What's The Deal With Deutschland? The European Consequences of Changes in Germany's Political Economy

Conference organized by Mark Blyth and Abraham Newman
with the assistance of the Center for German and European Studies
and the Mortara Center for International Studies
Online seminar organized and edited by Henry Farrell

Formatted for $\LaTeX$
by MultiMarkdown

Contents

Contents **iii**

1 Abraham Newman - What Are The Germans Doing? 2

2 Richard Deeg - Too Fast and Too Furious 5

3 Mark Blyth - The End Game for the Euro 10

4 Aaron Boesenecker - Connecting Past and Present 16

5 Mark Vail - Keynesianism By Stealth 20

6 Matthias Matthijs - Not Just a German Problem 24

7 Wade Jacoby - Germany: Europe's Company Store 31

8 Henry Farrell - "One of the Fingers on the Button Will be German" 35

9 Sheri Berman - Germany: The Necessary But Not Sufficient Nation? 42

10 Tobias Schulze-Cleven - Discovering the Limits of *Ordnungspolitik* 46

List of Contributors

- Sheri Berman is Associate Professor of Political Science at Barnard College.
- Mark Blyth is Professor of International Political Economy at Brown University.
- Aaron Boesenecker is Assistant Professor at the School of International Service of American University.
- Richard Deeg is Professor and Department Chair of Political Science at Temple University.
- Henry Farrell is Associate Professor of Political Science and International Affairs at George Washington University.
- Wade Jacoby is Professor of Political Science at Brigham Young University.
- Matthias Matthjis is Assistant Professor at the School of International Service of American University
- Abraham Newman is Assistant Professor at the School of Foreign Service of Georgetown University.
- Tobias Schulze-Cleven is a Postdoctoral Researcher at the University of Bamberg.
- Mark Vail is Assistant Professor of Political Science at Tulane University.

One

Abraham Newman - What Are The Germans Doing?: Einbindungspolitik, Ordnungspolitik, and National Interest Volatility

After nearly a half century, the "Germany through Europe" bargain, intended to help Germany overcome the political and cultural legacies of World War II, has unraveled. In just a few years, Germans have demanded a rebalancing of the European budget, strict rules governing monetary union, have pushed Eastern European member states into the hands of the International Monetary Fund, and balked at a quick bailout of Greek sovereign debt. In short, the European free ride on the German economy is over.

In many ways, the new Germany is a product of the reunification experience. Far from becoming an emboldened revanchist nuclear state, post-reunification Germany slogged through years of slow growth, record budget deficits, and difficult economic adjustment. As the East failed to bloom, long effective political narratives calling for a European *Einbindungspolitik* lost their luster. Unification, far from making Germany into a resurgent great power, shackled the nation with mounting debt and decades of regional transfer payments.

Some observers argue that Germany has simply become a normal nation following its self-interest. As the memory of World War II fades and a reunified Germany has become an accepted part of the international landscape, Germany can be just another member of the league of nations. But the crisis reveals that Germany's situation is more complicated and perhaps more dangerous. The shackles of Europe have been thrown off, but a new driving paradigm has not emerged to shape German policy. In quick succession, beliefs in moral hazard, the inherent prudence of the German people, Chancellory infighting, and regional party politics have shaped the German response. The incoherence of this response has often hurt the position of key interest groups like export oriented firms or big banks typically associated with

simple national interest stories.

Germany's decisions to oppose European stimulus measures and the timing of the Greek bailout plan highlight these shifting motivations. Although the German economy is overwhelmingly dependent on exports to other European countries, German officials strongly opposed pan-European interventions in the wake of the financial crisis. Instead, German politicians raised the specter of moral hazard and run-away inflation by its neighbors. Ordo-liberal beliefs in market stability trumped calls for pan-European solidarity and fears among German exporters. Krass Keynesianism captured the German view of stimulus efforts in countries with large budget deficits. The response to the Greek debt crisis was shaped by similar ordo-liberal concerns. German policy-makers feared the signal that might be sent to other EU debtor countries if Germany became the bank of last resort. But at the same time, bailout efforts became entwined in regional German elections. The Chancellor repeatedly delayed efforts to put together a pan-European response to Greek's debt crisis, hoping to push off the decision until after elections in North Rhine-Westphalia. This delay cast a further cloud on Greek debt, raising the price of the bailout and putting further pressure on German banks with large holdings of Greek sovereign debt. In a blow to the Chancellor the Greek debt crisis came to head days before the regional election, where she lost in part due to her attempt to politically game the timing of the bailout.

The demise of Germany's Europe strategy has not created a Bismarckian realpolitik, where predictable political horse trading has replaced Euro-optimism. Instead, it has resulted in a period of extreme policy volatility marked by shifting positions and the absence of a clear logic behind German decision-making. Faced with the mounting uncertainty of the crisis, the natural instinct of a rules-based society like Germany is to turn to more rules. But without trust in other European partners to follow the rules, this approach has quickly hit a dead end. German leaders have turned to a series of ad hoc responses that are strikingly erratic, in contrast to the Teutonic caricature.

The German case calls for a reevaluation of the national interest in foreign policy debates. International relations scholarship has increasingly relied on rational-calculation models to understand state preferences. In many foreign policy situations, however, high levels of uncertainty reign. Policy-makers face circumstances in which it is very difficult to calculate the risk associated with different courses of action. In the face of such uncertainty, underlying beliefs about the nature of the world frequently steer decision-making. The British special relationship, Gaullist independence, or *Einbindungspolitik* are historically derived beliefs that guide policy when probabilistic calculations become incalculable. The current German case is a stark

illustration of how socio-cultural events such as reunification can undermine basic belief structures and leave national decision-makers tossed in the wake of shifting guiding paradigms.

This new volatility has several critical policy implications. In the short-term, we cannot rely on Germany to deal with Europe's mess. In fact, Germany will likely be part of the problem, calling for new austerity rules that will further squelch growth on the European Continent, which is already faltering. As further financial trauma hits the region, US policy-makers must actively engage the situation and resist the temptation to count on the old engine of Europe. Within Europe, German volatility severely weakens the hand of the European Commission. Long enjoying the de facto support of Germany, the Commission's ability to maneuver has been curtailed and with it pan-European governance.

In the long-term, in order to face the challenges of the post-crisis environment and the rise of competitors in Asia, we need a strong transatlantic partnership. Given the current state of economic and political affairs in the United Kingdom, Germany should play the major role in that partnership. Ironically, Germany is one of the few advanced industrialized countries that is doing well. The US has the opportunity to help Germany find a new foreign economic agenda based in *prudent sustainable growth.* This agenda would have two key pillars. First, regulate risky Anglo-market excesses of the past decade (e.g. unregulated derivatives) that many Germans blame as a root cause of the crisis. Second, reframe global trade imbalances between deficit and surplus countries as a cornerstone to German and global macro-prudential stability. In short, give the Germans an easy win in the former and couch the latter in terminology that appeals to their concerns about risk and economic instability. By reframing German interests, the US has the opportunity to fill a void in German foreign economic policy and shape the development of the global economy for the next half-century.

Germany is up for grabs and the short-term might see a Sino-German alliance based on stability and shared export strength. Ordo-liberal beliefs guiding much of German monetary policy could easily emerge as a pillar of a Sino-German economic regime. At the same time, we could witness a cozy new relationship between the two export engines of the world economy. But without functioning import markets, the engine will quickly overheat.

Two

Richard Deeg - "Too Fast and Too Furious? Germany as Europe's New Drift King."

Why is Germany in Europe's catbird seat? Yes, it's Europe's largest economy, but not so long ago it was the "sick man of Europe," earning only disdain or indifference from its European neighbors. What really matters is what didn't happen: the German economy did not blow up in the global financial crisis like its erstwhile Anglo detractors – the UK and the US. Thanks to the Chinese stimulus plan, German exports quickly boomed again and without a huge domestic debt or banking crisis holding it back, Germany was the only one in a position to bail out the rest of Europe (to a point) and thus call the political shots. So, why did Germany come through the financial crisis of 2007-09 in relatively good shape? The answer lies in understanding why the German financial system (and economy generally) didn't come to depend on a derivatives pyramid and debt-driven growth.

Let me start by summarizing the institutional cornerstones of the postwar German financial system. First, through equity ownership by banks in many large firms, widespread bank representation on company boards, as well bank voting of proxy shares on behalf of other investors, large banks played a central role in the corporate governance of many large German firms. Banks supported long-term corporate strategies of competing through innovation and productivity growth rather than cost cutting, labor shedding or outsourcing, and a focus on revenue growth as much as profitability. Second, banks played a central and supporting role in firm-level co-determination or stakeholder corporate governance by accepting labor as a partner (even if junior) in corporate management. Third, postwar Germany developed/preserved a large system of public banks that served both commercial markets and broader social purposes. In a narrow sense, many of these banks provided funds (often government subsidized) for a variety of investment purposes, notably for smaller firms, infrastructure development, R&D, and housing construction. More than half the banking sector is comprised of "boring" savings and cooperative banks

which never did much other than conventional commercial and retail banking. Finally, the provision of long-term funds to firms was enabled by the savings behavior of households because they channeled most of their savings into banks (and insurance companies) that, in turn, channeled these to firms.

