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The Crisis of the Euro: The Problem of German Power Revisited.

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The pathologies of the euro zone have been thoroughly examined in recent years. For most commentators the euro zone crisis has not been misfortune but the consequence of structural fault lines (cf. Bastasin, 2012). These are both economic and political. On the economic side, some argue that the crisis has demonstrated that the euro zone is not, what Martin Feldstein (1997: 36) called a 'natural monetary union' or, in the favoured parlance of economists, an optimal currency area. From this perspective, the economies of the member states were always too different to sustain a single monetary and exchange rate policy (Feldstein, 2012; Moravcsik, 2012). This economic discrepancy arises from the fundamental structural imbalances between the core, especially Germany, and the periphery. Explanations of this mismatch range from divergences in competitiveness (Dyson, 2010a; Shambaugh, 2012), export-led and demand-led growth models, varieties of capitalism (Hall, 2012), or the presence or absence of wage-settling mechanisms (Boltho and Carlin, 2013). The implication of such arguments is that the euro zone is too large (Eichengreen, 2012a) and will remain so without a change of national economic outcomes in the core and the periphery. Achieving this result would in turn require a combination of structural reform in the periphery to improve external competitiveness (Arghyrou and Tsoukalas, 2011) and a more demand-oriented approach in Germany (Feldstein, 2012; Moravcsik, 2012; Pettis, 2013: 119-135; Schwartz, 2012).

On the political side, many have argued that the crisis has exposed the fundamental institutional design flaws of the euro zone, including fiscal decentralisation (James, 2012: 16-18; De Grauwe, 2011; Eichengreen, 2012a; McNamara, 2011; Featherstone, 2011; Heise, 2012), the absence of political union (McNamara, 2011-12; De Grauwe, 2011), the failure to create a banking union, (James, 2012 16-20; Eichengreen, 2012a; 2012b; Shambaugh, 2012) and inadequate crisis management mechanisms (Dyson, 2012a; 2013). In principle, these problems could be solved by collective action by the euro zone states, and it is the case that, since 2010, reform at the level of the euro zone itself has indeed taken place, some of which has created more supranational authority (Yiangou, O'Keefe and Glöckler, 2013). In particular, the euro zone now has much tighter fiscal rules through the Fiscal Pact than those in operation under the Stability and Growth Pact (SGP). Meanwhile, the European Central Bank (ECB) will become the single supervisor of euro zone banks in 2014, and in the European Stability Mechanism (ESM) there is a permanent crisis resolution mechanism.

Whether these moves are sufficient to reinvent the euro zone on terms that address the original design flaws is at best questionable. As Schmidt (2011) has said, reform has been a succession of 'half measures' that have ultimately failed to restore bond market confidence. Tighter fiscal rules do not constitute a fiscal union (Cohen, 2012: 697). Similarly, the establishment of a singular site of authority does not create shared deposit guarantees, or entail a single agency for dealing with failed banks that allows for debt mutualisation. For its part, as presently constituted, the ESM is inter-governmental and under capitalised, and it would easily be overwhelmed by any need to bail out Italy and Spain (Dyson 2013: 2016).

Nonetheless, there remains a strong belief expressed in recent commentary that the euro zone will survive. Even if this collective institutional reform is inadequate, many argue that the sheer political will to preserve credibility will keep the euro alive (Bergsten 2012; Bergsten and Kirkegaard, 2012; Cohen, 2012; Wolf, 2012), regardless of whether some individual states in the periphery leave (Eichengreen, 2010). From this perspective, the economic and political problems the euro creates do not ultimately matter for its durability; the euro simply cannot be abandoned, however misconceived as a currency area it was, or badly designed it remains, because the price of failure is too high.

Given the power dynamics of the euro zone, the claim that the euro will endure because it must has necessarily also to be an argument that Germany cannot give up on it. However, this judgment rests on an assumption that Germany's actions during the crisis show Germany as doing if not, as Guérot and Leonard (2011: 8) argue, 'whatever it takes to save the euro', at least what is minimally necessary. In this paper, I assess this claim by examining German actions during the crisis in the context of Germany's approach to European monetary matters since the 1970s and German interests in the euro zone sovereign debt and banking crises. The analysis follows the approach of those who have argued that German power is central to the fundamental divergence problem

in the euro zone (Moravcsik, 2012; Blyth and Matthijs, 2011; Rodrik, 2010), but goes further in suggesting both that the conflict between Germany and those who resist its preferences has deepened through Germany's actions during the crisis and that Germany's commitment to the euro cannot be assumed. Taking Cohen's (1994: 157) structural requirements for an effective monetary union, namely, that there is either a 'powerful state committed to using its influence to keep a monetary union functioning effectively on terms agreeable to all', or 'a broad constellation of related ties and commitments sufficient to make the sacrifice of monetary sovereignty whatever the costs, basically acceptable to each party,' this paper argues that neither applies to the euro. Germany has not succeeded in producing a broad consensus of interests and preferences around its own, and it is not at all clear whether the German government is willing to use its power to sustain the euro on terms that are agreeable within the contours of German domestic politics let alone to anyone else.

The first section of the paper looks at Germany's position in European monetary matters from the end of Bretton Woods to the beginning of the euro zone crisis. It argues that Germany's commitment to common European monetary arrangements prior to the crisis was always qualified by its insistence on maintaining its own monetary preferences that were not shared by others. It suggests that the diminution of German structural monetary power through the abolition of national currencies made monetary union during this period minimally tolerable to its other members. Section two considers the euro zone crisis. It examines the impact of the recreation of German structural monetary power by the bond markets and shows how the German government's subsequent actions in the crisis then produced a further divergence of preferences and interests within the euro zone, leaving a new power relationship that is extremely difficult for other states, most consequentially France, to accept. The final section draws some conclusions, arguing that Germany's commitment to the euro is unproven.

German power before the euro zone crisis

Germany structural monetary power in relation to other European states arises from the international financial markets. It first became apparent as the Bretton Woods system frayed in the late 1960s in the interaction between Germany's post-war commitment to price stability and the foreign exchange markets. As inflation began to diverge between the major economies and capital flows grew, investors showed a preference for holding Deutsche Marks (DM) over other European currencies. This perception of relative risk made it difficult for Germany to stem market pressure for a revaluation and for most of the other European Economic Community (EEC) states to contain pressure against devaluation. From 1969, the EEC states worked towards a Community solution to the mutual problems of exchange rate management through the Werner Plan. However, the German government was interested in a Community approach to the problem only so long as this allowed Germany to achieve price stability. In May 1971, just two months after the EEC states formally adopted the Werner Plan, Germany unilaterally floated the DM to try to stave off the inflationary effects of using monetary policy to keep the value of the DM down. The French President, Georges Pompidou, was left to denounce Germany's action as a violation of 'Community morality' (quoted in James, 2012: 87). This particular Franco-German conflict passed with US President Nixon's move three months later to end dollar-gold convertibility, pushing the question of the relative value of the European currencies into discussions of a broader realignment within Bretton Woods. But the institutional power that Germany could exercise inside a European monetary arrangement as a result of its structural monetary power did not go away so easily.

