Germany's Role in Crafting a Solution to the 2010 EMU Sovereign Debt Crisis: Persuading with Power or the Power of Persuasion?

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Abstract:

The sovereign debt crisis that shook the euro zone and took the Brussels-based policy elites by surprise in 2010 was in many ways the logical consequence of the global financial crisis which started in the US housing market in 2007. The euro crisis has raised serious questions as to the original design and long-term viability of Europe's Economic and Monetary Union (EMU) as it was originally constructed in Maastricht in December 1991. Throughout 2010, Europe's heads of state and their finance ministers cobbled together various ad hoc bail-out responses, first to solve the pending Greek default in the spring of 2010, and then to stave off Irish default in the autumn. In order to prevent Portugal, Spain, Italy, and others from falling down the same cliff, Germany and France agreed on a "permanent mechanism" to deal with future crises, to be formally approved in a European Council meeting in March 2011.

This paper argues that – even though there were at least five crisis "narratives" of what had gone wrong with the euro zone and how it could be fixed – Germany's narrative would ultimately prevail and German *ordoliberal* ideas rather than French-Mediterranean *Keynesian* ideas will inform the future institutional structure of the EMU. The paper argues that Germany's stance prevailed in 2010 and 2011 because of the persuasive power of its economic ideas, rather than because of Germany's abuse of its all-powerful position as Europe's largest and most dynamic economy to push through reforms to serve their own national interests. The paper concludes that the German position is inherently unsustainable, however, but likely to prevail during the medium-term, forcing Europe on yet another lengthy period of austerity. In that sense, there is a German problem again, but not for the reasons most people believe.

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The German question never dies. Instead, like a flu virus, it mutates. (The Economist)[1]

If any good can come out of the Irish disaster it is via the realisation that the classic German perspective on the problems of the eurozone is mistaken. Any currency union among diverse economies is bound to be a risky venture. But, with mistaken ideas about how it should work, it may prove calamitous. (Martin Wolf)[2]

1. Introduction: Crisis and Uncertainty in 2008-2010. What Happened?

The story of the 2008 global financial crisis is well known by now. It all started with the bursting of the mortgage debt bubble in the U.S. housing market in 2007. Once it was clear how a "global inverted pyramid of household and bank debt" was built on a narrow range of feeble American sub-prime mortgages, the "debt balloon started to deflate, at first slowly, [but] ultimately with devastating speed."[3] Banks soon stopped lending, both to each other and to their private customers, which caused a credit crunch in early 2008 and put an astonishing amount of pressure on the financial sector.

Bear Stearns all but collapsed in March 2008, and was rescued by JP Morgan Chase, which was only convinced to buy the bank because of U.S. government support. By the summer of 2008 commodity prices started to fall and giant American mortgage lenders Fannie Mae and Freddie Mac were taken into public ownership.[4] These events were part of the run up to the mindboggling events of September 2008, when the world economy was at the edge of the abyss and flirted with total collapse: Lehman Brothers fell down, Merrill Lynch narrowly avoided bankruptcy by dissolving into Bank of America, and big banks all over the world had to be

[1] The Economist, "Will Germany now take centre stage?" 21 October 2010
[2] Martin Wolf, "Ireland upends the German perspective on the eurozone," *Financial Times*, 24 November 2010
[3] Robert Skidelsky, *Keynes: The Return of the Master*, London: Allen Lane, 2009, p. 4
[4] Ibid., pp. 4-5

rescued by their governments, all in the midst of a U.S. presidential campaign. Stock markets plunged, and the financial crisis soon translated into a massive slide of the real economy, leading to falling output levels, rapidly increasing unemployment, and increasing savings resulting in a Keynesian liquidity trap.

Talk of a new Great Depression was rife in the world's major capitals. Only one thing was certain in the midst of the chaos: governments had to step in to rescue their banking systems and guarantee most of the deposits in those banks if they were to avoid an accelerated slide into a certain Great Depression. Central banks slashed interest rates to close to zero, and governments – in haste – put together fiscal stimulus packages of a magnitude unprecedented in peacetime. However, the world would be unable to avoid its first global contraction in output since World War II. The world economy shrank 1.1 percent in 2009, according to the IMF: the advanced economies contracted by 3.4 percent on an annual basis, while emerging and developing economies grew at a scant 1.7 percent in 2009.[5] While it did steer clear of another Great Depression, the world was definitely grappling with a "Great Recession" and a fierce debate over what had caused the dramatic series of events leading up to it quickly entered into full swing.

The initial focus of the financial crisis during the autumn of 2008 was on those countries with heavily developed and exposed financial sectors, mainly the United States and the United Kingdom. There was even some veiled *schadenfreude* in Continental Europe at the time, with economic and political elites in Paris and Berlin to some extent feeling vindicated. In their minds the crisis was laying bare all the shortcomings of the Anglo-Saxon model of financialized capitalism. In Britain, there was even brief talk of the missed opportunity of not having joined

[5] IMF, *World Economic Outlook – Sustaining the Recovery*, Washington, DC: IMF, October 2009, p. 169

Europe's Economic and Monetary Union in the late 1990s.[6] However, not for long: the crisis had quickly spread from the United States to Continental Europe and to the rest of the developed and developing world. In order to stem wholesale financial collapse, all advanced industrial states of the euro zone had passed unprecedented bailouts of their financial sectors and passed fiscal stimulus plans to stop the slide in the real economy. By mid-2009 it was clear that many governments in Europe – with the Southern European countries around the Mediterranean and Ireland in front (the PIIGS)[7] – faced the consequences of a fiscal triple whammy. A collapse in government revenue due to the recession, a fast increase in spending due to rising unemployment and large stimulus bills, and the extra cost of taking on all the toxic private debt on the public sector balance sheet translated into ballooning budget deficits and sovereign debt.

As Carmen Reinhart and Kenneth Rogoff remind us in their latest book, we should not be surprised that financial crises often lead to fiscal and sovereign debt crises.[8] Yet, the financial markets somehow did seem surprised that governments, after having bailed out their financial sectors with an unmatched infusion of public money, found themselves with all the bad debt they had taken on from those private sectors. And as the initial focus of financial market participants shifted from private debt in 2008-2009 to sovereign debt in 2010, concerns about the long-term fiscal solvency of Europe's periphery led to the collapse of confidence in PIIGS bonds and subsequent capital flight to safety. Bond traders sold risky Mediterranean sovereign debt and purchased perceived risk-free assets such as German *Bunds* and United States *Treasuries*. This led to a highly fluctuating euro-dollar exchange rate (figure 1, appendix) and widening sovereign

[6] Author interviews in London in October and November 2008
[7] Those countries were soon dubbed the "PIIGS" (Portugal, Italy, Ireland, Greece, and Spain)
[8] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009)

debt yield spreads (figure 2, appendix) within the Europe. Now, it was the rescuers who were in need of rescuing.

Just like with the global financial crisis in 2008, there were multiple competing explanations or crisis narratives as to what caused the EMU sovereign debt crisis of 2010. The purpose of this paper is to explore those multiple competing narratives, weigh their respective merits, and explain why certain explanations and economic ideas won out over others, using a constructivist theoretical approach. I will argue in this paper that – even though there were at least five crisis "narratives" of what had gone wrong with the euro zone and how it could be fixed – Germany's narrative would ultimately prevail and German *ordoliberal* ideas rather than French-Mediterranean *Keynesian* ideas will inform the future institutional structure of the EMU. The paper argues that Germany's stance prevailed in 2010 and 2011 because of the persuasive power of its economic ideas, rather than because of Germany's abuse of its all-powerful position as Europe's largest and most dynamic economy to push through reforms to serve their own national interests. This outcome will determine how the euro zone will be managed in the medium-term future.