Some elements of this financial system as just described have changed dramatically over the last twenty years while others remain largely intact. Perhaps the most important change is that large banks – both commercial and public – turned increasingly to investment banking and international banking as their traditional business with large firms declined. The strategic redirection coincided with a substantial withdrawal of large banks from providing long-term patient capital to firms and participating in stakeholder corporate governance. With the exception of Deutsche Bank, however, this strategic shift has not been very successful. Though bank revenue as a share of GDP in Germany has grown since the early 1990s, profitability remains quite low by international comparison and has not grown (figure 1). This is partly because Germany is "overbanked" and thus a highly competitive market. Meanwhile, conservative regulation limited the involvement of German banks in the dark but outrageously profitable corners of the Anglo financial world, such as securitization, derivatives trading, prime brokering, etc.

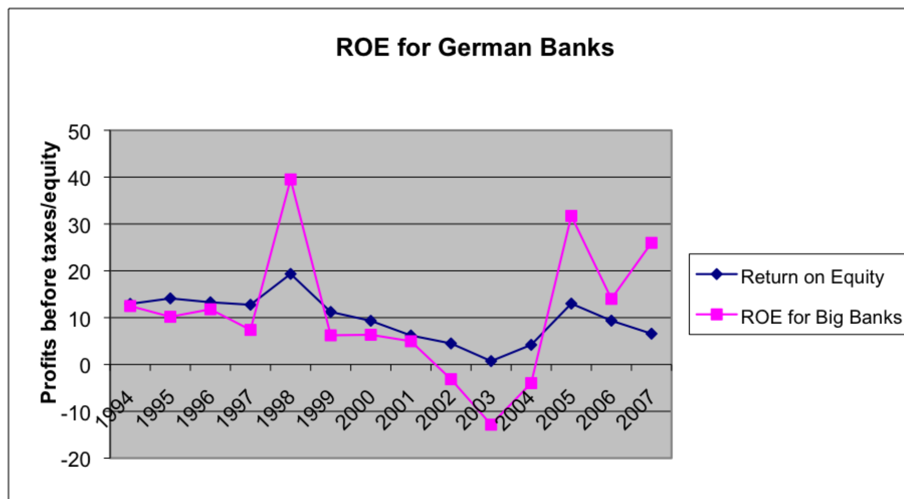

Figure 2.1: Return on Equity of German Banks (1994-2007) Source: 'Die Ertragslage der Kreditinstitute', April 2009, Bundesbank (own calculations)

To overstate the case and confirm the popular view, the financial derivatives (aka

'risk management') revolution that transformed finance in the US and UK largely bypassed Germany's domestic financial system. Though many large German banks – notably several of the Landesbanks and some public sector banks – did participate in this revolution by buying lots of bad assets in London and New York (they were generally the suckers on the wrong end of the bets). Landesbanks were driven in this direction by long-running problems, including the loss of much of their public utility functions during the 1990s, the loss of state guarantees of their assets in 2005 as a result of EU decisions, and their inability to transform into pure commercial banks (but this is a long story for another day). Among the public Landesbanks, quite a few suffered very large losses from their foreign asset exposures, in several cases requiring bailouts from the state government and savings banks. The worst of the public banks was the IKB, one of the two banks burned in Goldman Sachs' infamous Abacus deal. Among private banks, the worst was Hypo Real Estate, which got burned in American muni bond insurance and was taken over by the state at cost of more than €100 billion. The Dresdner Bank was merged with the Commerzbank, greased with a very heavy infusion of public money.

In most cases these losses are tied to non-domestic financial activities by these banks. In other words, the sources of Germany's financial crisis are not domestic in origin. This is largely a result of the fact that Germany did not experience a debt-fuelled consumption binge nor a liquidity-driven asset (real estate) bubble, unlike the UK, Ireland and Spain. There are undoubtedly several factors that explain this: First, with very low inflation, real interest rates were relatively high in Germany during the 2000s, thus limiting borrowing. Second, while there was a significant shift from savings via bank deposits to savings via mutual funds, pensions and life insurance since the early 1990s (see figure 2), German household saving and investing behavior remained relatively conservative compared to other countries. Thus the expansion of the institutional investors who drove financialization process elsewhere (including demand for structured financial products at the root of the crisis in the UK and US) was more limited than elsewhere and German institutional investors, for a number of reasons (mostly regulatory) remain more conservative in their investment strategies. Third, Germany already had a long established covered bond market – a form of mortgage securitization that proved immune to the excesses and manipulation that occurred elsewhere (and probably precluded the rise of a big RMBS market in Germany). Finally, the mortgage financing market in Germany is accounted for to a great degree by savings and public banks, which are subjected to tight prudential regulation and conservative lending practices. Thus while the bailouts were costly to the German taxpayers, the fact that households and firms were not saddled with

excessive debts meant the German economy could quickly revive.

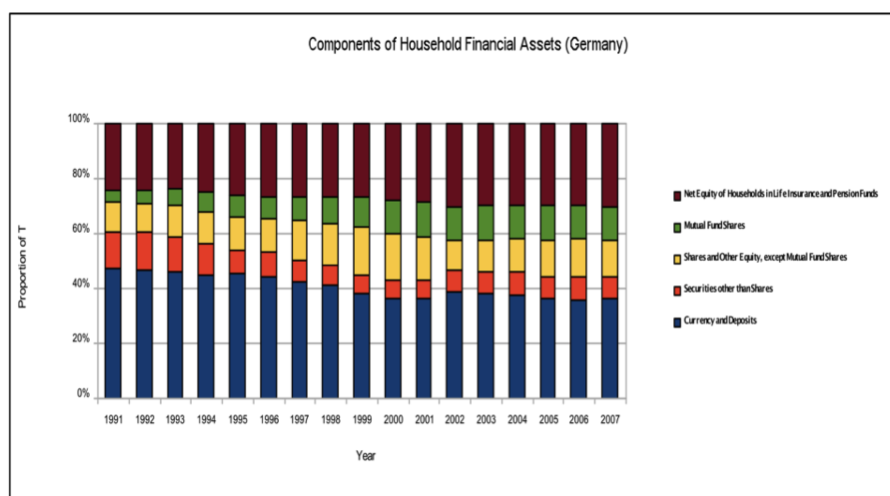

Figure 2.2: Composition of German Household Financial Assets, 1991-2007

Altogether, then, the financial crisis in Germany was not 'made in Germany' (at least in the sense of the bad assets or bad bets not originating in Germany) but in the Anglo-American financial world. Although German banks are certainly not without culpability, the largely external character of Germany's financial problems enabled Merkel and other leaders to portray Germany and its banks as victims of Anglo-American finance. This is central to understanding how the government has subsequently altered domestic financial regulation and what kinds of international financial regulation it has pursued.

Of course, the banking/financial crisis of 2007-09 has turned into a eurozone crisis this past year. The sovereign debt problem at the root of the eurozone crisis is a result of both fiscal profligacy in a number of states but also, in several instances, a result of massive bank bailouts by governments. From the German perspective, fixing this problem must thus address two sources: excessive leverage, risk-taking and non-transparency in the financial system which created the bank failures that led to government bailouts, on one hand, and the lack of spending discipline in several states on the other. While perhaps more due to dumb luck than pluck, the fact that Germany didn't take part in the debt-binge and derivatives frenzy of the US and UK affirmed in the minds of many German elites that their conservative approach to financial regulation should be reproduced at the European and international levels.

It is Germany that has strongly pushed for more regulation of hedge funds, moving all derivatives trading onto exchanges, and taxing banks to fund future bailouts and limit the exposure of taxpayers to bank and, now, sovereign debt in Europe.