In the remaining years of Bretton Woods and the first years of the floating regime, continuing efforts to find a Community-based method of managing exchange rates foundered between the ongoing relative perception in the foreign exchange markets of the anti-inflationary credibility of the DM compared to other European currencies and the singular monetary decisions made by the Bundesbank. In principle, the Snake was a Community mechanism that pegged the European Community (EC) currencies against each other, first in a tunnel within the Bretton Woods parities and then in an effective joint float. In practice, it operated as a DM zone (Kaltenhaler, 1998: 45). Consequently, any state that wished to maintain exchange rate stability with Germany had to follow the monetary policy of the Bundesbank. Since German monetary policy was tight in the middle of the 1970s, most member states eventually abandoned the Snake. The French

approach towards the Snake is instructive. France left in January 1974, returned in May 1975 with a demand that the Snake be reformed to impose greater obligations of intervention on the Bundesbank, and quit again in March 1976 when no German change was forthcoming. The French political elite identified the problem as one of DM market strength, German institutional power and the singularity of German preferences. In one conversation immediately before France's first exit, the French Finance Minister, Giscard d'Estaing, told President Pompidou: 'ultimately we will not be able to prevent the franc and the DM from drifting away from each other'. Pompidou replied: 'As soon as one comes to the [Germans] with monetary questions, they react completely egoistically. They like to exploit their superiority' (quoted in Marsh, 2011: 72-73).

The design of the European Monetary System (EMS) and the Exchange Rate Mechanism (ERM) and temporary deficits in the German current account appeared for a few years to offer a partial solution to the European monetary problem. The ERM pegged currencies against an artificial currency, the ecu, and the EMS allowed for some pooled reserves. But the illusion that German monetary strength could be diluted institutionally or structurally was only tenable so long as all central banks were willing to use the ecu as an intervention currency and Germany ran a current account deficit. By early 1983, the monetary and institutional power of the Bundesbank was once again overt. The appreciation of the DM under a tighter Germany monetary policy from 1981 and the Bundesbank's unwillingness to use the ecu meant that either other states had to follow German monetary policy, or leave the ERM. Like the Snake, the ERM became a DM zone that tied other states to the Bundesbank's price-stability oriented monetary policy and left them looking to cut the market premium they faced in interest rates by seeking to reduce inflation (Giavazzi and Giovannini, 1987; Herz and Röger, 1992).

President Mitterrand's decision in March 1983 to retain French ERM membership and pursue the *franc fort* policy in one sense recognised a reality that the foreign exchange markets had created. The alternative for France was almost certainly higher interest rates for a given rate of inflation because the ERM had itself acquired credibility as the symbol of an EC state being serious about anti-inflationary discipline. Yet for the remaining years of the ERM, French policy-makers, whether Gaullist or Socialist, chafed at the political corollary of that market monetary constraint which was *de facto* institutional German power within the EMS. In January 1987, French Prime Minister, Jacques Chirac, and Finance Minister, Edouard Balladur, described German monetary policy as 'egotistical' (quoted in Marsh, 2011: 118). A year later, having failed through the Basle-Nybourg reforms to impose any meaningful obligation for intervention on the Bundesbank, Chirac complained that the EMS was not 'egalitarian' (quoted in Kaltenhaler, 1998: 72).

This dual reality - that the foreign exchange markets privileged the DM and German monetary policy was un-penetrable by other states - was emphatically demonstrated during the ERM crisis of 1992-93. As the Bundesbank pursued a tight monetary policy to deal with the inflationary consequences of German reunification, other ERM members were left with far higher interest rates than were required to maintain anti-inflationary discipline in their economies. The problem put pay in September 1992 to the ERM membership of Italy and the UK. Thereafter, the French government was adamant that it could not be expected to sacrifice its *franc fort* policy in the same way and pressed for German support, citing the fact that in this period French inflation was lower than German. Future ECB President, Jean-Claude Trichet, then working for the French Treasury, told his colleagues:

I told [a German Finance Ministry official] with brutality that the Bundesbank (and Germany) were making a mistake if they thought they could treat us in the same way that England and Italy had been treated quantitatively and qualitatively. We were not comparable (quoted in Marsh, 2011: 174).

When what German support was offered proved inadequate in the spring and summer of 1993, the French government tried direct confrontation, first by cutting interest rates below the German benchmark and then giving Germany an ultimatum either to leave the ERM or provide unlimited intervention to support the franc (Marsh, 2011: 179-80). Yet the market pressure on the franc and the Bundesbank's unwillingness to compromise ensured in the *dénouement* of the crisis in July 1993 that the German preference for significantly widening the ERM bands – producing the *de facto* suspension of the ERM - triumphed over the French preference for a

German policy shift.

The 1992-93 ERM crisis was an acute illustration of why the French had already turned to monetary union. Balladur's memo on monetary union to ECOFIN in January 1988 damned the monetary power relationship in the ERM that bedevilled France during the crisis: 'The discipline imposed by the exchange-rate mechanism ... produces an abnormal situation when its effect is to exempt any countries whose policies are too restrictive from the necessary adjustment' (quoted in Dyson, 1994: 126). For its French architects the single currency was supposed to eliminate both German structural monetary power by abolishing the DM and German institutional power by making Germany one more seat around the monetary decision-making table. In substantive terms this was supposed to open up the possibility of what in the early monetary union discussions the Italian Treasury Minister, Giuliano Amato, described as 'a common and homogenous attitude to inflation' (quoted in Dyson, 1994: 126).

Yet while monetary union necessarily eliminated German structural monetary power in relation to the foreign exchange markets, it could never have taken place if there had been any possibility of it producing the substantive policy outcome Amato and the French wished. Even Hans-Dietrich Genscher, the first German politician to respond positively to the idea of monetary union in 1988, said explicitly that an ECB would have to replicate the Bundesbank at the EU level (Kaltenhaler, 1998: 73). At German insistence, the Maastricht Treaty subsequently established the independence of the ECB on even harder terms than those that governed the Bundesbank. Consequently, any common attitude to inflation that ensued through monetary union would have to be based on the convergence of the preference of other member states with Germany's, not the other way round.