The next section will examine the five competing narratives of the 2010 EMU sovereign debt crisis. Section three will briefly lay out the constructivist theoretical framework that will be used in analyzing why certain ideas win out over others during periods of uncertainty, and explain why other, more "standard" explanations of political economy do not work as well in the case of the EMU crisis of 2010. Section four will review the European decision-making process during the Greek and Irish bail-outs in 2010, looking at whether the outcome of that process was decided by German power, by EU institutions, or by the power of German economic ideas. Section five will look at whether the current solution to the EMU sovereign debt crisis is sustainable. Section six will draw the conclusions of this paper.

2. What Kind of Crisis Was This? Competing Narratives.

Once it was clear by the summer of 2010 that the EMU sovereign debt woes were not going to be limited to tiny Greece, multiple explanations emerged on what had caused the crisis in the first place. Some people argued that this was a crisis of design since Europe was not an optimum currency area, and had it coming all along. Others pointed to the high fiscal deficits and debt-to-GDP ratios in Europe's peripheral countries, pointing out its un-sustainability given its ageing populations. There were those who saw 2010 mainly as a crisis of competitiveness where slow, anemic and economic reform-resistant Southern Europe could no longer pretend to compete on an equal footing with a flexible, productive and fast-growing Northern Europe; and there were those who thought it was all due to integrated European capital markets and too high German savings, arguing that goods markets adjusted to capital flows and not vice versa. A minority view blamed inefficient financial markets and intra-European bond yield convergence hard to justify given the economic fundamentals of some countries. In this section, I will examine those competing crisis narratives one by one.

The first explanation of the EMU sovereign debt crisis is Martin Feldstein's view (probably shared by Milton Friedman if he were still alive) that this was a crisis of institutional design. The EMU of the original twelve EU members that introduced the euro in 2002 never was and never will be an optimum currency area (OCA), so they had it coming all along.[9] No monetary union has ever survived without a fiscal union, which would be needed in the case of asymmetric shocks, and thus political union. Furthermore, there is insufficient business cycle convergence, too little labor market mobility in EMU, while product and labor markets remain relatively rigid in Southern Europe compared to Northern Europe. In order to counter the OCA theorists, the European Commission put forward its theory of “endogeneity” in the 1990s, arguing that – theoretically – a currency union could be expected to increase trade and financial integration by a decrease in transaction costs and the elimination of exchange rate risk. Thus, increased trade and financial integration should lead to greater business cycle convergence, and thus a greater suitability of the participating countries for a currency union. This endogeneity thesis seems to have been overly optimistic, with the benefit of hindsight, if not dangerous, according to the first view, since it confused European dreams with reality.[10]

The second explanation, partly associated with the German policy elite view, is that this is a budgetary or fiscal crisis. The Stability and Growth Pact (SGP), building on the Maastricht ‘convergence criteria’ to join EMU, was far from “stupid” – as Romano Prodi once called it – but rather a good idea. The European Council’s trumping the European Commission’s power over a looming ‘excessive deficit procedure’ for France and Germany gave the green light for other members to do the same thing. Ignoring the SGP in 2003 as the Council of Ministers did thus let the genie out of the bottle, setting a dangerous precedent for smaller, peripheral countries that their fiscal profligacy would go unpunished. The result was widening public sector borrowing, and increased public spending, facilitated by an accommodating financial

[9] For theories of Optimum Currency Areas, see Mundell (1959), Kenen (1994) and McKinnon (2004)
[10] M. Feldstein, “The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability,” *The Journal of Economic Perspectives* 11 (4), Autumn 1997, pp. 23-42

environment (low interest rates) which made borrowing cheap and apparently low risk. Especially Southern European countries took advantage of the historically low interest rates – courtesy of Germany – to go on a public spending spree (see figures 3, 4, 5 and 6 in the appendix). Once the financial sector collapsed and needed a bail out in 2008, many governments, who were already deeply overleveraged, had to go deeper into debt to save their financial systems. This was in many ways the German nightmare scenario of the early 1990s: other EU members would free ride on German credibility and be able to borrow cheaply, hence undermining the credibility of the euro zone as a whole.

The third explanation – the flip side of the German policy elite view – is that this is a crisis of competitiveness in Southern Europe. North-South divisions widened after the euro launch in 1999, with labor costs widening and total factor productivity divergences pricing Mediterranean goods and services out of the European market. As the economies of Southern Europe and Ireland were booming in the early 2000s, wages tended to grow faster in those countries compared to their trade partners, especially Germany. The persistence of growth and inflation differentials across the EMU have therefore led to diverging movements in international competitiveness and strong trade imbalances within the euro area. Especially vis-à-vis Germany, real appreciations in the PIIGS countries led to their current account deficits (see figures 7, 8 and 9 in the appendix). In this view, Germany is more competitive than the rest of Europe because of the painful reforms enacted under the Schröder governments in the early 2000s, wage restraint and high productivity.[11] The introduction of the euro in 1999 took away all incentive in Southern

[11] Schoeder's program was called Agenda 2010 – his reforms were continued by Angela Merkel's 'Grand Coalition' in 2005.

Europe to continue structural reforms, hence leading them to continue along their old bad ways, this narrative goes.

The fourth explanation – the *Financial Times* columnist Martin Wolf view – is that this is a crisis of intra-European macroeconomic imbalances. Initial bond spreads in the 1990s allowed financial market participants to buy higher yield Mediterranean bonds and sell their lower yield Northern European bonds. This flooded Southern European countries with capital, fueling a cycle of housing booms and consumer spending, causing their current accounts (and goods markets) to adjust. The evidence for this view seems overwhelming. According to Eurostat, while Germany's trade surplus with the rest of the EU was €46.4 billion in 2000, it had grown to €126.5 billion in 2007. Looking at the evolution of Germany's bilateral trade surpluses with the Mediterranean countries, between 2000 and 2007 Greece's annual deficit with Germany grew from €3 billion to €5.5 billion, Spain's almost tripled from €11 billion to €27.2 billion, Italy's doubled from €9.6 billion to €19.6 billion, and Portugal's quadrupled from €1 billion to €4.2 billion.[12] Similarly, a recent IMF working paper by Claire Waysand, Kevin Ross, and John de Guzman on "European Financial Linkages" reveals Germany and France to be the two biggest net creditors within the Eurozone in 2008 with intra-Eurozone net investment positions of +€735 and +€764 billion respectively, the exact mirror image of Portugal (–€136 billion), Greece (–€199 billion), Italy (–€334 billion) and Spain (–€794 billion).[13] So, it was the capital flows that attended nominal interest rate convergence in the late 1990s and early 2000s that caused the

[12] Eurostat, *External and intra-EU trade – Statistical Yearbook (Data 1958-2009)*, Brussels: European Commission, 2010, p. 145
[13] C. Waysand, K. Ross, and J. de Guzman, "European Financial Linkages: A New Look at Imbalances," *IMF Working Paper*, WP/10/205, Washington, DC: December 2010

current account divergences across Europe.[14] We thus need to look at private capital flows and private debt in order to understand the EMU crisis. Since one country's capital inflows are another's capital outflows, the Eurozone cannot as a whole become more like Germany: since EMU members indirectly share liability for private sector debt, the SGP would have to be complemented with an ESP ("External Stability Pact"), according to this view.

The fifth explanation, often ignored in the existing literature, is that this was a crisis of "efficient" financial markets. Interest rate convergence happened while financial markets were asleep: the EMU crisis would have never happened if financial markets had "correctly" priced the sovereign debt holdings of different European countries. As Jacob Kirkegaard from the Peterson Institute for International Economics has argued, the current high yields for certain countries mean a return back to "normal" as deficient policies are now met with instant default premiums. According to this view, governments should think twice before they try to please the markets: austerity as a response to spiraling debt is likely to make matters worse in the short run. If it is true that financial markets tend to under price risk during economic booms and over price it during recessions, why should we trust them next time?