So what is Germany's plan to get Europe through this? This is where drifting comes in. To quote from Wikipedia, "drift racing challenges drivers to navigate a course in a sustained sideslip by exploiting coupled nonlinearities in the tire force response." Got it? Ok, in drifting drivers let their rear wheels spin and slide when entering a curve in order to exit the curve at a high speed. It works, if you know what you're doing. If not, your car spins out of control and you end up with lots of twisted metal. As the largest and soundest economy in Europe, Germany is drift driving Europe right now: Germany is leading the bailout plan for Europe (steering the front wheels), but flirts with the euro's demise by hesitating to bail out Greece, then by talking about haircuts for sovereign debt holders and imposing Germanic fiscal austerity and financial regulation on the rest of Europe (spinning the rear wheels) – all of which it sees as necessary to get Europe quickly back on course (exiting the turn). The risk is that Germany is pushing too fast, forcing levels of fiscal austerity and proposing fiscal coordination across the euro-zone that may not be politically tolerable in much of Europe. The irony is that crashing the euro-car would hurt Germany more than anyone else because Germany needs exports to thrive. German export competitiveness hinges on both high productivity and moderate unit wage costs. If the euro goes, everyone else in Europe devalues vis-à-vis Germany and German competitiveness goes out the window. The good news is that Porsche 911s are good for drifting (rear wheel drive), the bad news is that angry Germans are at the wheel – Europe had better hope they took good driving lessons.

Three

Mark Blyth - The End Game for the Euro: German Rules and Bondholder Revolts

Things Continue, 'Till they Don't...

The end game for the Germans, and the rest of Europe, in terms of resolving the current Eurozone crisis is pretty straightforward. There are four ways to deal with a financial crisis: devalue, default, inflate, or deflate. For any country in the Eurozone who transferred private debt from the banking sector to their public balance sheets, and thus blew a hole in their debts and deficits, neither inflation nor devaluation were options. That leaves default, which pushes the costs onto bondholders, or deflation, through domestic wages and prices via the public balance sheet, which places the costs onto taxpayers. For a host of reasons, as guardians of the Eurozone, as an inflation-averse savings-culture, we would expect the Germans to prefer austerity to expediency, and force deflation, but there are real and obvious limits to any such strategy, which is what I have found puzzling since the crisis began just over a year ago.

The first and most obvious limit is that currency unions should not be suicide pacts. There should be exit-clauses; otherwise the only way to adjust is through deflation. Unfortunately, as the 1920s demonstrated clearly, and as anti-austerity protests across Europe today continue to make plain, democracy and deflation do not mix well together. Hard money commitments such as the Stability and Growth Pact, the ECB's inflation targeting regime, and the Maastricht criteria, were supposed to serve as a check on profligate governments. But what we have in this case, with the Greeks as a possible exception, is not state profligacy. Rather, the situation is akin to a giant 'bait and switch' operation where massively leveraged financial institutions wrote deep out of the money options on other financial institutions, and when it all went wrong tax receipts dried up at the same time as huge amounts of private debt were transferred to the public sector balance sheet to keep various national payments systems operating. What was a crisis of banking became, in short order, a

crisis of state-spending via a massive taxpayer put, and with sovereign bondholders' interests being held sacrosanct while their investments were diluted (if not polluted), the taxpayer had to shoulder the costs twice: once through lost output and new debt issuance; and then twice through the austerity packages held necessary to placate the sovereign bondholders. But if the EU is at base a democracy then the problem is clear. Is it reasonable to expect mass publics to pay for the mistakes of private elites on a multi-billion dollar and multi-year scale? As the Irish example shows, publics may be able to take some of the pain, but eventually they can vote against it. The Germans must know this, so why insist on it?

Second, the preferred German policy to get us out of this mess, austerity for others and exports for them, cannot work even in its own terms. As the ECB's much trumpeted June 2010 report admits, examples of successful 'growth friendly fiscal consolidation' are few and apply mainly to small export dependent states whose budgetary consolidation was cushioned by export led growth. Crucially, such states had their own currencies and could devalue as well as deflate, giving them more room to move. Poster child for this policy was Ireland in the late 1980s. Ireland today is discovering that not only is it much harder to do this when everyone else is not growing, and is therefore not importing, you can actually cut so much that the policy cannibalizes future growth via debt deflation.

The problem of exporting your way to success is, as Martin Wolf has ably demonstrated in his FT columns, essentially similar. We can't all export at once. Someone has to be importing, and for that to happen a state needs to either be able to import capital to cover their current account deficit, as in the cases of the US and the UK, or blow a whole in their current accounts. Now, if I assume that there is no existential reason for Germans not to understand the notion of a fallacy of composition, why do they wish to follow a policy course that is so obviously flawed on both grounds of political sustainability as well as basic economic logic? It can't work and it will not work, so why keep doing it?

"Spain/Portugal/Italy/France is just another Greece/Ireland Waiting to Happen…"

The joke doing the rounds a year ago was, "what's the difference between Ireland and Iceland?" The answer was, "one letter and six months." The unfunny and better answer should have been "not much." Both of these countries are exceptions, not rules. Both of them turned their economies into Ponzi-schemes so highly levered that all it needed was a less than three percent turn against their biggest banks' assets to make them insolvent. Both were far too small to absorb such losses. Icelandic

and Irish bank indebtedness now hovers between $18,000 and $35,000 per person, depending on how you count it.

This is however, simply not true for any of the other Eurozone states, even the biggest of the problem cases - Spain and Italy. Italian debt is large but it is long term and mainly held domestically. Their banking system is notoriously closed and conservative. Spain certainly got hit hard despite having prudential banking regulations in place at the time of the crisis and being the Eurozone 'best in class' for debts and deficits in the years up to the crisis. However, having effectively deindustrialized, it turned its economy into a real estate and financial services hub. So when (external) demand dried up, the current account went awry, and the banking sector stopped paying taxes, and the 'best in class' became the last of the PIGS. Portugal did not have a financial crisis, it had an Eastern European-style current account crisis when exports collapsed and consumption came through imports. For those outside the Eurozone, for example, the UK, whose public debt is still below the 60 percent Maastricht threshold, the claim makes even less sense. Yes, Greece and Ireland are in bad shape, but that's no reason to start a continent wide austerity movement. It simply will not do anything for growth. But maybe that's not the real problem.

"The Real Problem is Avoiding the Mother of all Bank Runs"

Another possible explanation for German behavior is more plausible. Putting regional elections and other such trivia to one side, there is a reasonable fear of a general run in the European bond market, similar to what we saw in the US repo-market crisis in 2008. The basic problem is twofold: institutional mismatches and portfolio correlations. First, on a macro level, the European political project was based around a deliberately incomplete contract that allowed agreements to change over time in accordance to circumstances since the final shape of the EU could not be established ex ante. The European financial project was, on the other hand, based on a complete contract that attempted to specify ex ante all possible states of the world via sets of rules and monitoring institutions on the assumption that behavior is a function of rules plus incentives and can be programmed as such.

Unfortunately, such a design does not consider the possibility that private sector actors might, for example, develop swap contracts with governments that allow said governments to perform fiscal prudence while practicing fiscal profligacy, a la Greece and Goldman. Consequently, the possibility that the European bond market might suddenly suffer widely divergent, rather than convergent prices, wasn't considered at all likely. This contract-mismatch became a problem when bondholders, including

some of the biggest European banks, dumped low yielding Northern bonds for higher yielding Southern bonds on the assumption that the risk premium priced in a credible commitment by the ECB to maintain the value of the bond via monitoring the fiscal policies of the member states. Unfortunately, the ex ante mechanism designed to make this happen, fiscal rules and self-disciplined behavior, fell by the wayside during the last decade. So when the banking crisis hit and the true state of public finances became apparent, the risk premium for holding Southern bonds was revised upwards quite spectacularly. The political incomplete contract had flexibility built into it to deal with contingencies. The monetary complete contract denied contingencies could arise, until they did.

At this point the obvious thing to do would have been for the Germans to buy and hold the troubled bonds, thus denying the markets a piñata strategy, thereby limiting the possibility of a bank run through the bond market where attacks on weak currency leads to attacks against the next most weak currency in anticipation of a short sell. But the Germans did not do this. There were many reasons for not doing this: moral hazard vis-à-vis other countries, upcoming regional elections, schadenfreude. But there was also one very good reason for doing just this, which is the other side of the bank-run story.

What the Germans Know and are Afraid to Admit

You can get a run through a bond market in two ways. The first is to discover that the real price of the bond is not reflected in the risk premium and dump it or short it. The other lies through contagion mechanisms. If banks have essentially similar positions in similar assets, in this case Southern Bonds, the chances are that they also have similar hedges. If so, and these assets are in demand, Southern European bonds in this case, bond rates go down as demand goes up, leading to lower risk premiums as far as the bank is concerned. But if there is a shock that leads to a rapid revision of prices, as there was in 2008 and 2009, the temptation is to look to the hedge to take up the strain. Unfortunately however, by 2010 other available asset classes, real estate and equities are on the floor. So to avoid taking these losses banks will have to liquidate similar assets in an effort to cover their losses, if their hedges will not cover their losses. But it gets worse. If those losses are anticipated in advance, then the temptation is to 'dump good to cover bad.' But if my 'good' asset is also your 'good' asset, then I will try to dump them ahead of you doing the same. You can see where this story of asset correlation goes.