In practice, that shift simply did not occur. Among top-level politicians there never was a convergence of preferences of the kind described by McNamara (2006: 809) as 'a new European neo-liberal policy consensus' or by James (2012: 15) as a 'European consensus that central banks were concerned primarily with price stability'. Most significantly, there was no shift in monetary preferences in France. French politicians from both main parties remained opposed to central bank independence from the Delors Committee to the Maastricht negotiations, accepting the ECB only as the price of German acquiescence to monetary union (Howarth, 2007: 107). After the publication of the Delors Report, the French Finance Minister, Pierre Bérégovoy, complained that 'a future ECB, being independent of governments, would be entirely dominated by the Germans', whilst President Mitterrand expressed his anxiety that monetary union would replace 'the German zone' of the EMS with German 'authority over our economies' through an ECB (quoted in Marsh 2011: 132). During the Maastricht ratification referendum campaign in France, Mitterrand was left to pretend that the ECB would not be independent but under the control of the Council of Ministers (Moravcsik, 1998: 414). Throughout the pre-crisis years of monetary union, French politicians attacked the ECB. In July 2004, President Chirac used his Bastille Day speech to advocate reform of the ECB's institutional commitment to price stability. In his campaign for the French presidency in 2007, Nicolas Sarkozy attacked the independence of the ECB and its unwillingness to deploy monetary policy to achieve higher employment (Howarth, 2007: 1074; Marsh, 2011: 189). During his presidency, Sarkozy continued his criticisms to the point of directly attacking the decision of the ECB to raise interest rates in July 2008 as a 'misguided' use of monetary policy (quoted in Marsh, 2000: 233).

In political terms, France's complaints were futile because the terms of monetary union had strengthened German institutional power over monetary matters. Germany had guaranteed the monetary pursuit of price stability in other EU member states by treaty (Dyson, 2012b: 197) and, as a consequence, no longer required the foreign exchange markets to impose discipline on others. Germany's ratification of the Maastricht Treaty had also given it the chance to pronounce a unique authority to act as the arbiter of whether that treaty commitment was upheld before and after monetary union began. The German Constitutional Court in 1993 insisted that the transfer of German monetary sovereignty was dependent on monetary stability, and was explicit that Germany was not 'subordinating itself to an unclear and automatic mechanism towards monetary union which it could not steer' and that every further step required explicit approval from the German government 'subject to influence' from the Bundestag (quoted in Marsh, 1994: 154). What is more, the Court continued, once monetary union began, Germany had the

constitutional right to leave if stability was violated (Proissl, 2010: 21).

Put simply, from the start German consent to ongoing monetary union was entirely dependent on the maintenance of the German preference for price stability. Moreover, the German response to attempts to resist this political reality was not to pretend that there was preference convergence but rather to assert that German preferences must, and inevitably would, prevail. Responding to Sarkozy's call in 2008 for a change to ECB policy, the German Finance Minister, Peer Steinbrück retorted:

There is no possibility that France can succeed in reducing the ECB's independence.
... These criticisms by Nicolas Sarkozy of the ECB have no effect. I do not know why he rattles at cages like this – it is completely idiotic (quoted in Marsh, 2011: 231).

Only on fiscal policy were original German preferences weakened after monetary union began by the de facto suspension in November 2003 of the enforcement provisions of the SGP. Yet even here it was the German government's unwillingness between 2002 and 2005 to comply with the SGP budget deficit limit that weakened the fiscal stability rules on which Germany had insisted prior to monetary union. As Heipertz and Verdun (2011: 204) note, the SGP could not be defended unless Germany sided with the Commission, and it did not. Moreover, Germany's ability to break those rules without consequence for the price of its own borrowing was at least in part the product of latent Germany structural monetary power and investor perception of relative risk (Jones, 2012: 92-93). In this instance, though, this power also worked to France's advantage since the markets were unlikely to have been as indulgent as they were of France's breach if Germany was not at the time acting as an ally of France against the SGP.

Nonetheless, monetary union provided some benefits to other states in ways that, in principle, made it possible for Germany to contain disquiet at its institutional power. In particular, it eliminated the impact of German structural monetary power on other states. Even Greece, as the latecomer to the euro zone, enjoyed a reduction on interest-rate spreads with Germany on ten-year government bonds from around 1100 basis points in 1998 to a range between 10 and 30 between 2002 and the end of 2007 (Gibson, Hall, and Tavlas, 2011:7). While German monetary preferences remained dominant, eradicating the interest rate spread made the ECB's monetary policy remit easier to bear. The end of market perception of risk in the periphery also produced large flows of capital from the core to the periphery, creating at least the potential for greater commonality of interests in the euro zone through financial interdependence.

In sum, Germany's support for European monetary arrangements prior to the crisis both before and after monetary union was conditional on its institutional ability to realise its own preferences, whether expressed by a monetary authority or the German government. Monetary union did not produce preference convergence on monetary matters, which prevented the development of the euro zone as a currency entity based on broad constellation of shared interests and commitments. However, the diminution of structural German monetary power and Germany's unwillingness to enforce the SGP made it possible for Germany as the most powerful state to maintain monetary union on terms that were at least minimally tolerable to all.

German power, 'domestic sacrifice' and the onset of the euro zone crisis

The euro zone changed into a much more difficult currency area with the return of German structural monetary power. This mutation was first manifest in the midst of the Bear Stearns crisis in March 2008 when the market perception of risk in relation to Germany that had operated in the past in the foreign exchange markets reappeared in the sovereign bond markets. Hitherto, investors had been willing to act as if they were treating lending to all euro member states much the same as lending to Germany, not least since there was large-scale, short-term reward for them in doing so (Blythe, 2013: 78-84). Thereafter, higher budget deficits and projections of state debt relative to Germany produced higher long-term sovereign bond yields through the perception of relative risk (Attinasi, Checherita, and Nickel, 2009: 5). For Greece, the spread rose from around 30 base points in early 2008 to around 300 in March 2009 and 900 in October

2010 (Attinasi, Checherita, and Nickel, 2009: 5; Gibson, Hall, and Tavlás, 2011: 10). While the problem was most acute in the periphery and eventually led to Greece, Ireland, Portugal, and Cyprus finding the cost of continuing to borrow in the sovereign bond markets prohibitive, some core states, including France, were affected to a lesser degree too. In a clear echo of the ERM years, the French Prime Minister, François Fillon, said in June 2010: 'The first thing I look at every morning is the spread differential between France and Germany' (quoted in Proissl, 2010: 10). Once this dynamic set in, other euro zone states had a strong incentive to try to match Germany in reducing their budget deficits in a similar way to the manner in which they had previously allied their monetary policy in the ERM. In principle, this could have acted as pressure towards preference convergence, but the combination of differing domestic costs to fiscal tightening and Germany using its institutional power also to insist on this policy change produced instead political divergence.