3. Theoretical Framework: The Central Role of Ideas during Crises

Five different crisis narratives – some of which can be combined – imply five different crisis solutions. The main question is what factors ultimately determined which view would prevail during European economic decision-making in 2010 and 2011? Before I answer this question in

[14] To quote Professor Erik Jones of the SAIS Bologna Center: "contrary to the rule of thumb used in international economics, goods markets accommodated, capital markets cleared first."

the next section, I will first take a brief step back in this section to discuss the "constructivist" theoretical framework which I used to analyze the EMU sovereign debt crisis, highlighting the central role of economic ideas during periods of uncertainty, which are needed in addition to the more standard "material" and "interest-based coalition" approaches I discuss first.

a. Materialist and Interest-Coalition Approaches

There are several important lines of analysis that have been developed to explain continuity and change in European economic policymaking. The key claims of two competing approaches suffice for the purposes of this paper: structural or "materialist" approaches and coalition or "interest group" approaches. This paper will be framed within a theoretical school that could be characterized as a "punctuated evolution" model.

The structural or "materialist" approach is a particularly influential strand in the literature. This approach looks at the impact of an integrating world economy on economic policymaking. According to these structural explanations, it is "globalization" – the increased intensity of international trade, capital, and information flows – that drives a government's economic policy decisions. Helen Milner and Robert Keohane spell out three pathways by which changes in the world economy have altered domestic politics over time: by creating new policy preferences and coalitions, by triggering domestic economic crises, and by undermining government control over macroeconomic policy.[15] Jeffry Frieden and Ronald Rogowski argue that the sheer magnitude of international exchange flows have affected policies in virtually every country, as evidenced in

[15] R. Keohane and H. Milner (eds.) *Internationalization and Domestic Politics*, Cambridge: Cambridge University Press, 1996, pp. 243-258

the "widespread repudiation of tax, regulatory and macroeconomic policies that inhibit international competitiveness."[16]

This literature emphasizes the importance of exogenous international shocks, such as the oil shocks in the 1970s or the liberalization of capital markets in the 1980s. One of the problems with this line of thinking is that the effect of the policy under discussion often precedes the supposed cause. For example, the liberalization of financial markets in Britain (or so-called "big bang") did not trigger the Thatcherite experiment: it only happened in 1986, when Thatcher's neoliberal policies were already well under way. Also, if one were to take materialist theories at face value they would point the way towards a convergence in national economic policies and institutions. Of course, one only needs to take a quick look to see the vast diversity in political economic arrangements all over Western Europe and North America.

The second approach, that of coalition and interest group theories, seeks to explain how political alliances are formed and uses these alliances to explain the occurrence of continuity or change. In this view, political actors are driven by a desire to maximize their income share of the national (or European) economy, and coalitions emerge as a result of the tendency of socioeconomic groups to pursue their economic interests. Politicians are seen as the translators of societal pressures into policy choices. These politicians, however, do not play any major independent role in the process.[17] The alliance choices of political actors are instead seen as predetermined by their respective positions in the international and domestic political economies. Therefore, the coalitions that eventually emerge in each country are the result of the particular economic logic

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[16] J. Frieden and R. Rogowski, "The Impact of the International Economy on National Policies: An Analytical Overview," in Keohane and Milner (eds.) *Internationalization and Domestic Politics*, p. 25
[17] S. Berman, *The Social Democratic Moment*, Cambridge: Harvard University Press, 1998, p. 202

in that country at the time. For example, Gourevitch and Rogowski argue that the political alliances formed during the Great Depression of the 1930s were held together by shared economic goals and interests.[18] In this domestic interest view, collective ideas are simply those notions put forward by the most powerful groups or individuals. If you push this to the extreme, ideas have, in Jeffrey Legro's words, "no power to constrain groups, let alone constitute their interests."[19] In other words, according to this theory, understanding radical change in a country's or region's economic policy framework is a matter of understanding first how the relative power and interests of smaller groups within the state either shift or endure. New ideas are brought to the forefront by the rise and fall of these interest groups.

Interest group theory explanations can be summarized in the framework developed by Jeffrey Frieden. His framework aims to identify the distributional consequences of increased international capital mobility, arguing that the intensified pace of capital flows across national borders has produced new sources of harmony and friction over how national economic policy is shaped. Tension arises between internationally oriented investors and firms on the one hand and domestically oriented ones on the other.[20] These cleavages eventually play out in the policy arena, and the winning coalition is eventually able to convince the national government to pursue a specific economic policy agenda.[21] This type of argument attributes the adoption of certain

[18] P. Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crisis*, Ithaca: Cornell University Press, 1986 and R. Rogowski, *Commerce and Coalitions: How Trade Affects Domestic Political Alignments*, Princeton: Princeton University Press, 1989

[19] J. Legro, *Rethinking the World: Great Power Strategies and International Order*, Ithaca: Cornell University Press, 2005, p. 45

[20] J. Frieden, "Invested Interests: the politics of national economic policies in a world of global finance," *International Organization* 45 (4), autumn 1991, pp. 425-451

[21] K. McNamara, *The Currency of Ideas*, Ithaca: Cornell University Press, 1999, pp. 32-4

economic models and policies to the pressures of powerful economic interests, which can alter due to the changing nature of the global economy.[22]

The problem with coalition and interest group theories, as I argue later in the next subsection, is that economic and political interests are not directly perceived by political actors. Rather, these interests are perceived through the lens of the existing ideologies in different historical settings. What coalition and interest group theories cannot explain is what brings about the development let alone the change in interest perceptions in the first place.

b. Constructivist Explanations

Faced with a crisis, a policymaker will either turn to established rules of the game for direction or engage in radical reform. When it comes to economic policymaking this choice between continuity and change is fundamental, and yet fundamentally uncertain. While continuity entails using longstanding mechanisms to address economic problems, change introduces innovative ideas that establish new norms.

In my book, *Ideas and Economic Crises in Britain from Attlee to Blair*, I problematized the notion of economic crises as self-apparent and material phenomena.[23] Building on the work of Mark Blyth and Colin Hay, I argued that we need to look at crises as political constructions that require decisive interventions.[24] During the social construction of a crisis, the movement of the

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[22] K. Sikkink, *Ideas and Institutions: Developmentalism in Brazil and Argentina*, Ithaca: Cornell University Press, 1991, p. 7

[23] Matthias Matthijs, *Ideas and Economic Crises in Britain from Attlee to Blair (1945-2005)*, New York: Routledge, 2010

[24] See C. Hay, "Crisis and the structural transformation of the state: interrogating the process of change," *British Journal of Politics and International Relations* 1 (3), October 1999; and M. Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*, Cambridge: Cambridge University Press, 2002

data by itself is not always as important as the "narration" of the movement in the data. What exactly defines whether a moment in time constitutes a crisis in need of a decisive intervention is delimited by the stock of available economic ideas. And here, it would be wrong to see economic ideas as mere technical knowledge or a simple correspondence theory of the world. Rather, they are seen as what one could call "simplifying devices" politicians use in moments of uncertainty to define "what exactly has gone wrong" and "what to do in order to fix it."

Thus at the center of my analysis is the concept of economic "crisis," and how it is experienced, narrated, and explained by the different parts of the political elite to the society at large. I have argued that the ability of political actors to construct a convincing narrative of the causes of a crisis is of critical significance and ultimately shapes their capacity to change prevailing popular and elite views of the political and economic context. If political entrepreneurs prove successful in doing exactly that – i.e. persuade a sufficient majority of the merits of their solutions out of an economic or political impasse – they will create the necessary conditions for a change in the pre-existing institutional arrangement.

4. Crafting a Common European Response to the 2010 Sovereign Debt Crisis: Powering, Puzzling or Persuading?

The five different explanations of the 2010 EMU crisis I discussed in section two of this paper are all plausible to some extent and probably should all be addressed if the euro zone wants to emerge stronger out of its current shambles and avoid a similar crisis in the future. However, as is always the case, some explanations are more plausible than others. There is no doubt that

Greece and Portugal suffered from more chronically weak public finances, while Spain and Ireland had very healthy fiscal positions for the past ten years, but saw their booms being financed with unsustainable inflows of private capital. The competitiveness argument applies to the whole Mediterranean, but definitely not to Ireland.