If I know you want to dump Greece, I will dump Ireland, and you will dump Italy to cover the anticipated losses, and I will dump Spain to get ahead of you, and as

we all try to cover the bad with good, we all try to find liquidity, when in fact it is a community property, thus creating illiquidity in the bond market, just as happened in the repo market in the US in September 2008. This is why any talk of exiting the Eurozone has to be quashed and austerity is the only game in town. With billions of dollars of risk held in a myriad of banks in dozens of EU countries no one is immune from contagion effects. So if anyone gets wind of someone printing a new currency, for example, the whole thing unravels at light speed as investors try to liquidate ahead of the pack. Investors don't want to do this in the main. Speculators aside, most bondholders want to 'be made whole' rather than blow up their portfolio. But if someone is going to shout fire in a crowded theater, then it pays to be close to the door, the signal for which is the increasing pressure on spreads that we see today.

So if the Germans are smart enough to see this bank run coming, and that they know austerity politics cannot work as advertised, and if the 'rescue' vehicle of choice is a $750 billion SPV with no actual cash in it supported by new 'restructuring mechanisms' that are seen as less-than-credible by bondholders, and if we can assume that at some point mass publics will vote against austerity, then what is the end game? I think that it might be the case that the Germans are 'performing austerity' to buy some time for the inevitable bank run that lies ahead.

Passing the Put Around: Eventually Someone Has to Pay Up.

Go back to the macro story laid out above for a moment. About two and a half years ago highly levered companies trading deep out of the money options with massive amounts of leverage blew up. For heavily financialized economies (UK, Ireland, Iceland) this ended up on the public sector balance sheet via lost tax revenues, higher interest payments, deficits and debt increases. Globally, two trillion dollars was lost and someone has to pay for it. For those countries that didn't have a banking crisis, the true extent of their budgetary imbalances (Greece), structural current account deficits (Portugal) or export dependence (Germany, Austria) was revealed in short order. When this happens the way out is, again as noted above, devaluation, default, inflation or deflation, and the EU chose deflation of wages and prices, and the Germans at least talked a good game concerning austerity politics. What they practice was something else entirely; but if other states really did it then its all the better. But why do so if its only performative, and it cannot 'do what it says on the tin,' as the Brits like to say?

If the Germans read the game as I do, then they only hope is delaying the bank-run that is coming with promises of SPVs filled with magic Euros and bailouts for the Irish and the Greeks as they slash themselves senseless. But if you know that

it's coming, then so must the bondholders. And if they do, their interests are clear. They bought sovereign debt, not the crappy corporate debt that is now bloating the balance sheets of their sovereigns and increasing their risks, so they really don't want to take the hit for finance's 'put' on the state.

So the state put that 'put' on the taxpayer. But in a democracy there is only so much you can put on the taxpayer before they throw out the rascals and vote for someone that promises to put that 'put' elsewhere, and the only place left is back on the bondholders. So if the bondholders know that the haircut is coming, they can try and put the put back on the banks, but given the state of the bank's balance sheets and overall business model (it's bust - and its not coming back), that's not going to happen. So bondholders have only one out. They pressure the EU, and the Germans in particular, by squeezing peripheral bonds to make sure that taxpayers there take the hit that they don't want to. But this of course, has a limit. That limit is called Spain. When you put $750 billion in a bag and say 'bailout funds' that tells everyone how much you are really willing to lose. It's a chunk of change and it will take care of Ireland and Greece. But if everyone is, metaphorically speaking, trying to get towards the door in case someone shouts 'fire' in the crowded theater, then there is no guarantee it will stop there as contagion mechanisms take hold. In which case Spain's liabilities, dotted across the bond portfolios of major Eurozone banks, blow through the bag of cash and the limit is reached. When that limit is reached, the mother of all bank runs will begin and the endgame for not just the Euro, but also the EU, will enter its final act.

Four

Aaron Boesenecker - Connecting Past and Present: Germany's Search for a New Success Story

As Mark Twain once observed, "The trouble with the world is not that people know too little, but that they know so many things that aren't so." The aphorism is appropriate in light of the current confusion concerning Germany's role within Europe. According to German public and political discourse, Germany is experiencing a second economic miracle (look no farther than the FT Deutschland's Wirtschaftwunder blog) thanks to balanced social and economic policies, fiscal responsibility, and respect for the rules and institutions of the European Union. Although much attention has been paid to this "new" German model, little has been focused on how this reading of events was constructed or, to use Twain's formulation, how and why many among the German public and elite are convinced of so many "things that aren't so." Doing so not only helps clarify the seemingly contradictory or ad hoc nature of contemporary German politics. It also sheds light on how problematic the current German approach is as a perceived solution to Europe's woes.

Germany is struggling to reconcile the competing domestic and European dimensions of the financial crisis in the search for a story, or discourse, that makes sense of these complex events. The predominant German discourse frames the overall financial crisis as stemming from regulatory failure and the excesses of "Anglo-Saxon" capitalism. As such, the domestic response has emphasized fiscal responsibility and the "automatic stabilizers" of the German social welfare system instead of stimulus spending. Within Europe, German officials have emphasized austerity for states facing financial troubles and new EU rules for ensuring the credibility of the Euro and preparedness of the Union for future crises.

Two aspects of this nascent discourse are noteworthy. First, contrary to impressions of an ad hoc approach, key elements of the German response are grounded in

ordoliberal thought and tradition. Second, and more important than the substance of recent policy decisions, the German discourse is setting the tone of the debate in Europe. Germany is cast as the voice of reason and discipline in the midst of a crisis caused by irresponsibility, exuberance, and a disregard for the rules and institutions of the Euro. Given such a diagnosis, discipline and punishment appear as appropriate responses.

As Sheri Berman notes in this seminar, Germany was never a fan of Keynesianism. As such, German resistance to U.S. calls for demand-led growth approach is no surprise. The collective memory of the Weimar Republic provided a powerful frame through which demands for deficit spending were filtered: these arguments were heard as exhortations to print money, awakening fears of hyperinflation, mass unemployment, and economic stagnation. The counterarguments deployed by German officials drew on the postwar experience of the *soziale Marktwirtschaft* and the *Wirtschaftswunder* in articulating an appropriate response: a rejection of manipulating the money supply as a macroeconomic instrument; a defense of fiscal responsibility; the state as a guarantor of the free market; and a social system that helps (responsible) individuals and employers bridge difficult times without fostering dependence on the state.

Although the oft-cited "automatic stabilizers" (job training, part-time work, furlough programs) constitute stimulus spending under another name, there are important qualitative differences, especially as regards who is considered an appropriate beneficiary (primarily those employed in skilled manufacturing). The discursive linkage to post-WWII German ordoliberalism is evident in a social dimension that emphasizes opportunities for labor market participation over general safety nets–a central aspect of Ludwig Erhard's interpretation of the *soziale Marktwirtschaft*. Similarly, the insistence on fiscal responsibility reflects monetarist tendencies present in Erhard's practice of ordoliberalism, more than the economic theory developed by Eucken, Röpke, and Müller-Armack. Invoking a legacy in which the state serves as the guarantor of free markets through the reasoned application of regulation made certain options appropriate and legitimate while discrediting others (such as stimulus spending). Moreover, German officials have interpreted the combination of domestic economic recovery, growing business confidence, and positive economic forecast as confirmation that their diagnosis was correct and their responses appropriate. Germany has also led the drive for austerity in Europe, especially in response to the spread of sovereign debt crises. The general idea of austerity entered the debate through a peculiar European Central Bank articulation concerning "growth-friendly fiscal consolidation" in 2010.[1]

[1]European Central Bank, "Monthly Bulletin: June," *Frankfurt: European Central Bank,* 2010.

However, German articulations of the concept have taken a harder edge, with the implication that harsh cuts are the appropriate punishment for states that have flaunted the rules of the monetary union or have been irresponsible with public finances. To some, this stance contains a pernicious message of vengeance, or of Germany being "strong against the weak."[2] For their part, German officials have justified their conception of austerity in terms of what it means to be a member of the European community. As Merkel pointedly stated, a good European is "not necessarily one who offers help quickly. A good European is one that respects the European treaties and national rights so that the stability of the euro zone is not damaged."[3] What is important here is that key actors (German and European) do not mean the same thing when invoking the austerity trope, or when invoking "Europe" and the European idea in defense of policy positions.