Institutionally, German power was initially exposed in the crisis by past German unwillingness to enforce fiscal rules. Greece's heavy borrowing left Germany with a choice between upholding the legal provisions of the Treaty that prohibited member state bailouts, and the ECB from directly funding budget deficits, and maintaining the euro with all its members. With the first Greek bailout in May 2010, Angela Merkel's government moved to maintaining the existing euro zone with what seemed considerable reluctance, not least given rhetoric from Merkel two months earlier against any expectation of a bailout and the possibility of expulsions (*Financial Times*, 21.03.10). However, once the Merkel government took the decision to allow a bailout, the opportunity for Germany to exercise more institutional power about the terms of monetary union was established. If Germany were to support bailouts, new fiscal rules were the price. In the week after the first agreement on Greece, Germany pushed for other euro zone states to implant fiscal restrictions into national law in line with Germany's own move in 2009 to enshrine constitutionally from 2016 a balanced budget (*Financial Times*, 16.05.10). This German proposal eventually became the Fiscal Stability Treaty. After the agreement in principle on a second Greek bailout in October 2011, the German government also secured a Macro-economic Imbalance Procedure, an Excessive Imbalance Procedure and reform of the SGP.

Meanwhile, the bailouts that have occurred since May 2010 and the parallel moves to adopt a crisis resolution mechanism first in the European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism (EFSM) and then the ESM have been realised on German terms, not least through the claim to authority of the German Federal Constitutional Court. In September 2011, the Court upheld the constitutionality of the first Greek bailout, but insisted that the Bundestag had to retain sovereignty over the German budget and therefore have a larger say in future bailouts through the prior approval of the Bundestag Budget Committee (*Spiegel International*, 7.09.11). A year later, the Court ruled that Germany's contribution to the ESM could only exceed a €190 billion liability if the German representative agreed and that the position of the German representative must be authorised by the Bundestag (*Spiegel International*, 12.09.12).

Although it certainly strengthened German institutional power, this set of moves could also be construed as Germany using that power to maintain the euro and making domestic sacrifice to do so. Here the unpopularity in Germany of the bailouts and the institutional mechanisms that facilitated them and the Bundesbank's opposition to the ECB's Securities Market Program (SMP), Long Term Financing Operations (LTFO) and Outright Monetary Transactions (OMT) appear crucial. Taking these domestic costs as paramount, Paterson (2011: 203), for example, has argued that the crisis has 'catapulted Germany into a hegemonic role' that it has not 'sought'.

This argument on the surface has much evidence to support it. Undoubtedly, many German citizens perceived the decisions made at the 7-9 May 2010 summit as German acquiescence to the unacceptable. Wolfgang Proissl (2010: 8) has described the triple move to a bailout for Greece, establishing the EFSF and EFSM, and the SMP as prompting a strong collective belief in Germany that 'the model of EMU that the Germans had agreed to participate in' had been destroyed. The backlash contributed to the loss of the Christian Democrat/Free Democrat Coalition's majority in the Bundesrat after the defeat of the coalition between the two parties in the state election on 9 May in North Rhine-Westphalia. From May 2010 the Bundesbank also became severely critical of the ECB, with Axel Weber, the then Bundesbank President, voting against the ECB move on

the SMP, and then the day after the 7-9 May summit ended the Bundesbank formally declaring its opposition (Alessi, 2013). Subsequently, the preferences of the Bundesbank President on the Governing Council of the ECB have been increasingly marginalised.

This perception of German defeat was compounded by the failure of German representatives on the ECB to reverse the ECB's support for government borrowing in the periphery, producing the belief among some that there has been a fundamental transformation of the ECB's purposes, in Brendan Brown's (2012: 179) words 'in pursuance of French ambition'. In October 2010, Weber (2010: 2) said that the SMP should be phased out because it risked 'blurring the different responsibilities between fiscal and monetary policy'; but no policy change was forthcoming and, in February 2011, Weber announced his intention to resign, as seven months later did Jürgen Stark, a German member of the ECB Executive Board. Weber's successor as Bundesbank President, Jens Weidmann, has regularly been at odds with Mario Draghi since the Italian's appointment to the ECB presidency (*Spiegel International*, 29.05.13). Indeed, Weidmann was outvoted in August 2011 on the use of SMP to buy Italian and Spanish bonds to try to push down yields (*Financial Times*, 22.08.11). In the autumn of 2011, Weidmann went public with his opposition, insisting that what the ECB was doing was an 'absurd' disregard for the law (*Financial Times*, 2011). Weidmann was then the sole vote in the ECB against OMT (*Financial Times*, 6.09.12). The Bundesbank said after the ECB meeting on OMT that Weidmann 'regards [such] bond purchases as being tantamount to financing governments by printing banknotes' (quoted in *Financial Times*, 6.09.12).

The bailouts and creditors

Seen from this perspective, the ECB's moves do indeed look like a mechanism by which German monetary preferences have finally been defeated. However, looking at only the public face of the shifts in Germany policy since May 2010 ignores the financial and political realities underlying these moves in terms of German interests and their consequences for further divergence in the euro zone. At the onset of the crisis, German politicians faced a specific practical problem that militated against maintaining the euro zone under the rules that their predecessors had insisted upon in the Maastricht Treaty. That problem centred on Germany's banks. In both the summer of 2007 and the autumn of 2008, the German banks were acutely vulnerable to the prevailing problems of funding in the wholesale markets, as well as the collapse of the sub-prime mortgage backed securities market, and these problems did not go away. The Landesbanken were particularly problematic, and it was market concern about the Landesbanken that pushed the EU in 2009 into bank stress tests (*Financial Times*, 27.09.10). The German government responded to the financial crisis by establishing a €480B federal bank rescue fund, while several Länder gave financial support to individual Landesbanken. By mid-February 2009, the cost of German financial stabilisation amounted to 3.1 per cent of GDP, compared to 1.8 per cent for France and 0.9 per cent for Italy (IMF, 2009: 48). Germany also had by the same time \$556B of sovereign guaranteed bank debt, which was significantly higher than that reported by the IMF for other European states except Ireland (IMF, 2009: 49).

The explosion of the euro zone crisis later in 2009 threatened to unravel the support system the German government had erected. As Table 1 shows, just under half of foreign claims on Portugal, Ireland, Italy, Greece and Spain in the final quarter of 2009 belonged to Germany and France.