Given the environment of high uncertainty, the crisis narrative is just as important as the objective facts themselves, and to understand the solution to the crisis, we need to look at how the European Union has responded in 2010 and which economic ideas have informed those decisions and why. Throughout the spring of 2010, there was constant tension on how to solve the crisis between two opposing camps. On the one hand there was what I call a "French-Mediterranean" *Keynesian* view which emphasized growth, a European economic government, the need to avoid IMF involvement at all cost, and arguing that similar crises in the future should always be solved by political actors. On the other hand, there was the 'German' *Ordoliberal* view, which emphasized price stability and national fiscal discipline, the need for IMF conditionality and technical assistance for any bail-out, and quasi-automatic rules to deal with similar crises in the future.

The Greek crisis was finally solved with an EU rescue package in May 2010 after months of uncoordinated and fragmented crisis meetings at the European level. Angela Merkel was the central person in those meetings, and she stated before that she would resist turning the euro zone from an economic and monetary union into a "transfer union."[25] On 9 May 2010, a rescue package of €750 billion was put together by all 27 member states of the European Union and the

[25] A. Merkel, "Die Währungsunion ist eine Schicksalgemeinschaft," Statement made in the German Parliament, the *Bundestag*, on 19 May 2010, printed in: Das Parlament. Debatten Dokumentation.

International Monetary Fund. The rescue plan consisted of €440 billion euro zone-backed loan guarantees for stricken euro zone members raised by a newly created (and AAA rated) European Financial Stability Facility (EFSF); a European Union balance of payment facility totalling €60 billion to raise debt by the European Commission using the EU budget as collateral; and €250 billion loans from the International Monetary Fund. Furthermore, the ECB promised to intervene in public and private debt markets, and take extra measures to boost euro zone bank liquidity.

Furthermore, during the European Council meeting in Brussels in late October 2010, in the midst of the Irish crisis, the EU heads of state agreed to amend the Lisbon Treaty in three significant ways. First, the EU would create a new macro-economic surveillance network to detect emerging imbalances and risks, including divergences in competitiveness. Second, EU leaders agreed to strengthen national governments' fiscal responsibility under a stronger Stability and Growth Pact: from now on, progressive sanctions may kick in earlier in the budgetary surveillance process, and public debt will also be taken into account, alongside the existing deficit criterion, in determining whether EMU members are abiding by the rules. Third, the establishment of a permanent crisis mechanism was proposed to safeguard the financial stability of the euro area. EU Council President Herman Van Rompuy committed himself to open consultations with the member states on a limited treaty change required to establish such a mechanism. The final deal is supposed to be sealed during a special European Council meeting in March 2011.

In many ways, it is remarkable how the two main "German" explanations of the crisis – fiscal profligacy combined with a lack of competitiveness – have informed European decision making in 2010. The establishment of the EFSF as well as the German demand for "amending" the

Lisbon Treaty meant that the German view of fiscal austerity would prevail, even though this hardly solves all the problems. Why the German view prevailed can be analyzed from the classic "interests, institutions, ideas" troika.

Many observers, especially in the financial press, have concluded that Germany was "powering" its way through European Council meetings and using its influential position of economic strength to bully its European partners. From that point of view, the German problem – dormant for sixty years – is back with a vengeance, and a new generation of German leaders, with no sense of historic guilt for World War II, sees their country as a "normal" country with legitimate domestic and national interests. German solidarity with the European Union thus has its limits and the current crisis is nothing more than the country finally flexing its economic muscle. As tempting as this explanation may be, the reality is much more complicated than that. As is clear from the minutes of European Council meetings, Germany does not "run Europe" or impose its will on its fellow euro zone members – like some kind of *Diktat* from Berlin. Rather, it uses its powerful position as Europe's "indispensable economy" to persuade their European partners during the decision-making process of puzzling a solution together that their ideas are ultimately the right ones. The fact that their economy had seen the fastest quarter-on-quarter economic growth in 2010 since reunification and that business confidence in the country was at record highs obviously only strengthened the German view that their anti-Keynesian austerity approach to their domestic economy had been right along.[26]

As both the *Wall Street Journal* and the *Financial Times* reported this year, the initial European crisis solution was "puzzled" together in a series of messy, panicky meetings at the level of the

[26] As Sheri Berman argued in a Georgetown workshop paper in December 2010, "the German Sonderweg."

euro zone's finance ministers in Washington and Brussels during the spring of 2010.[27] Those accounts would seem to suggest that the final outcome to the Greek crisis in May 2010 was a careful compromise between the major European players with help from the IMF and the Americans. It also shows that the EU bureaucracy works quite well, given their lack of experience in dealing with real time financial crises. In other words: the institutional response in Brussels to the sovereign debt crisis set in motion by a series of meetings at the EU level, cobbled together the solution. But the Maastricht Treaty did not have an instruction sheet on how to deal with the crisis, given the no bail out clause. In other words, existing European institutions were unable to deal with the sovereign debt crisis. It was simply not in the script. So, in order to explain the outcome of the crisis, EU institutions have been a facilitator at best. And Germany still seems to be the "linchpin" part of the jigsaw puzzle, without which any solution would have been elusive.

I would argue that Germany had the most convincing crisis narrative. Of course, the Germans are all too aware that their own well-being is bound up with the fate of the euro. But, even more so, the euro zone's fate is bound up with Germany. And given Germany's banks' heavy exposure to Greek, Irish, Portuguese and Spanish bonds – and the calamity its default would cause to the German economy – Germany saved Greece and Ireland partly to save itself, just as it is likely to save other EMU members. In the case of Greece, Germany did so against huge popular discontent at home, where the German voters seemed to assume that they were paying the bill for

[27] See the *Financial Times*' three-part series by Tony Barber: (1) The euro: Dinner on the edge of the abyss (10 October 2010); (2) Saving the euro: Tall ambition, flawed foundations (11 October 2010); (3) Saving the euro: Bound towards a tense future (12 October 2010). (London: Financial Times). Also, see the *Wall Street Journal*'s two-part series by Marcus Walker, Charles Forelle and Brian Blackstone: (1) On the Secret Committee to Save the Euro, a Dangerous Divide (24 September 2010); (2) Currency Union Teetering: 'Mr. Euro' Is Forced to Act (27 September 2010). (New York: The Wall Street Journal)

a Mediterranean party they were never invited to. So, naturally, without strict conditions on profligate states and the imposition of losses on risk-happy creditors, all other EMU members would be taking free rides on Germany. Even though critics rightly pointed out that a formal debt restructuring mechanism would raise the cost of borrowing in the PIIGS countries and frighten already skittish markets in the short term, once Angela Merkel convinced Nicolas Sarkozy that Germany had the better argument, the others could not do anything else but grudgingly agree.

5. The Limits to the German Response in Europe: Restoring (G)local Imbalances in the G20 and Europe's EMU

However, the point remains that the current EU proposals for a formal debt restructuring mechanism might go a long way to calm the markets in the short term; they do not solve many of the crisis' fundamental and underlying problems. In the case of Ireland for example, it is hard to understand why a fiscally sound country which had slashed public spending and public sector wages in response to the 2008 financial crisis could solve a banking crisis with more austerity measures. Yet, that is what they have to do. It is simply impossible for the rest of Europe to become more like Germany if the whole point is that Germany could only be Germany because the others were not. Any current account surplus means that another country has a current account deficit. If Germany wants the euro zone as a whole to become more like Germany, this would only exacerbate the existing global macroeconomic imbalances.

It is interesting how the 2008 global financial crisis and the 2010 EMU sovereign debt crisis saw two dormant economic powers rise to the fore in the battle for economic ideas: China in the G-20 and Germany in the European Union. This has been a long time in the making – at least for twenty years – and the similarities between both countries' positions are striking. China and Germany have both always been skeptics of the Anglo-Saxon model of short-term finance capitalism, and their economic models – based on robust export growth and long term investment in the real economy (read manufacturing) – have weathered the financial storm of the past three years remarkably well. What matters here is not so much the real data in both economies – even though impressive if you choose the right indicators – but the perceptions of the policy elites in both countries which have them convinced that they had it right all along.[28]

At the heart of the global financial crisis is the emergence over the past ten years of so-called "global macroeconomic imbalances." Ever since Guido Mantega, Brazil's Finance Minister, commented in Sao Paulo in late September 2010 that "we are in the midst of an international currency war," the focus of most analysts shifted from praising the G-20's efforts at international cooperation to growing tensions and fault lines between the institution's main protagonists China and the United States.