These brief examples from the broader German discourse highlight the struggle to define a story that "makes sense" of a complex series of events in order to respond to them, as well as the difficulty of conducting politics amidst competing discourses. As is typical, the emergent German discourse exaggerates some "actual" events and ignores leaves others altogether. Understanding the sources of this discourse make clear the fact that it is not just an ad hoc policy response, but one that could have been anticipated with some attention to the larger historical and political context. The central problem, though, is that the current German story is not sustainable. As Mark Blyth has noted, pushing austerity for Europe (and a blunt or vindictive variant of austerity at that) amidst a massive economic downturn constitutes a fallacy of composition on a grand scale. If neither governments nor consumers are spending, then there is no route out of the crisis. The dilemma is even more pointed for Germany, in that *"Wirtschaftswunder II"* cannot be sustained without consumption of German exports by other Eurozone economies.

What, then, can be done to help Germany navigate out of the crisis to which it has contributed, even as so many believe that the country has not only escaped crisis but, in doing so, has highlighted a path for others to emulate? Three scenarios suggest ways in which the debate may develop in Germany and Europe - Germany as the rule-maker, Germany as the contrite winner, and Germany as the blissfully ignorant fool - are discussed here in brief. Readers are invited to contribute their own thoughts and suggestions as to other options.

Although Germany seems to have adopted the role of "rule-maker" at present, there

[2]Gabor Steingart, "Merkels Europapolitik Is Versailles Ohne Krieg," *Der Tagesspiegel,* November 19, 2010.

[3]Angela Merkel, Quoted in Matthew Saltmarsh, "E.C.B" Signals Policy Shift That Could Benefit Greece," *The New York Times,* Mart 25, 2010.

is no European consensus that this new role is appropriate or desirable. Part of the problem is that there is no European level narrative to help legitimate this role. For much of the post-WWII era the European project helped justify difficult domestic policy decisions. For example, the idea of a Single Market provided an overarching narrative for a range of reforms in the 1980s, as did the Euro in the 1990s. However, both of these were grounded in a "negative integration" narrative of removing barriers to the fundamental freedoms. A rule-making role requires a narrative of "positive integration" to justify new institutions and regulations, yet averting a future but as of yet unknown crisis is not as compelling a narrative as the creation of a single market or single currency.[4]

A second variant may be the idea of Germany as the contrite winner. Little mention has been made of the ways in which Germany (and France) flouted the rules of EMU, especially the deficit criteria, in the not so distant past. This is little short of ironic given the current austerity drive. Although difficult to imagine in the current political climate, there might be space for a discourse in which relaxing the austerity-punishment focus is made possible by invoking these "forgotten" elements of recent European history. This would, in effect, involve a mea culpa on the part of Germany and the construction of a discourse that emphasizes the long-term interest of all rather than the short-term "tit-for-tat" spiral that characterizes the current political dynamic.

Finally, the status quo may continue for some time, especially if demand for German exports via China sustains the idea that the German recovery is the product of German policy innovation at home and persistence vis-à-vis the rest of Europe. In this scenario, Germany plays the blissfully ignorant fool implied by Mark Twain's aphorism, in that it is only sustainable until growth declines in conjunction with declining exports and Germany finds itself in trouble vis-à-vis its own banks, and a new crisis ensues.

All of this brings us back to the question of future the pathways for Germany. What are the options to work out of the corner into which the government has backed the country? What combinations or recombinations of history, memory, and events might provide the way out for Germany? Without offering a definitive answer, the foregoing should at least highlight that the possibilities are constrained by ideas and perceptions as much as they are by bond markets and balance sheets.

[4] The notion of negative vs. positive integration is drawn from the work of Fritz Scharpf. See, for example, "Negative and Positive Integration in the Political Economy of European Welfare States," Jean Monnet Paper Series No. 28, Firenze: Robert Schuman Centre at the European University Institute, 1995.

Five

Mark Vail - Keynesianism By Stealth And Symbolic Austerity: German Fiscal Policy And The Post-2007 Economic Crisis

In the aftermath of the current economic downturn, German policy makers turned to Keynesianism with ambivalence, hesitation, and no small amount of bad faith. Notoriously fearful of debt, government spending, and state power, the German government was among the last in the G-20 to adopt a stimulus package, as one might well have expected. And yet, German stimulus measures were actually more than met the eye and represented one of the more extensive efforts in Europe, though the rhetoric surrounding the debate over the package hewed closely to traditional German narratives about fiscal probity, debt, and inflation. This inconsistency between rhetoric and reality also characterized the German turn to austerity in summer 2009. While excoriating the Greeks for fiscal profligacy and egged on by an unsavory public discourse about southern European work habits, Chancellor Angela Merkel announced plans to cut €80 billion from the German federal budget over the next four years. And yet, these cuts amounted to less than they appeared and spared politically powerful groups.

Much of the puzzling aspects of the German response to the crisis can be explained with reference to the ideas that lie at the center of German understandings of the role of the state and a distinctly German variant of liberalism, which I term "corporate liberalism." This tradition is quite different from the Anglo-American liberal tradition of expansive markets and limited states, but is no less liberal for that. The German variant assumes groups to be integral components of the social and political order and conceives of equality and political responsibility largely in group terms. Its conceptual core rests on the tension between liberty and group responsibility, with each group responsible for the welfare of its members and sharing political responsibility with other groups. The state's role in this tradition is to establish and

maintain the legal and institutional context and to intervene when necessary to support a competitive, fair framework. This tradition grew out of the Ordoliberalism of the inter-war period, which rejected the more atomistic liberalism of Smith and Hayek and was reinterpreted after World War II by the architects of the German Social Market Economy at the dawn of the Economic Miracle.

With the financial meltdown of 2007-2008 and the prolonged downturn that has followed in its wake, German policy makers turned to demand stimulus in order to boost economic growth, though in ways that were true to this tradition. At first glance, Germany's response indeed seemed to conform to conventional images of a country fearful of inflation and debt, ambivalent about state power, and skeptical about government intervention in the economy. Its stimulus package was adopted much later than most. In November 2008, when the government finally unveiled it, it did so with reluctance and apparently ruling out additional future spending. Merkel stated flatly that Germany would not join other countries "in a senseless race to spend billions," and Finance Minister Peer Steinbrück claimed that the package was "not a stimulus package of the old style." So far, so traditional.

As it turned out, this rhetoric was misleading as to both the substance and scope of German efforts. The two measures were more extensive than those of most other European countries, amounting to a full 3.4% of GDP, despite moderate baseline jobless rates, deficits, and levels of debt. The first law, whose wooden moniker *Konjunkturpaket I* ("Economic Conditions Package I") revealingly avoided any mention of "stimulus," provided for a trivial €12 billion (0.25% of GDP) of additional spending, which Merkel claimed hopefully would trigger about €50 billion in total investment. This apparent reluctance to adopt a robust Keynesian strategy was certainly not dictated by fiscal circumstances in Germany, which was among the few advanced countries with a balanced budget in 2008. In response to widespread criticism, including a surprising push by the country's five conservative economic "wise men" to expand spending, the government announced a second in February 2009. This legislation provided €50 billion in additional spending (about 1.4% of GDP) and included €17 billion for infrastructure and a €2500-per-person rebate for drivers who trade in old cars for new, more environmentally friendly ones. The bulk of the package consisted of tax cuts for firms, a cut in payroll taxes, a small cut in personal income tax for the poor and increases in tax thresholds. The newly elected center-Right administration enacted a third measure in September 2009, dubbed the "Economic Growth Acceleration Act," which consisted mostly of tax cuts, including an annual €2.4 billion for companies and €945 million in hotel VAT, as well as a €4.6 billion boost in child benefits.

These measures were informed by German corporate liberalism's privileging of

core constituencies, including industrial workers, families, and small and medium-sized enterprises. One of its key aims was to reduce taxes for the *Mittelstand,* the traditional backbone of the German economy and a symbol of Germany's self-image as a hard-working, self-reliant exporter. The majority of the reductions (about 54% of the total) involved an increase in the standard per-child tax exemption coupled with a €20 increase in monthly child allowances. Merkel promoted the measure with a narrative of group-based prosperity, which fit well with its other, arguably more effective component: an extension of the *Kurzarbeit* ("short-time work") program. Enacted under the previous government, this program provides subsidies for (mostly industrial) workers to compensate for wage reductions resulting from cuts in working hours, thereby limiting firms' incentives to lay them off. This program was typical of German strategies of protecting jobs and subsidizing existing capital and labor constituencies rather than attempting to create new employment through the force of the state. It was also largely responsible for German firms' avoidance of mass layoffs in 2008 and 2009, even as the economy shrank by an eye-popping annualized 7% in the last quarter of 2008, resulting in unemployment of only 7.6% in July 2010, compared to 9.6% in the US. This program offered many German workers income support and continued employment during the downturn and thus represented a sort of Keynesian "automatic stabilizer," but avoided connotations of a profligate state in much the same way as the stimulus packages had focused disproportionately on tax cuts rather than high-profile spending measures.

