability of agents to discriminate between changes in relative prices and changes in the price level, the Brunner-Cukierman-Meltzer model focuses on the inability of agents to discern temporary from permanent shocks. The authors show that this has rich implications for the dynamics of prices, wages, output and unemployment, such as partial and hump-shaped price adjustments and real effects of purely nominal shocks although prices and wages are perfectly flexible in principle.

Robert J. Barro's and David B. Gordon's paper, "A Positive Theory of Monetary Policy in a Natural Rate Framework" was presented at the 1982 Konstanz

[6] *Robert Lucas*, "Some International Evidence on Output-Inflation Trade-Offs," American Economic Review 63, 1973, pp. 326–334

Seminar and published in the *Journal of Political Economy* in 1983. Their paper was one of the first introducing concepts of game theory, *viz.* the idea of subgame perfect Nash equilibria originally developed by Reinhard Selten, into macroeconomics. The paper argues that agents expect policymakers to always act rationally and in their best interest. This implies that policymakers cannot credibly announce a policy strategy that can be expected to be suboptimal at a later point in time. In an application to monetary policy where nominal wages embed inflation expectations formed in the past, this implies that policymakers known to have a greater tendency to use monetary surprises to reduce unemployment end up with higher equilibrium inflation and no gains in terms of unemployment. Barro's and Gordon's paper gave the impetus to a large literature on designing monetary policy institutions to increase the credibility of low-inflation strategies, such as central bank independence and performance contracts for central bankers. Some of that subsequent literature was presented at later Konstanz Seminars.

Jürgen von Hagen and Ian Harden's paper, "Budget Procedures and Fiscal Performance in European Countries," was presented at the 1992 Konstanz Seminar and published in the *European Economic Review* in 1995. This paper focuses on the "common pool problem" of public finances, i. e., the fact that public spending financed from general taxes tends to target specific groups of voters. The political process allows individual groups of voters to direct public spending to their benefit and creates a tendency for excessive spending in the sense that the marginal benefit of public spending is lower than the marginal cost of its funding. The authors show that the resulting spending bias can be mitigated by designing the budget process in ways that help the relevant decision makers to internalize the common-pool externality and they provide empirical evidence supporting the call for proper design of the budget process. The paper has sparked a substantial literature on fiscal policy institutions and had some influence on the fiscal framework of the European Monetary Union.

The paper by Christopher J. Erceg, Dale W. Henderson, and Andrew T. Levin, "Optimal Monetary Policy with Staggered Wage and Price Contracts," was presented at the Konstanz Seminar in 1999 and published in the *Journal of Monetary Economics* in 2000. It marks a central contribution to the so-called "New Keynesian" macroeconomics that has continued to shape central bank policy in the new millenium. New Keynesian macroeconomics combines the hallmarks of the rational expectations revolution, such as rational, optimizing households and firms, with Keynesian elements, first and foremost nominal rigidities. In the paper, prices and nominal wages are set by optimizing agents, but can only be updated infrequently. Knowing this, the monetary policy authority seeks to set its policy so as to maximize the welfare of the economy's households. The authors show that once both goods prices and nominal wages are rigid, monetary policy cannot, generally, achieve the first-best allocation. Optimal monetary

policy, in this setting, next to price inflation focuses on a measure of real economic activity or wage inflation.

The paper by Bartosz Mackowiak and Mirko Wiederholt, "Optimal Sticky Prices under Rational Inattention," was presented at the Konstanz Seminar in 2006 and published in the *American Economic Review* in 2009. Next to its contribution to macroeconomic theory, it has proved influential in motivating empirical research on the determinants of firms' macroeconomic expectations and how these feed into price setting behavior. The paper is very much in line with Karl Brunner's view of the behavior of rational agents, namely that they economize on resources not only in the process of production but also when it comes to processing information. The authors assume that information processing is costly and that agents do not spend much effort and resources on acquiring information about things which are generally of low relevance to them. In this sense, inattention, even though it is known to lead to expectation errors and misguided decisions, can be rational. Once applied to the firm sector, the authors show that these considerations can generate inertial nominal price setting and hump-shaped price adjustment patterns in a world where agents cannot discriminate between shocks affecting the macro economy and shocks that are specific to their markets. As in the Lucas "island" model mentioned above, this gives rise to persistent real effects of monetary policy.

Altogether, these six papers indicate the breadth of the scientific debates held at the Konstanz Seminars and the development of monetary macro economics since the first Konstanz Seminar. We publish this volume as a tribute to Karl Brunner, who founded the Seminar over 50 years ago, and the many participants who made the Konstanz Seminar a special event every year. We hope that it will continue for many more years to come.