The central issue is whether the main cause of the world's macroeconomic imbalances – a large US current account deficit and large current account surpluses in China, Japan and Germany – is a global savings glut in Europe and Asia, or deficient savings and too loose monetary policy in the United States. Recent developments only seem to make a bad situation worse: the United States claims that China is prolonging and worsening global imbalances by deliberately keeping its currency, the renminbi, undervalued vis-à-vis the dollar, while the Chinese point to the US

[28] There is no doubt that the German banking sector faces serious problems and that its exports were fuelled by easy money in Europe's periphery. Compared to Germany, the Chinese economy's challenges seem enormous, with a risk of inflation and the effects of an ageing population just the top of the iceberg.

Federal Reserve's fresh round of quantitative easing (a policy Wolfgang Schäuble, Germany's Finance Minster, has called "clueless"), which pushes down long term interest rates and fuels speculative capital flows into the emerging markets, forcing them to respond with short-term protectionist measures. China argues the US should take austerity measures while the US argues that China should stimulate domestic demand and allow its currency to float. Since there was no agreement reached during the recent G-20 meeting in Seoul on how exactly to deal with global imbalances, apart from vague commitments to "mutual assessment processes," this has reinforced the sense of malaise in the global economy.

All comparisons are flawed, but without too much of a stretch of the imagination, you can see a mini-version of the global economic scene being played out within the euro zone, with "competitive" export-led Germany playing the role of China and the "profligate" spendthrift Mediterranean countries of Greece, Portugal, Spain and Italy, as well as former Celtic "Tiger" Ireland, playing the role of the United States.

The euro lesson for the world economy – and the G-20 – is clear. If the world wants to avoid another 2008-style debacle, the ideological debate needs to change as much as the fiscal parameters. If the US slashes its own budget deficit and stops quantitative easing, as the Chinese are suggesting, we risk deflation on the global level. If the EU periphery is forced to constrict, then we compound the global error on the local level. China, just like Germany in Europe, will need to respond to fiscal austerity abroad with an accommodating demand stimulus at home, and allow other countries to rebalance their economies, especially their trade balances. Europe is the meso-level compliment to the macro-level problem of the world economy. And while the first one is acknowledged, the second one does not even seem to register; at least not in Brussels, and definitely not in Berlin.

6. Conclusion

This paper has argued that, even though there were at least five crisis "narratives" of what had gone wrong with the euro zone and how it could be fixed in 2010, Germany's narrative would ultimately prevail and German *ordoliberal* ideas rather than French-Mediterranean *Keynesian* ideas would inform the future institutional structure of the EMU. I argued that Germany's stance prevailed in 2010 and 2011 because of the persuasive power of its economic ideas, rather than because of Germany's abuse of its all-powerful position as Europe's largest and most dynamic economy to push through reforms to serve their own national interests.

The paper concludes that the German position is inherently unsustainable, however, but likely to prevail during the medium-term, forcing Europe on yet another lengthy period of austerity. In that sense, there is a German problem again, but not for the reasons most people believe.

Bibliography

<To be added – most references are in footnotes already>

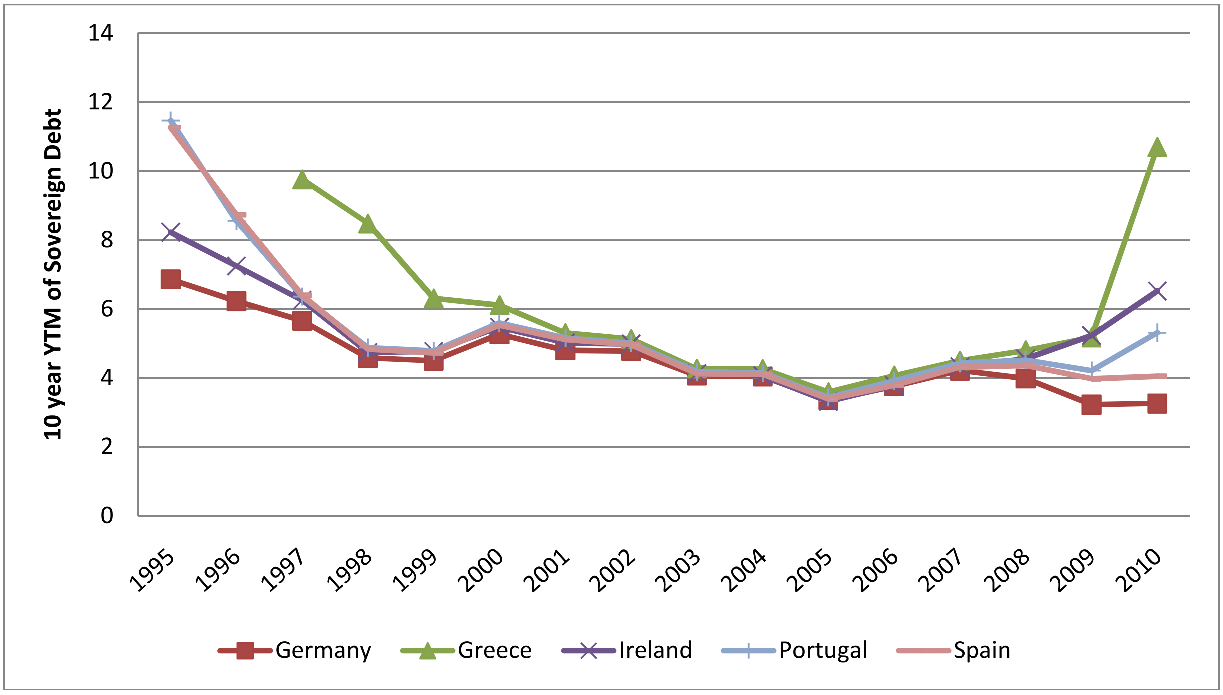
Appendix

Figure 1: The Euro-Dollar Exchange Rate and Bloomberg European Composite Stock Market Index (December 2009-October 2010)