Germany's fiscal stimulus measures were thus surprising in their scope but broadly consistent with the German liberal tradition with respect to their composition and political packaging. Despite strong reluctance to boost spending and ambivalence about state intervention, Germany adopted the largest fiscal stimulus of all major European countries and the fifth largest in the G-20. In 2009, Germany's total stimulus amounted to about $130.4 billion, which was almost six times as large as ostensibly statist France's ($20.5 billion) in monetary terms and nearly five times as large as a percentage of GDP. This German strategy of "Keynesianism by stealth" prioritized tax cuts, subsidies to firms, and other masked measures that did not attract public criticism of public profligacy.

This past summer, mounting fears of (not to say hysteria about) a so-called European "sovereign debt crisis," stemming from alarm at Greece's fiscal situation and growing pressure in bond markets on other (mostly southern) European countries, led Germany to undertake a partial reversal of course. The government unveiled an austerity program that pledged to cut €80 billion from the budget by 2014. It proposed small cuts to pension contributions for the poor and cuts in heating subsidies and child benefits for some welfare recipients. However, the so-called *Sparpaket*

sheltered the same groups (largely families and SMEs) that had been favored by the stimulus measures. The cuts were as much an exercise in symbolic politics as they were evidence of a commitment to fiscal rectitude. They left unemployment benefits untouched and continued funding of the *Kurzarbeit* program, as well as the child benefits and other targeted subsidies contained in the original stimulus packages. They largely spared the families and middle-class households who constitute the primary constituencies of Germany's employment-based welfare state. In this sense, the SPD's claim that the measure represents a "continuation of clientelistic politics" rings true. Just as Germany's original stimulus was much more extensive than it appeared, the subsequent reversal was less dramatic than it appeared.

Germany's response to the post-2007 crisis has thus been puzzling in a number of respects. It was among the last advanced industrial countries to turn to Keynesian demand stimulus but did so more extensively (but much less explicitly) than most other nations. Under the mantle of aggressive fiscal rectitude, it then enacted a series of budget cuts that were as much an exercise in symbolic politics as they were an embrace of fiscal austerity and which left most politically powerful constituencies relatively untouched. In both cases, there were significant discrepancies between rhetoric and reality. This fact alone is perhaps not surprising–this is politics, after all. What is surprising is the extent of these discrepancies and the coherence of an economic strategy couched in significantly inconsistent rhetoric.

Clearly, institutions–in this case automatic stabilizers such as the *Kurzarbeit* program, collaborative arrangements for cooperation between labor and capital, and the legally enshrined principle of self-administration by capital and labor–sheds light on some aspects of the German response (such as the reluctance to engage in aggressive industrial policy and the need to mask state efforts to revive the economy). To understand the contradictions and tensions within this response, however, we must also pay attention to ideas, as manifested in elite interpretations of the crisis and public expectations of government. Recent German experience reminds us that politics operates on both substantive and symbolic levels and that liberalism comes in many flavors, many of which taste remarkably different than the typical American recipe.

Six

Matthias Matthijs - Not Just a German Problem: Lessons from the EMU Sovereign Debt Crisis for Global Adjustment.

The German question never dies. Instead, like a flu virus, it mutates. (The Economist, 21 October 2010)

In late September 2010, Brazil's Finance Minister Guido Mantega commented in Sao Paulo that the world was "in the midst of an international currency war." His comments effectively ended all the premature praise for the G-20's efforts at international cooperation with regard to the global financial crisis. In vogue came the assessment of the actual lack of cooperation as evidenced by the growing tensions and fault lines between the new global institution's main protagonists, China and the United States, who disagree so starkly on the origin of the global macroeconomic imbalances. Those systemic imbalances - a large US current account deficit balanced by large current account surpluses in China, Japan, and Germany - have been identified as one of the main causes of the credit crunch of 2007-8 which led to the Great Recession. The central issue preventing a unified solution to the current crisis is whether the main cause of those imbalances is a global savings glut in Europe and Asia, or deficient savings and too loose monetary policy in the United States. This disagreement has risen to the forefront of the existing crisis debate as evidenced by Mantega's remarks. No one point of view, or "narrative," so far seems to have won the day and allowed cooperative steps forward.

Recent developments only seem to have made a bad situation worse. The United States claims that China is prolonging and worsening global imbalances by deliberately keeping the Chinese currency, the renminbi, undervalued vis-à-vis the US dollar. China points to the US 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 many emerging markets to respond with short-term protectionist measures such as capital controls. China argues that the US should take fiscal austerity measures at home, while the US argues that China should develop its internal demand and allow its currency to float according to market principles. With no agreement reached on how to deal with global imbalances during the November 2010 G-20 meeting in Seoul, notwithstanding vague commitments to "mutual assessment processes," the sense of malaise in the global economy due to the lack of a clear policy direction has only been reinforced.

All comparisons are flawed, but without too much of a stretch of the imagination, one can see a smaller version of the global economic debate being played out within the Eurozone today. Strong, "competitive," and export-led Germany is playing the role of China, and the United States is being played by the "spendthrift" Mediterranean countries of Greece, Portugal, Spain and Italy, as well as former Celtic "Tiger" Ireland (inauspiciously referred to by financial markets analysts as the "PIIGS" countries). Of course, the comparison is not entirely apt, since the PIIGS obviously do not (or no longer) enjoy the United States' "exorbitant privilege" of being able to borrow internationally at low rates in their own currency. Furthermore, just like at the global level, the Eurozone is currently in turmoil, facing a "crisis of survival" in the words of European Council permanent president Herman Van Rompuy in late October 2010, which has caused many analysts to doubt the future of the European project altogether.

In effect, the global financial crisis - triggered by the fall of Lehman Brothers in September 2008 - and the subsequent European sovereign debt crisis - prompted by Greece's pending default in February 2010 - 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 of 27. The rise of Germany and China has been a long time in the making, at least twenty years. What is striking, however, is the similarity between their political-economic positions. China and Germany have always been skeptical of the Anglo-Saxon model of short-term finance capitalism. 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. While the real growth data of both economies has been impressive, what matters for the purposes of my analysis is that German and Chinese policy elites fundamentally *believe* they had it right all along: that their political economic model is superior to that practiced elsewhere, and in particular, to that of the Anglo-Saxon world.

Just as the ideological divide between the United States and China at the global

level has significantly widened since the financial crisis began, so has the divide between Germany and the PIIGS in the Eurozone, particularly in recent months. Germany has taken on a more and more strident and uncompromising tone while driving its own political-economic ideology in the face of competing crisis narratives.

The role of Germany in exacerbating the EMU sovereign debt crisis has been particularly controversial. First, let me put Germany's role in context. As Carmen Reinhart and Kenneth Rogoff remind us in their recent book *This Time Is Different*, financial crises often lead to fiscal and sovereign debt crises. Eurozone governments, after having bailed out their financial sectors with an unprecedented infusion of public money, found themselves with all the bad debt they had taken on from those private sectors on their own balance sheets. As the initial focus of the financial markets 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 US Treasuries. This led to a highly fluctuating euro-dollar exchange rate and widening sovereign yields within the European Economic and Monetary Union. Now, it is the rescuers that are in need of rescuing.

As Peter Spiegel and Gerrit Wiesmann reported in the *Financial Times* in mid-November 2010, the drive by Angela Merkel, Germany's chancellor, to amend the Lisbon Treaty to set up a new bail-out system where private investors bear more of the cost of future Greek-style rescues, was very much resented by other EU leaders when she appeared to steamroll it through a Brussels summit in late October 2010. This resentment has only grown since bond markets plummeted in reaction to Merkel's proposals in the weeks since, and as the Irish crisis resulted in yet another messy European bailout, the bond markets shifted their focus to Portugal and Spain, and the crisis refuses to go away. Since Europe finds itself now in a moment of unusual uncertainty, any solution to the crisis will depend on the competing explanations, or crisis "narratives," that are lying around. I can identify at least five competing - but not mutually exclusive - crisis narratives that are currently out there.

The first explanation of the EMU sovereign debt crisis is summed up by Martin Feldstein's view that this is a crisis of institutional design. The EMU never was and never will be an optimum currency area, so they "had it coming all along." The Commission's theory of "endogeneity" was always flawed, if not dangerous, according to this view, since it confused European federalist dreams with economic and political realities. Introducing a single currency was not going to speed up the process of integration, but would create a whole new host of economic problems. The current crisis seems to vindicate this view, even though there is little evidence for it.

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) was far from "stupid" - as Romano Prodi once called it - but a rather good idea, and ignoring the SGP and its "excess deficit procedure" in 2003 as the Council of Ministers did in the case of France and Germany itself set a dangerous precedent for smaller, peripheral countries that their fiscal profligacy would go unpunished. 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, eventually undermining the credibility of the whole Eurozone.