Although the German exposure was less than the French both in total and in Greece, as Table 1 also shows, Germany had an acute interest once the Greek crisis broke in October 2009 in preventing contagion to Italy and Spain. For the first months of 2010 Merkel seemed to hold on to the hope that the Greek government could do without a loan. However, once that illusion became untenable the German choice was either to contribute to a repayable loan to Greece and try to stave the risk of contagion across the periphery, or massively to increase financial support for its own banks. In outcomes, the first Greek bailout and the subsequent deals for Ireland and Portugal effectively moved liability for bad loans in the periphery from German and French banks to the IMF, EU, ECB and EFSF for which Germany and France bore a share of responsibility but not the whole. Put differently, these bailouts shifted the risk of default in the periphery from German and French banks to collective European and other taxpayers.

Table 1: Foreign claims on the euro periphery in Q3 2009 in millions of dollars

	Greece	Ireland	Italy	Portugal	Spain	Total
Germany	43 236	19 3271	209 295	47 261	240 296	733 359
France	78 571	52 130	484 103	36 359	172 805	823 968
Austria	6337	8968	21 121	2634	9276	48 336
Belgium	8292	42 443	52 457	11 707	47 389	162 288
Ireland	8717		46 669	5809	335 34	94 729
Italy	8753	22 597		6664	32 925	70 939
Japan	8777	21 940	53 163	3529	27 511	114 960
Netherlands	12 054	32 090	74 551	13 171	125 805	257 671
Portugal	10 453	4857	5722		30 116	51 148
Spain	1157	14 612	51 376	87 403		154 548
UK	12 492	191 849	81 966	26 264	120 723	433 294
US	19 448	73 759	68 753	6202	68 194	236 356

Source: Bank of International Settlements

Table 2: Foreign claims on the euro periphery from Q3 2009 to Q4 2012 in millions of dollars

	2009 Q 3	2010 Q 4	2011 Q 4	2012 Q 4	Reduction	Percentage reduction
France	823 968	646 491	540 628	502 629	321 339	39
Germany	733 359	524 814	418 942	358 401	374 958	51
UK	433 294	347 187	308 077	290 879	142 415	33
US	236 356	142 386	135 723	146 633	89 723	38

Source: Calculated from Bank of International Settlements, International Banking Statistics

As Table 2 shows, the moves made since May 2010 have allowed German creditors to reduce their exposure in the euro zone periphery more significantly than those in other large economies.

The particular reduction of exposure in regard to Greece between late 2009 and late 2011 is particularly significant. As Table 3 shows, Germany in particular was in a much stronger position by the time of the agreement in principle on a second Greek bailout than it had been when the crisis started.

Table 3: Foreign claims on Greece in Q3 2009 and Q3 2011 in millions of dollars

	2009 Q 3	2011 Q 3
France	78 571	47 899
Germany	43 236	18 636
UK	12 492	11 546
US	19 448	6 007

Source: Bank of International Settlements, International Banking Statistics

Consequently, the German government could agree the outline of a bailout package in the autumn of 2011 that included Private Sector Involvement (PSI) at a much lower domestic cost than would have been possible in May 2010.

As the IMF (2013) argued in its report on the 2010 Greek stand-by arrangement, the absence of any debt restructuring in the May 2010 agreement and its delay until the 2011 bailout inflicted huge problems on Greece and made the projections on which the programme rested untenable. The IMF (2013: 27-28) noted that the unwillingness of the euro zone states to reduce debt through PSI in May 2010 was in sharp contrast to other cases of debt crisis since 2000 and was at odds with all independent analysis of the sustainability of Greek debt. The IMF was also keen to insist that the decision to exclude PSI was made by the euro zone authorities and not the Fund itself, noting that one of the arguments made was that, 'for the euro zone as a whole, there might be limited gain in bailing in creditors who subsequently might themselves have to be bailed out' (IMF, 2013: 27). Those creditors were, of course, first and foremost French and German; even here German creditors had the advantage, since several French banks only reduced their exposure after May 2010 by writing off large capital holdings in Greek banks (*Financial Times*, 27.05.10; *Daily Telegraph*, 17.10.12).

Nonetheless, whatever the German gain in view of German interests, the politics of shifting national private sector exposure to euro level and IMF official claims was indeed problematic for the German government. Exempting creditors from the costs of the bailouts was domestically unpopular, especially when, as they often were, these creditors were presented as foreign. Domestic politics thus created an incentive for German rhetoric that demanded tough terms for creditors. This was particularly apparent in the autumn of 2010 when the prospect of the Irish bailout and rising spreads across the periphery graphically demonstrated that Greece would not be a one-off. Seemingly channelling this imperative, the CDU finance policy spokesperson in November 2010 said that the party's policy rested on the view that 'Wall Street investors have got to shoulder their liabilities', even though, as Table 2 shows, American creditor claims in the euro zone periphery were much smaller than Germany's (quoted in Crawford and Czuczka, 2013: 82). Merkel herself also began to talk about the need for PSI. At a bilateral Franco-German

summit in Deauville in October 2010, she appeared to do a deal whereby she secured agreement from Sarkozy to a treaty-based new crisis resolution mechanism to replace the EFSF, when it expired, that would include PSI (Gardner, Barber and Spiegel, 2010). However, the detail of the subsequent agreement moving towards what would become the ESM revealed that PSI would only apply to new bonds issued after 2013 (*Economist*, 2011). Consequently, while judged by rhetoric Germany appeared to be getting tougher with creditors, its actions in late 2010 still averted any burdens being placed on German banks. When within a month of the Deauville deal there was no PSI in the Irish bailout, this policy stance reopened the domestic political argument that German taxpayers were bearing costs that should be borne by creditors. In the fallout, the former Social Democratic Foreign and Finance Ministers penned a *Financial Times* column calling for a 'haircut' on holdings of Greek, Irish and Portuguese debt (Steinmeir and Steinbrück, 2010). But, even in this implicit attack on the German government's policy stance, the underlying reality of German interests was clearly discernible; in making their argument Steinmeir and Steinbrück (2010) insisted that the 'entire outstanding euro zone debt of stable countries', explicitly meaning Italy and Spain where the bulk of German exposure lay, be guaranteed.

Seen in this light, Eichengreen's (2012a: 132) puzzle as to 'why the German government ... finds it even more difficult to sell its constituents on the idea that taxpayer money should be used to recapitalise the country's own banks than to bail out Greece and Ireland' is not quite the question. If periphery bailouts have been unpopular in Germany it is because they have not been understood for what they were, which was an opportunity for Germany to 'Europeanise' the problems of its own banking sector, particularly in regard to Italy and Spain. This is not to deny that there is a paradox at work, as Eichengreen suggests, but rather to say that the puzzle concerns the relationship between practical utility and political difficulty. The more economically beneficial option appeared more domestically politically difficult, but explaining its utility to the domestic political audience would have lessened the opportunity both to impose the costs of the banking crisis entirely on the debtor states and to change economic policies in the periphery through new institutional rules.