Blue: EUR/USD exchange rate
Red: Bloomberg European Composite Index

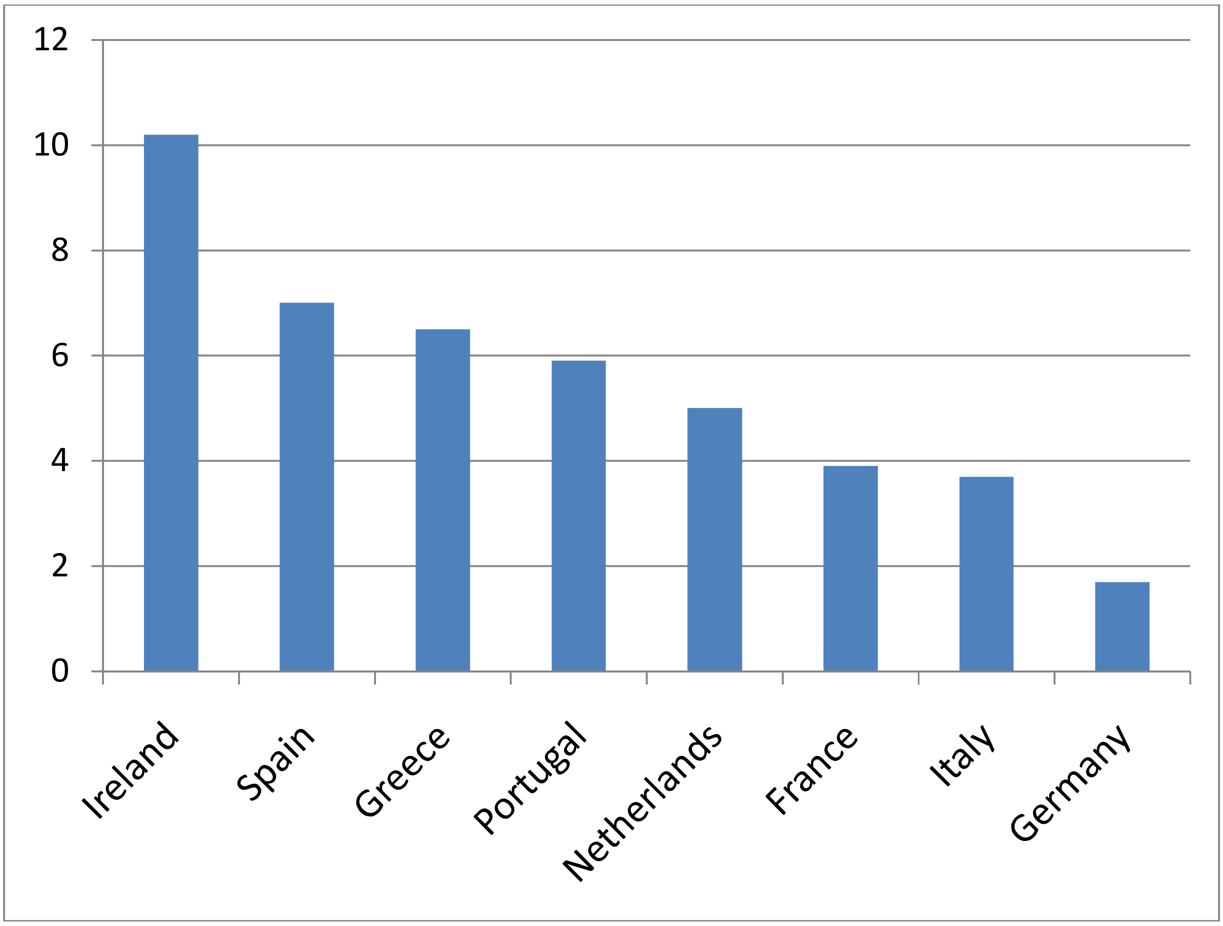
Source: Bloomberg

Figure 2: European 10 Year Government Bond Spreads (1995-2010): Selected Countries



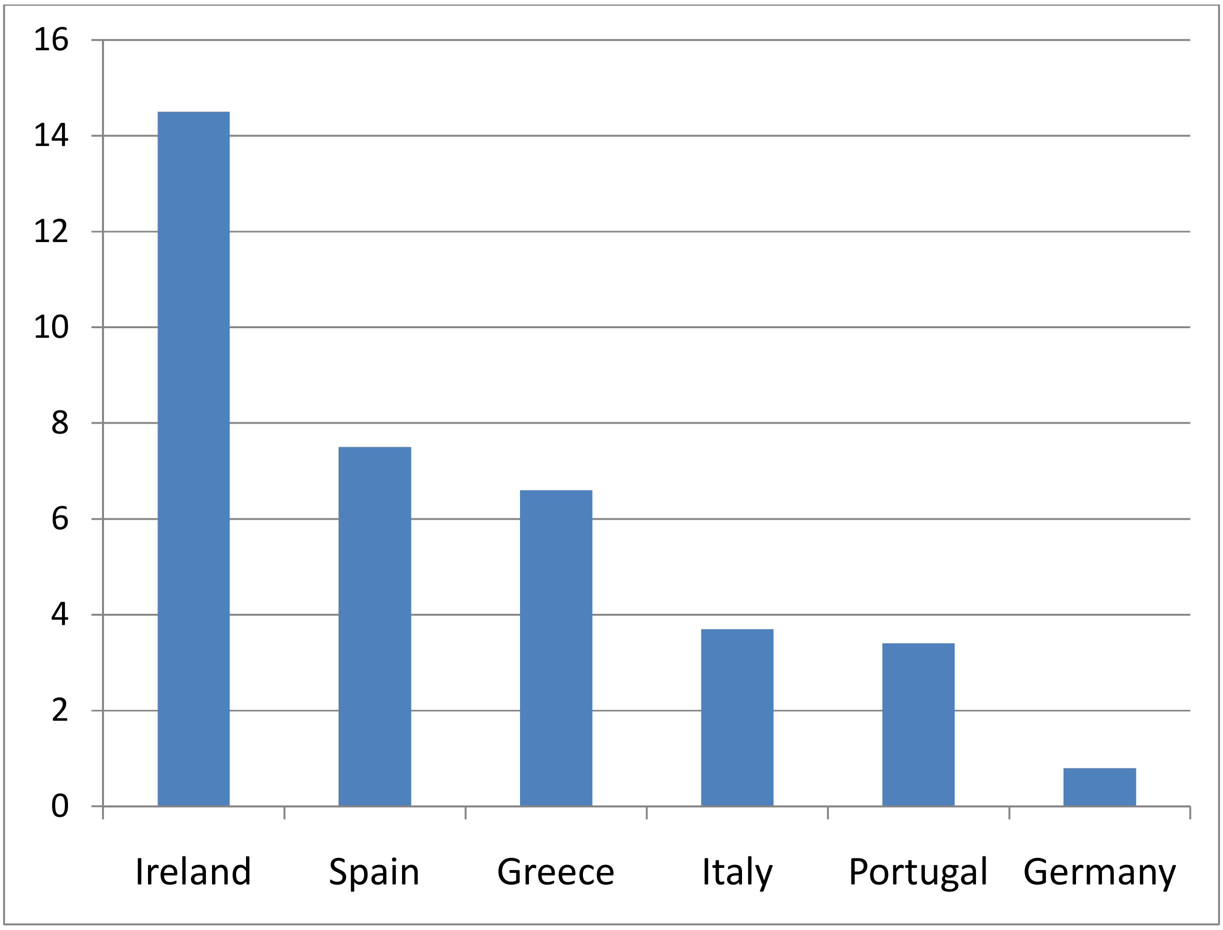
Source: Bloomberg

Figure 3: Annual Growth of Government Expenditures (Selected Countries, 1997-2007)