The third explanation - the other half of the German policy elite view - is that this is a crisis of competitiveness in Southern Europe. North-South divisions grew 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. In this view, Germany is more competitive than the rest of Europe because of the painful reforms enacted under the Schröder governments during the early 2000s (Hartz 4, etc.), serious wage restraint and high productivity. The introduction of the euro in 1999 took away all incentive in Southern Europe to continue the "necessary" structural reforms, hence leading them to continue along their old bad ways.

The fourth explanation - the 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. Since EMU members indirectly share liability for private sector debt, the SGP would have to be complemented with an ESP ("External Stability Pact").

The fifth explanation, often ignored, is that this was a crisis of "efficient" financial markets. Interest rate convergence took place 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. If one takes the fifth explanation seriously, 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. This explanation asks the rhetorical question: 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? They never make the same mistake twice?

All five explanations for the 2010 EMU crisis are plausible to some extent and should probably all be addressed if the Eurozone wants to emerge stronger out of its current shambles and prevent a similar future crisis. However, 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 large inflows of private capital. The competitiveness argument applies to the whole Mediterranean, but 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, which economic ideas have informed those decisions, and why.

In many ways, it is remarkable how the two main "German" explanations of the crisis - fiscal profligacy combined with a lack of competitiveness in the South - have informed European decision making thus far. This has led many analysts to conclude that Germany is "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 some 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 Germany as a 'normal' country with legitimate domestic and national interests. German solidarity with the European Union has reached its limits and the current crisis is nothing more than the country finally flexing its economic muscle.

Now, as tempting as this explanation may be, the reality is much more complicated than that. Germany does not "run Europe" or impose its will on its fellow Eurozone 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 has seen the fastest quarter-on-quarter economic growth in 2010 since reunification and that business confidence in the country is at record highs obviously only strengthens the German view that their anti-Keynesian austerity approach to their domestic economy has been right along.

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 and often rather embarrassing meetings at the level of the Eurozone's finance ministers in Washington and Brussels during the spring of 2010. Those accounts would seem to suggest that the final outcome to the Greek crisis in May 2010 was a compromise between the major 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. However, Germany still seems to be the linchpin, without which any solution would have been elusive.

I would argue that Germany had the most convincing crisis narrative, in the sense that it is considered the most appropriate by Eurozone leaders. 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 Eurozone’s fate is bound up with Germany. And given German banks’ heavy exposure to Greek, Irish, Portuguese and Spanish bonds - and the calamity those countries’ default would mean for the German economy - Germany saved Greece and Ireland partly to save itself, just as it is likely to save other EMU members in 2011. In the case of Greece, Germany did so against huge popular discontent at home, where the voters were all too aware who was footing the bill for the Mediterranean party. So, naturally, without strict conditions on profligate states and the imposition of losses on risk-happy creditors, all 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, once Angela Merkel convinced Nicolas Sarkozy that it had a case, the others could not do anything else but grudgingly agree.

However, just because Germany seems to have won the narrative debate for now does not mean that the German position is inherently sustainable. 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 (even though that is questionable, given recent events in the Eurozone), but they do not solve many of the crisis’ underlying problems. In the case of Ireland, it is hard to understand why a fiscally sound country which has slashed public spending and public sector wages over the past two years in response to the 2008 financial crisis could solve a banking crisis with even more austerity measures. Yet, that is what they are doing. And it is even harder to believe that the Irish population will support these policies for the next ten years just to remain in the Eurozone, when its main trading partners are the US and the UK.

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. German growth was fueled by buoyant demand in Southern Europe made possible by excess German savings. Any current account surplus means that another country has a current account deficit. By the iron logic of the balance of payments, that also means that one country’s capital inflows are another’s capital outflows.

If Germany wants the Eurozone as a whole to become more like Germany, this would only exacerbate the existing global macroeconomic imbalances, with the next financial crisis just around the corner, putting into doubt the fragile “green shoots”

of recovery most heads of state keep pointing towards in order to reassure their grumbling electorates that the worst is over.

So, the German lesson for the world economy is clear. China has been growing at record levels partially thanks to a surge in net exports, not solely because the Chinese are inherently more competitive (even though there is probably something to that point), but because someone else wants to buy their goods. If the world wants to avoid another 2008-style credit crash, something will need to give.

If all that happens is that the US does its share towards global re-balancing by slashing its own budget deficit, we risk deflating our way to another Great Depression. 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. The current state of the global economy is a "catastrophic equilibrium" at best.

Seven

Wade Jacoby - Germany: Europe's Company Store

Two popular views of Germany have dominated the current debate about the European financial crisis. Both are wrong. The first view sees Germany as an economically virtuous island in a sea of European profligacy. This is the view of most German voters and of their chancellor, Angela Merkel. In this view, Germany was industrious and prudent while others (Greece, Ireland, Hungary) were profligate. Therefore, these countries should rebalance their accounts without a "bailout" from Germany. This view conveniently ignores that German firms and banks financed these imbalances and that absent external demand for German goods and capital, Germans would be poorer. To put it bluntly, Germany can profitably do what it does only if most others do not.

The second view, popular more recently even in traditionally Germanophile Ireland, is essentially the opposite: that Germany is venomous, visiting an economic "Versailles" upon indebted countries by obliging them to pay above market interest rates for rescues that go primarily to repay foreign banks, many of them, you guessed it, German. The problem with this view is that it tends to give Germany both too much credit for masterminding the European rescue plans–when it has made several concessions–while also ignoring Germany's very real vulnerabilities.

A third view of Germany is more complex, but it has the advantage of being much closer to the truth. In this view, German is both hypocritical and more than a bit clueless. In fact, these things go together. Like most hypocrisies, deficient self-understanding lies at the root. Germans don't know themselves very well. The best way to see this reality is step a bit beyond Germany and look at its economic relations with its European neighbors. The hope is that buy seeing the dimensions of the problem clearly, German voters and politicians will be more willing to share in the necessary adjustments.

Germany's Political Economy of Surplus

Since at least the 1960s, there has been a tension between Germany as a co-organizer of European capitalism and Germany as the home of firms that compete very successfully in that system. In the former context, the German government tries to create order, but in the latter its powerful firms often sow disruption. The most common face of this disruption is that Germany tends to run very persistent trade surpluses with its partners. Its firms, on balance, outcompete those of its neighbors. Germany then had to learn to manage, sustain, and often finance the tastes of its key trade partners. In simple terms, and quite unlike the United States after the mid-1970s, Germany produced more than it consumed. Often, far more. It is, to use a term coined by Wolfgang Hager in the early 1980s, an "extraordinary trader."

This baseline tendency was both masked and exacerbated by key events in the past two decades. It was masked insofar as German reunification led to an impressive inflow of capital from other places in Europe, partly to finance the rebuilding of Eastern Germany. So while Germany continued to run a trade (and therefore) current account surplus, it often ran in deficit on the capital account. But Germany's proclivity towards trade surplus was exacerbated by other developments, including its own substantial wage moderation efforts but also the explosion of liquidity in the mid-2000s, as Germany's very favorable borrowing terms spread to many other countries. Bond spreads dropped to very low levels as not only the EMU-based southern European countries but even non-EMU countries in most of Central and Eastern Europe also saw borrowing costs fall (as did even non-EU member Turkey). The roaring economy of the 2000s in much of CEE was linked at least in part to high liquidity.

But the strong Euro during this period continued to really focus German efforts on the supply-side. Wage gains remained modest and generally well below productivity trends. In other words, Germany quietly returning to a pattern that had been much commented in the 1980s but that had been less disruptive in the 1990s, when Germany's always-robust export profile was obscured by capital inflows and a healthy appetite for imports from the Single Market. While these trends were more or less in plain sight, they were masked by liquidity, financed in no small part by export earnings of German firms recycled through German banks. With the financial crisis, this entire complex emerged as problematic.

Germany as Europe's Company Store

In fact, Germany came, for a time in the 2000s, to operate much like the famous company towns of late 19th- and early 20th-century American mining districts. The

mining town company stores were a bit more complex than the image handed down through popular music ("Saint Peter, don't you call me, 'cause I can't go/I owe my soul to the company store."). There was a level of exploitation, but one that generally needed to be kept within limits in order not to lose the miners whose labor brought the ore to the surface. Germany has walked an analogous line with the rest of Europe, ensuring that the terms of its exchanges did not grow so unfavorable for its partners that they sought other arrangements.