The ECB's programmes and creditors

Meanwhile, it is the very actions of the ECB that have so angered the Bundesbank that have acted as support for the firewall that the first bailouts created for German and French banks. Both the SMP and then LTFO, which supplied banks in the euro area with as much three-year euro denominated funding as they bid for in auctions in December 2011 and February 2012, have provided a crucial mechanism by which German and French banks could dispose of periphery assets. The LTFO gave Italian and Spanish banks in particular money to buy German and French holdings of Italian and Spanish government and bank bonds. German and French banks were also able to use subsidiaries in the periphery to secure LTFO funding (IMF, 2012: 33). The result was a sharp repatriation of capital from the periphery to the core of the euro zone and, by 2012, a significant inflow of capital into Germany (Cecchetti, McCauley and McGuire, 2012).

The ECB's actions through the SMP have also served as an instrument to further the German government's insistence on fiscal discipline and structural reform in the periphery. The institutional structure of the SMP formally was based on providing support in the bond markets only to those states committed to fiscal retrenchment and structural reform. The primary focus of the SMP during its operation, as Table 4 shows, was Italy, and the ECB used it in ways that allowed for the German government in particular to bring huge pressure to bear on the Italian government and the premiership of Silvio Berlusconi in the summer and autumn of 2011.

In early August 2011, yields on ten-year Italian governments bonds were more than six per cent and heading towards the level at which the bailout states had found the cost of market access prohibitive. On 5 August, the ECB's outgoing and incoming Presidents, Trichet and Draghi, wrote to Berlusconi making clear that any support from the ECB for Italian bonds through the SMP was

Table 4: ECB security holdings acquired under the SMP as of December 2012

Country's securities holdings	Outstanding amount
Ireland	14.2
Italy	102.8
Greece	33.9
Spain	44.3
Portugal	22.8

Source: Bank of International Settlements, International Banking Statistics

conditional on radical economic reform. Their demands included the full liberalisation of local public and professional services, reform of collective wage bargaining, labour market law and pensions, a major overhaul of public administration, and a plan for a balanced budget by 2013 achieved largely by expenditure cuts; they also gave a deadline of the end of September 2011 for passing legislation on each issue (*Financial Times*, 29.09.11). On 7 August, Berlusconi replied with a promise to undertake the reforms according to the requested timetable. The following day, the ECB began buying Italian bonds and the yield fell by more than 1 per cent. At the end of the month, Berlusconi seemed to suggest that he would not pursue pension reform and Italian yields started to rise again. During September and October, the ECB did not intervene sufficiently to change the direction of the yield's movement despite the fact that yields were rising above 6 per cent by the last week of October (*Wall Street Journal*, 30.12.11; Bloomberg Market Data). (As a point of contrast, the ECB purchased €22B - which would have included Spanish as well as Italian bonds - in the week ending 12 August, as well as a further €4B in the week ending 28 October (ECB, Weekly Financial Statements, 16.8.11, 28.10.11).)

The ECB's discretionary use of SMP significantly contributed to market pressure on yields during these two months and established conditions under which the German government appeared to coax a change of government in Rome. Before the 26-27 October 2011 EU summit in Brussels, Merkel and Sarkozy told Berlusconi in a personal meeting that he had to deliver 'specific and convincing reform measures soon' (quoted in *Financial Times*, 23.09.11). At the Cannes G20 summit on 3-4 November, Merkel and Sarkozy gave Berlusconi an ultimatum to act decisively or face the withdrawal of their support, and he agreed to let the IMF assess the Italian budget (Crawford and Czuczka, 2013: 14). According to an investigative report from the *Wall Street Journal* (2011), published on the basis of documents and more than twenty interviews, Merkel rang the Italian President, Giorgio Napolitano, after the summit to encourage him to find an alternative Italian government. Meanwhile, against a backdrop of intense speculation about Berlusconi's future, the ECB Governing Council Member, Yves Mersch, having been asked by *La Stampa* if a statement on the ECB's purchasing policy meant that the central bank would stop buying Italian bonds without further reform, was reported as answering: 'If the ECB board reaches the conclusion that the conditions that led it to take a decision no longer exist, it is free to change that decision at any moment' (quoted in *Reuters*, 7.11.11). The next day Berlusconi lost his parliamentary majority, and Napolitano moved to appoint a technocratic government.

In some ways the interactive dynamics of German institutional power and market perception during the Italian crisis of August-November 2011 clearly matched those of the ERM crisis of 1992-93. Any state with rising spreads over Germany in the bond markets was vulnerable to the

pressure of the SMP tap in the same way that those whose currencies were under pressure in the foreign exchange markets had been at the mercy of whether the Bundesbank was willing to provide support through reserve intervention. Moreover, the euro zone crisis accentuated this power dynamic since the SMP formally tied the behaviour of the central bank in question to fiscal and other economic policy areas.

Seen in this light, the Bundesbank's disquiet at the ECB's action since May 2010 is unsurprising. Clearly, monetary policy within the euro zone has been elided with other objectives, violating the Bundesbank's conception of what the pursuit of price stability through monetary policy entails. However, the Bundesbank's opposition to the SMP and OMT cannot then be seen as an argument against the claim that the German government has sought more institutional power during the crisis for its own ends. The German policy making elite appears split between those, like the officials of the Bundesbank, who wish to retain a purist conception of price stability, and the governing politicians who have prioritised protecting German banks and have been willing to use the euro zone crisis to bind other states more tightly to German fiscal preferences. The politics of that split have left the Bundesbank in a minority. But this is nothing new. If the Bundesbank had had its way, Germany would probably not have embarked on the monetary union path at all or, for that matter, the EMS (Kaltenhaler, 1998, 49-53; Marsh, 2011: 124-30). Moreover, once monetary union began, the Bundesbank's position as the self-appointed bell-weather of German stability policy was weakened to the advantage of the Finance Ministry (Dyson, 2009). Now, it is the German government that directly has to wrestle with the complex array of interests and imperatives at stake for Germany. If the German government has finessed the problem in ways that the Bundesbank dislikes, it has done so on its own terms in relation to other states and in ways that have strengthened the institutionalisation of German preferences within monetary union.