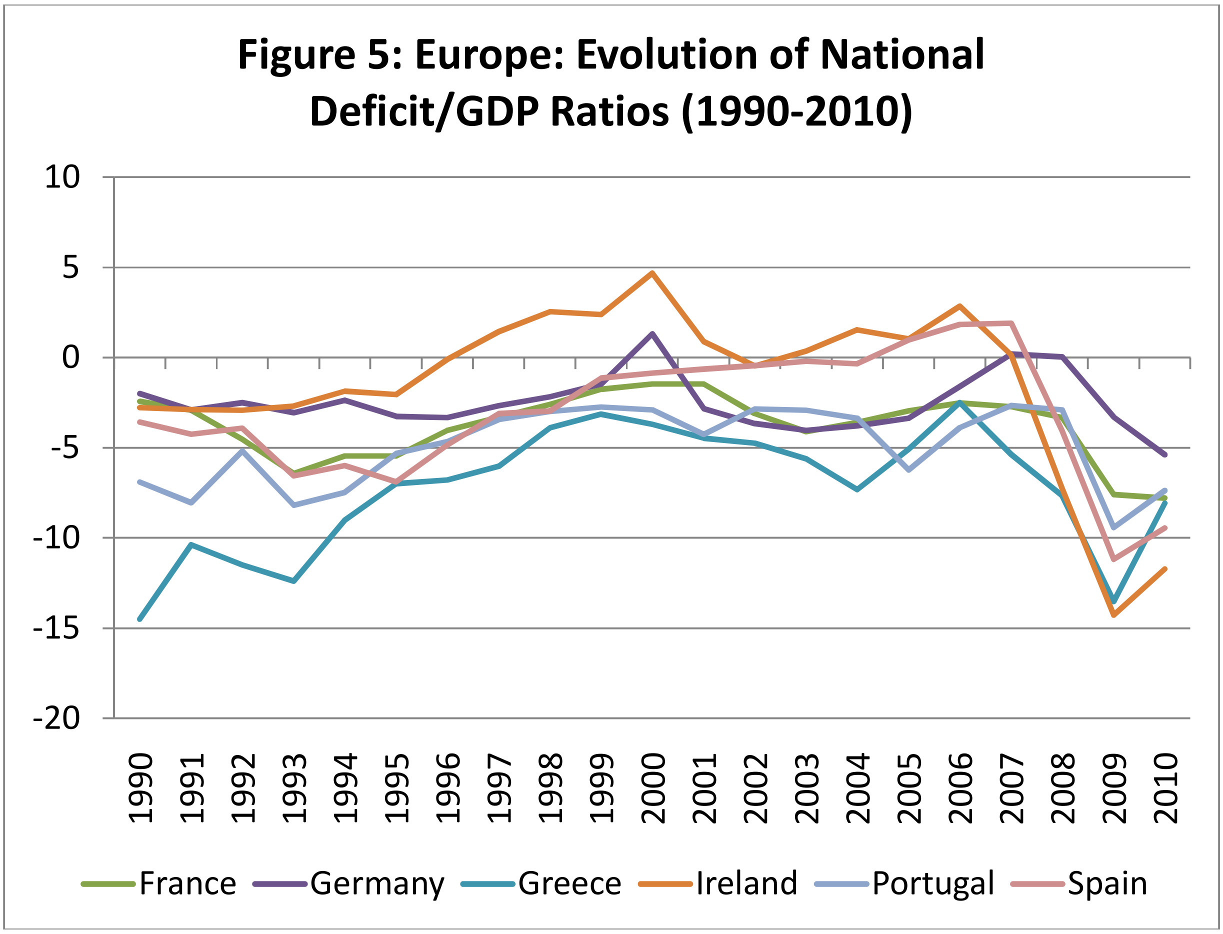


Source: OECD, Eurostat, own calculations

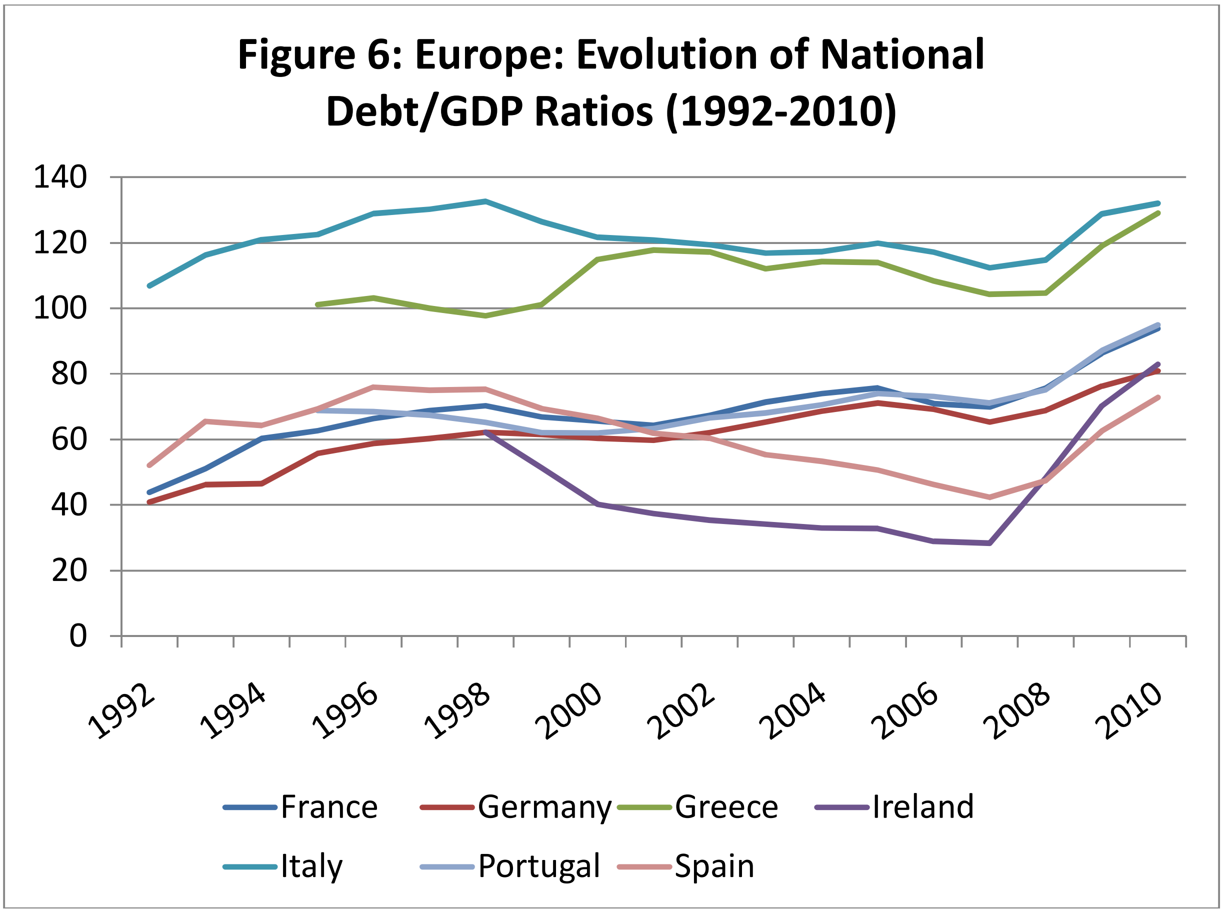
Figure 4: Increase in Overall Government Expenditure's Share of GDP