A strong counter-argument to the claim that Germany has strengthened its institutional power during the crisis is the problem Germany has had in finding allies at apparently crucial times to realise its preferences. Some have argued that the decisions made at the 7-9 May 2010 summit revealed the limits of German power within the euro zone (Bulmer and Paterson, 2010; 1071). This perception was reinforced by the rhetoric from Paris, with Sarkozy claiming that '95 per cent' of that agreement was made in France and the French European Minister suggesting that in effect France had 'changed the Maastricht treaty' (quoted in Proissl, 2010: 31-33). In this light, Merkel's subsequent failure to ground new fiscal rules in a commitment to a new EU treaty at the EU summit in Brussels in December 2011 also appeared as a defeat at French expense (*Financial Times*, 9.12.11). Others have seen a shift towards more accommodation in German policy from the middle of 2012 after the election to the French presidency of François Hollande deprived Merkel of an ally in Paris (Blythe and Matthijs, 2012; Schwarzer and Lang, 2012). This view appeared to be vindicated when, at the EU summit on 28-29 June 2012, the Spanish government believed that it had procured Merkel's agreement for direct use of the ESM to recapitalise banks, a move that would have been hugely beneficial for Spain in breaking the link between its banking and sovereign debt crises. This move was portrayed in the media reporting, including in Germany, as a triumph for a new triumvirate of Hollande, Mario Monti, the prime minister of Italy, and Mariano Rajoy, the prime minister of Spain - and, by the same token, a bitter defeat for Merkel (*Financial Times*, 29.06.12).

If German policy did indeed decisively shift through the crisis, then it would be possible to see the euro zone as moving through the crisis towards compromises that make the terms of monetary union more agreeable, if not for all, then at least for more, states. Yet again appearances are deceptive. Looking at the eventual policy outcomes of negotiations from May 2010 onwards where Germany seemed on the surface to be defeated, German preferences have in reality largely triumphed. The terms of the first Greek bailout served German interests in safeguarding German banks. In late 2011, Sarkozy took the supposed absence of automatic enforcement from the Commission on the Macro-economic Imbalance Procedure as a defeat for German preferences, but once the Procedure was operational it was clear that it does give explicit authority to the Commission to fine euro zone members in a way that is unlikely to be

compromised by the resistance of member states. By May 2013, the Commission had presented France with a long list of recommendations for urgent structural reform in exchange for giving France two additional years to meet its budget deficit targets, and Hollande was left to complain that the Commission had no right to 'dictate' what France should do (quoted in *Financial Times*, 30.05.13).

Since June 2012, German policy has in practice toughened both on the ESM and banking union despite increased co-operation between France, Italy and Spain. By September 2012, the German government was casting public doubt on any notion that it had agreed that the ESM could be directly used for bank capitalisation in Spain (*Financial Times*, 25.09.12). One month later, Standard and Poor's downgraded Spain's sovereign bonds to near junk status, precisely because it saw the German view that the ESM should not have the capacity 'to recapitalise large ongoing European banks' as victorious, in contrast to the rating agency's 'previous assumption' that 'official loans to distressed Spanish financial institutions would eventually be mutualised among euro zone governments' (quoted in *Financial Times*, 10.10.12). When, in December 2012, Spain finally took a loan of €39.5B from the ESM for the purpose of bank capitalisation, the ESM (2012) made explicit that the loan was to the Spanish 'sovereign' and 'the Spanish government remains responsible for its repayment'.

In the case of Cyprus, the German line on the use of ESM funds hardened even further. The Cyprus agreement that was struck in March 2013 imposed losses on the bondholders and large depositors of banks and prohibited the Cypriot government using the €10B loan to capitalise the country's two largest banks. While Germany was certainly not alone in insisting on such terms, it was the German government that was explicit that it could not be expected to provide German taxpayer support to bail out what it deemed Cyprus's 'unacceptable' off-shore banking sector (*Reuters*, 22.03.13). Following the Cyprus agreement, the German government has pushed to keep bank liabilities away from euro zone institutions and taxpayers. This approach culminated in the provisional agreement in June 2013 by EU Finance Ministers on a 'bail-in' regime from 2018 that will impose the primary costs of bank failure on bondholders, shareholders, large depositors and national governments as a condition of access to ESM funds (*Financial Times*, 27.06.12).

These German policy moves since the summer of 2012 have produced a clear rift in the Franco-German axis that in its consequences go beyond previous splits. A draft version of a French Socialist Party document on European policy in April 2013 condemned 'the selfish intransigence of Chancellor Merkel who thinks of nothing but the deposits of German savers, the trade balance recorded by Germany, and her electoral future' (quoted in *Financial Times*, 26.04.13). On the German side, the CDU's foreign policy spokesperson responded that Hollande's 'vehement criticism' of the Commission over the French budget deficit was incompatible with the 'spirit and letter of European agreements and treaties' and 'sh[ook] the foundations of the EU' (quoted in *Financial Times*, 30.05.13).

Beyond the rhetorical conflict, German and French preferences have diverged, especially since Hollande became French President, without Germany's institutional or structural monetary power weakening. Of course, Hollande's positioning is hardly the first time a French President has sought an alternative policy stance to that insisted upon in Bonn, Berlin or Frankfurt. A succession of French Presidents since Giscard d'Estaing have chafed under German monetary power and then found that the policy options confronting them in the face of the relative perceptions of Germany and France in financial markets lead them to accommodate German preferences. However, underneath the present divergence of preferences is an acute underlying divergence of economic interests since the two states' mutual exposure in the periphery has diminished. This is likely to widen even if, eventually, the spread between German and French bonds produces an incentive for the French government to retreat from resistance. Whatever the past strength of the French-German axis (Krotz and Schild, 2013), the problems of the French economy have more in common with Spain and Italy than they do with Germany, which was

not the case for much of the two decades that preceded the present crisis. Moreover, French economic policy making is much more tightly constrained by the new institutional rules insisted upon by Germany than it was under the SGP. The old trade-off where under protest French governments eventually accepted the monetary discipline of price stability while enjoying in practice significant fiscal latitude is no longer viable. Even those like Jacques Delors who were once strong proponents of the argument that accommodation was the only alternative are now describing the policy prescription the rules require as, in the words of Delors, 'impossible to accept' (quoted in *Financial Times*, 16.06.13). Even under a scenario whereby German structural monetary power pushes the French government back towards a willingness to accept German preferences, the cost of acquiescence may well run beyond what is politically tolerable within French domestic politics. If, as Sadeh and Verdun (2009: 295) have argued, 'the Franco-German political deal' is a safety belt for the euro zone, the crisis may well have unravelled the alliance by extending German institutional power beyond the level that can be tolerated in Paris.

Conclusions

The euro zone crisis has intensified, rather than lessened, the divisions that made the euro zone an unviable currency area. First, the divergence of policy preferences is now more acute. The core has imposed its preferences for structural reform on the periphery without economic outcomes in the periphery starting to resemble those in the core in ways that would allow for future convergence. Meanwhile, the German government, even if it wished to, could not loosen its fiscal policy to try to find a compromise of preferences in the short term to lessen the pressure on the periphery without undoing the balanced budget amendment to the Basic Law and inducing a domestic political crisis. Dullien and Guérot (2012: 10) may advise in their European Council on Foreign Relations policy briefing on Germany that, 'when negotiating with Germany, its European partners should focus on issues where some movement in the German position can be expected, rather than expect a change on issues on which there is a consensus in Germany', but the problem is that those issues leave very little space for preference convergence on matters at the centre of the crisis.