Source: OECD, Eurostat, own calculations

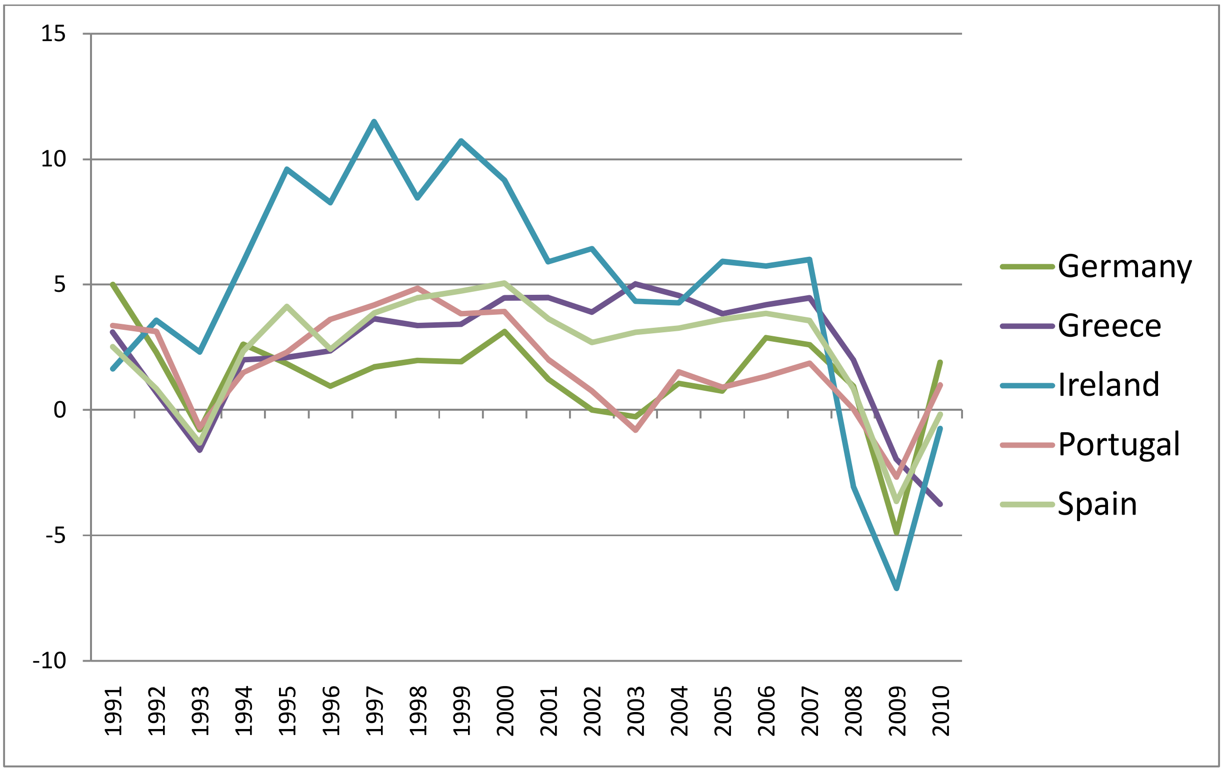


Source: OECD, Eurostat, own calculations



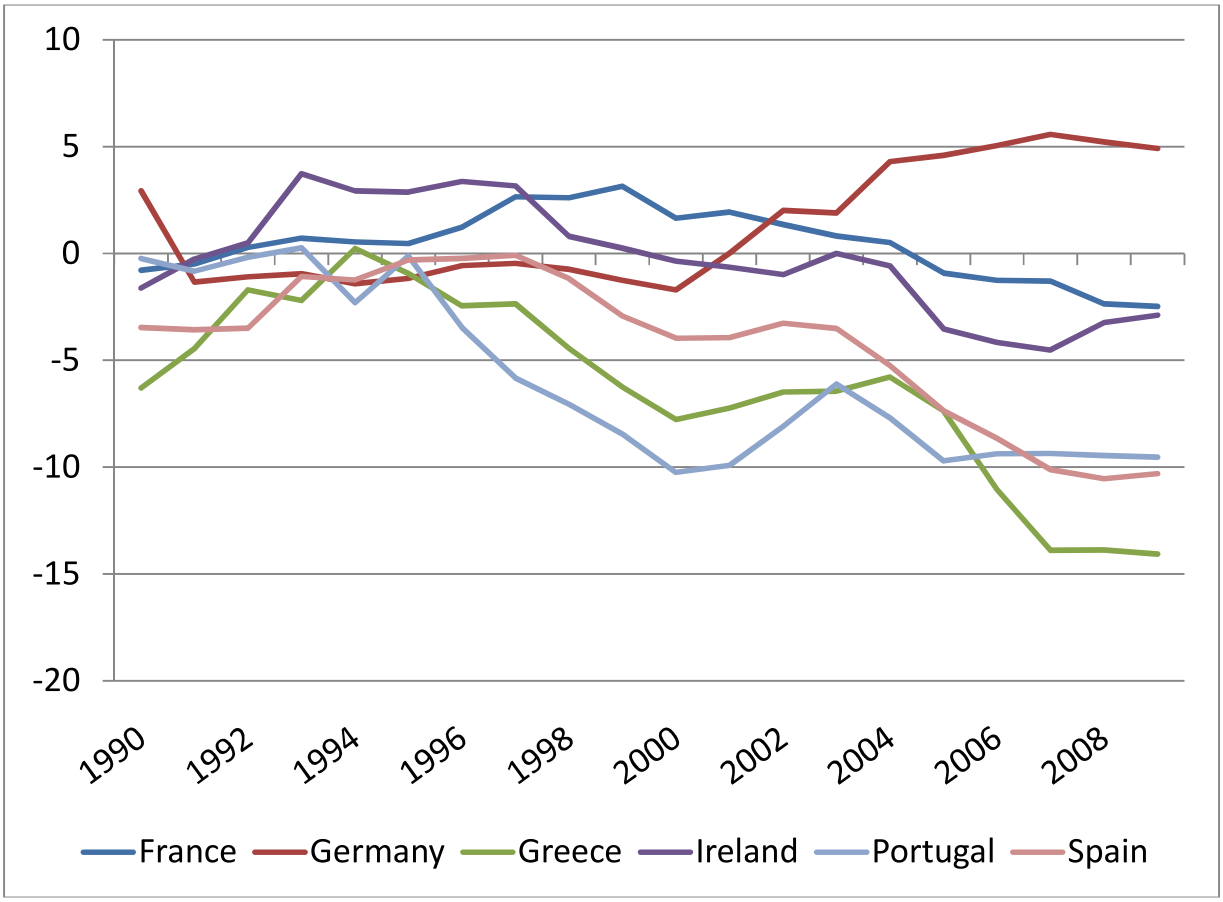
Source: OECD, Eurostat, own calculations

Figure 7: Europe: GDP Growth (Selected Countries, 1990-2010)



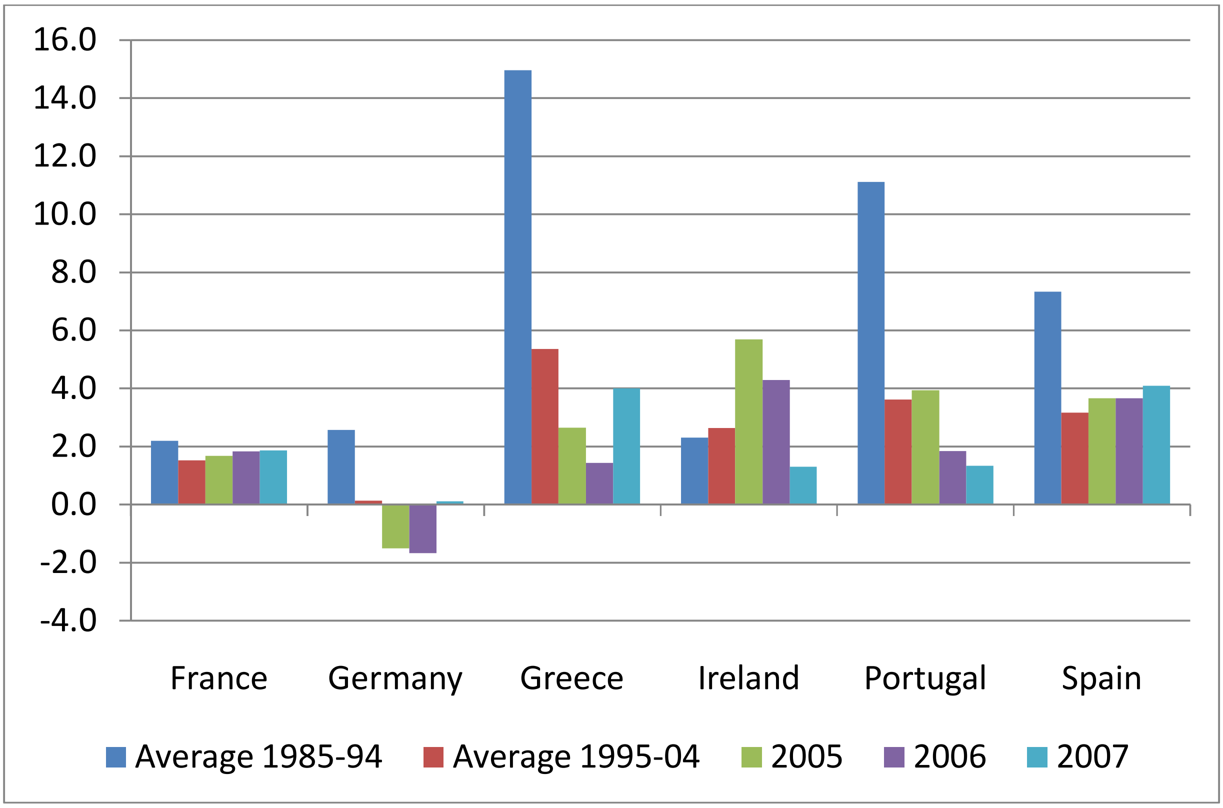
Source: OECD, Eurostat, own calculations

Figure 8: Evolution of Current Account Balances as a % of GDP (Selected Countries, 1990-2009)



Source: OECD, Eurostat, own calculations

Figure 9: Evolution of European Labor Costs (Selected Countries, 1985-2007)



Source: OECD, Eurostat, own calculations