Secondly, the breakdown since 2010 of financial interdependence between the core and the periphery has produced a widening conflict of economic interests. At the beginning of the crisis, creditors in the core and debtors in the periphery were at least bound to the same of problem of the risks of default and redenomination. But that minimal commonality of interests has now been broken by the various policy moves that allowed German and French creditors to withdraw their capital from the periphery. States and corporations in the periphery will henceforth have to be largely reliant on domestic banks to finance themselves, and they will have to do so at higher rates of interest than prevail in the core.

Thirdly, the exercise of German institutional power that was built into the Maastricht treaty and insisted upon by the German Federal Constitutional Court is now sharper and more overt. While the Constitutional Court's claim to authority over the terms of monetary union was articulated as a principle in the 1993 decision, since 2010 the Court has made a series of decisions that have decisively shaped the practical parameters of the policy options available. German institutional power is now also mediated through a new creditor-debtor politics. As Dyson (2010b; 2012a) has argued, the euro zone's creditor-debtor relations are fraught, inherently politically contested, and incite conflict. Privileging the interests of German and French creditors over periphery debtors was not the necessary cost of saving the euro zone for every one. Rather, it was a conscious act of the powerful that served the economic and political interests of two core states, which were saved from more bank bailouts, at the expense of states in the periphery, which were left with debt deflation. Now that national interests have changed, the distribution of burden is changing too, once again in favour of the core: the primary private creditors of the periphery are now banks in the periphery, and thus it is periphery creditors that will endure much more significant costs in future bail outs.

This deepening of German institutional power has been matched by the still brazen language used by German politicians about German monetary power. As Gerhard Schröder noted in 2007: 'If you try to fight the German stability culture, you are bound to lose. It's better not to start the game' (quoted in Marsh, 2011: 227). In this same spirit Merkel (2010, trans.) in May 2010 told the Bundestag: 'The rules will be geared not to weakest states but to the strongest states. I know that this is a tough message, but economically it is an absolute must'. The position of the German government and Constitutional Court is not simply a substantive argument in favour of monetary stability. Rather, it is an argument that Germany must be able to decide the terms of monetary union for itself and, therefore, its power must be accepted as power by others.

Fourthly, there has been a clear backlash against German institutional power not only in the periphery but also crucially in France. The old compromises that France could make are no longer tenable without a massive switch in approach in Berlin. On the German side, even if German institutional power was eventually weakened in the wake of a French-periphery alliance, the strongest institutional check that Germany has to hold its position is the right of exit, effectively asserted by the German Constitutional Court.

There are few reasons to suppose that the fallout of these sharpened clashes of preferences, interests and power relationships can be reversed. Dyson (2013: 221) has argued that what the euro zone needs is a supra-national executive capacity to act in a supreme emergency, and suggests that it is possible for those looking to reform the governance of the euro-zone to find in political thought 'inspiration on how to put flesh on the normative basis for acting in supreme emergency'. But that hope presumes that, in some sense, the exercise of German institutional power can be transcended by the claim of a substantive common good that all member states could in principle accept as disinterested. In practice, not only is there not the basis in the euro zone of what James (2012: 400) has described as a 'political mechanism that generates a legitimate and general political will', but there also cannot be one, because German institutional power is entrenched as the condition on which German membership of the euro zone continues.

The fear of loss of credibility could indeed serve as a partial substitute for at least the convergence of perspectives of ultimate tolerability. As Cohen (2012) has argued, the euro could endure even though it cannot succeed; the politics of the power dynamics become simply the price that is paid by the member states for the impossibility of collective retreat. Yet to suggest that, therefore, the euro will continue supposes that the inviolability of the euro for Germany has been demonstrated by the crisis when it is not at all clear that this is the case. Certainly, the German government chose to maintain the euro in May 2010. But, as the exposure of German banks to the periphery has lessened, German terms of support for maintaining the euro have become tougher. German terms for financial support for the ESM are conditional, despite the strong gap between the potential call on the ESM and German parameters. Most consequently, virtually all the moves made by the German government after the 28-29 June 2012 summit have been away from debt mutualisation and towards pushing liability for unsustainable debt on to national actors. It is not simply that German interests are now less bound to the periphery than they were at the beginning of the crisis that is especially significant; it is that it is German policy that has produced that outcome. If the German government is so committed to the credibility of the euro that it will not contemplate its failure and will make muddling through compromises to maintain a monetary union it knows is flawed, it has yet to prove this in action.

Of course, this argument leaves unasked the question of why economically the German government would be willing to leave the euro. After all, Germany's economic interests appear to have been well served by the euro since the middle of the last decade. Why, many ask, would Germany wish to return to a DM that would be under constant upward pressure against other European currencies when Germany is so dependent on exports to the rest of the euro zone (Reisenbichler and Morgan, 2013)? However, while important, this question risks missing the implications of German structural monetary power both in the present euro zone and a possible monetary order beyond it. The monetary union from which Germany benefitted,

most significantly between 2005 and 2008, no longer exists. The crisis has recreated German structural monetary power in the bond markets and the low interest rates in the periphery that supported high demand for German exports in those economies have disappeared. The retreat of capital from the periphery has taken with it any meaningful singular monetary policy within the euro zone beyond the nominal rate set in Frankfurt. Meanwhile, in any post-euro zone European monetary order structural German monetary power would entail that, after the initial inevitable devaluation, other states would still have a strong incentive to try to pursue exchange rate stability with Germany to keep the interest rate spread down. Prior to monetary union, the other ERM states were not looking to devalue their currencies against the DM. Indeed, they were looking to the Bundesbank to help them prevent devaluation; yet, when support mattered most during the 1992-93 crisis, it did not come. The German record is not to avoid devaluations of other currencies at all cost, but to insist that it must have monetary decisions made on its own terms. This line of analysis does not necessarily predict that Germany will leave the euro. German politicians may indeed come to the conclusion that they have invested too much credibility in the project to retreat, or that the economic calculus of costs and benefits still favours monetary union. It is, though, to argue that there is nothing either in Germany's approach to European monetary matters since the late Bretton Woods era, or the way it has responded to the crisis thus far, that suggests that the German commitment to monetary union is inviolable. The through line in German policy is simply the insistence that it must monetarily decide for itself, and that allows for the possibility of euro exit.

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