To illustrate, consider that American mining companies often had two distinct commercial relationships with their miners in the company towns. First, they certainly had a wage relationship in which miners dug ore in exchange for wages, whether in cash or company scrip. Second, they usually had a retail relationship in which the company store was the main source of supplies both for work (lamps, candles, clothes, tools, explosives) and for provisioning the home (food, furniture, clothing). In this way, wages paid out by the mining company often flowed back in the form of purchases of goods. In some cases, miners did end up in debt peonage to the corporation, though this was relatively rare unless the towns were extremely isolated and miners had no other options. The playing field was not "level," but there were rules and norms that constrained all parties.

The analogy captures a number of features of Germany's relationship with, in particular, Central and Eastern Europe (CEE) over the last decade. First, in terms of the "wage" relationship, Germany has been, by far, the largest investor in the region. Automobiles, and to a lesser extent, electronics assembly and even machine tools, have been sectors that have created many jobs through German investment. Moreover, it is clear that over time the quality of these jobs has improved. For example, Vera Scepanovic's data shows that the high value-added portion of auto sector production in CEE rose from 400 million Euros in 1996 to 11.3 billion Euros in 2006, moving from roughly 15% of total sectoral production to nearly 40%. The vast majority of CEE auto production is driven by German investment. Make no mistake: lots of jobs in Central Europe remain dependent on German investment.

The "retail" relationship is then tied to this dynamic. Put simply, Central Europeans have always looked to German producers for high quality consumer goods and to German banks for the liquidity to purchase such goods. Even during the communist era, consumption booms were generally financed by access to foreign credits. At least five CEE countries have, at one time or another, run double digit current account deficits during the 2000s, and two (Bulgaria and Latvia) have been over 20%. That said, the very low wages in CEE are, in good company store fashion, a major reason why borrowing for consumption is so high. In short, Germany has run a very persistent trade surplus with the region and has, through its banks, helped to

finance this surplus by boosting consumption spending (According to OECD data, Germany's trade surplus, which averaged $54 billion between reunification and 2001, jumped to an average of $199 billion from 2002-08). Credit helped square the economic circle for CEE, which understandably wanted to see living standards rise but not see major wage increases that would erode its attractiveness to, well, German investors.

Analogies can tell us which features of a complicated relationship to look at more closely, but all analogies eventually run out of steam. Company towns disappeared. Germany will not. But German voters and politicians must understand the country's core core dilemma if it is to manage it better. German voters have politicians on a short leash, fearing "appeasement" of profligate states that encircle them to the North (Ireland), South (Greece and maybe Spain), East (Hungary) and even West (Belgium). The result is that German politicians have to wait until the size and scope of the problem is so large that voters can see it. Until, in other words, it is too late. When Germany waits, the size of the problem grows, as does the pain of the adjustment. When this pain is borne exclusively by foreigners, Germany is resented. And so it will be until Germany's behavior changes–until domestic consumption and wages grow and until Germany's own banks clarify their balance sheets and share in the writedowns that must come. It will not do to whine that Germany is "being punished for making good products at a good price." It is being punished for failing to see that its trade partners cannot sustain these levels of consumption, no matter how hard Germans try to lubricate it.

Eight

Henry Farrell - "One of the Fingers on the Button Will be German": German Economic Preferences over EU Institutions and the Irish Economic Crisis

Most of the contributions to this seminar begin with Germany's internal politics and work outwards. This short piece instead emphasizes the external consequences, asking what they mean for European Union politics, taking Ireland as a test case. Ireland is the only 'Anglo-Saxon' member of an economic and monetary union which was built largely in order to match German preferences. Both its current crisis, and the ways in which Germany (and other EU member states) are seeking to respond to it, provide evidence both regarding German preferences, and their intellectual and material limitations when they become generalized as policy prescriptions at the European level. Because Economic and Monetary Union only provides fiscal restraints, and no very useful means of intervening in private markets, Germany and other member states face stark limits in their ability to prevent, and even to respond to crises that originate in the private sector. Moreover, when they do, they are likely to find their interventions politicized, and strongly resented by the populations of the countries that are intervened in.

The EMU and Ireland: External Consequences of German Preferences

The story of the battle between Germany and France over the institutions governing Economic and Monetary Union is well known in outline. Although France had some nominal success in labeling the accompanying institutional bargain the "Stability

and Growth Pact" rather than merely the "Stability Pact," this victory was one on paper only. The European Central Bank pursued a policy that adhered quite closely to German preferences for low inflation, paying no serious attention to growth promotion. Although the Stability and Growth Pact mandated serious limits on deficit spending, it proved incapable of restraining the major states – Germany and France – when they found its strictures temporarily inconvenient.

Economists' doubts about the sustainability of EMU returned to the fore when the crisis got into full swing last spring. It became clear that Greece had systematically lied in its statistical reports, and had in fact been building up an ever larger deficit that became completely unsustainable in the wake of the crisis. Economists and other commentators paid much less attention to the incompleteness of the European institutional bargain, which imposed half - but only half - of the German domestic economic model on other EMU member states. The Stability and Growth Pact – even when it worked – was intended to prevent governments from building up large deficits. There was no accompanying set of institutions that were intended to impose German style regulations so as to prevent private sector crises from emerging.

These problems are cast into sharp relief by the recent economic crisis in Ireland, in part because Ireland represents a very different economic model to the German one that EMU was intended to propagate. In order to create economic growth, Ireland lowered taxes (with particular attention to effective corporate taxation rates) and sought to attract investment from abroad. Towards the same end, it built an International Financial Services Center which combined taxation benefits with minimal regulation laxly enforced, so as to attract financial services firms both from London and elsewhere. Several German banks and reinsurers set up boutique subdivisions in the Center, sometimes with quite unfortunate consequences. Finally, lack of a strong system of banking regulation and minimal supervision, together with a close political relationship between Ireland's dominant political party and land developers helped inflate a property bubble which had dire consequences for both Irish fiscal stability and the Irish banking system when the bubble popped.

Ireland's Anglo-Saxon growth model, far from being restrained by EMU membership, was facilitated by it. Ireland's decision to join EMU, rather than to stay outside with the United Kingdom (with which Ireland had strong economic ties) was fundamentally a political rather than an economic choice. EMU membership was expected to lower interest rates and the cost of capital for Irish firms.

EMU membership provided these benefits in the short term. As anticipated, it led to lower interest rates and yields for Irish government debt. However, it also obscured the fundamental trade-offs faced by small open economies such as Ireland in ways that had pernicious long term consequences. As Avellaneda and Hardiman

suggest, EMU systematically helped promote pro-cyclical fiscal policies in member states. This had particularly damaging consequences for Ireland. Although Ireland achieved surpluses during most of the period in question, this was accidental rather than deliberate, and a consequence of higher-than-expected economic growth rather than careful government policy. There was little effort to plan spending, as indicated by Finance Minister Charlie McCreevey's publicly stated dictum of "When I have it, I spend it."

Public profligacy went hand-in-hand with private sector exposure. High growth rates in Ireland attracted money from Germany, France and the United Kingdom. A combination of extraordinarily high growth rates (which initially were a product of catch-up, then of an over-inflated property market), together with cheap borrowing via EMU supported policies that were insupportable in the long run.

When the crash came, it hurt very badly. GDP fell by an estimated 7.25 percent in 2009, while unemployment rose to over 13%. House prices have plummeted 30 percent since their peak, and may fall much farther.

In short – even if the Stability and Growth Pact instilled German preferences over economic stability as the baseline for EMU governance, it did not lead to a cloning of the German model across EMU members, nor even (as expected) a greater attention to the merits of fiscal caution. Not only did Southern European countries fail to reform their domestic economic institutions as economists had hoped but Ireland – which embraced an economic model that was in many respects antithetical to Germany's – found that EMU reinforced its institutional path of development in malign ways. EMU arguably made it easier for Ireland to maintain a feckless economic policy than it would have otherwise, through lowering interest rates. In contrast to EMU's fiscal policy strictures, there was no European structures to actively promote a social market economy approach, or even to monitor effectively for problems within EMU's private sector.

German preferences for an economic and monetary union based on low inflation and simple external rules on budget deficits would have proved insufficient even if Germany and France had not weakened EMU. Ireland's twin crises of fiscal importunity and property market instability not only went hand-in-hand, but were effectively invisible under EMU's strictures. Economic and Monetary Union's rules provided no very obvious way to investigate or forestall behavior that was manifestly fiscally irresponsible in the long run, but did not lead to budget deficits over the shorter term.

Responding to the Crisis: The Contradictions of the German-led Policy Response

If Ireland's initial economic difficulties were in part the result of a half-baked attempt to instill German policy preferences at the heart of an EMU composed of countries which did not resemble Germany, current efforts to extricate Ireland illustrate the problems of a more whole-hearted approach to change.

Ireland's current crisis was not caused by Germany, as some Irish commentators like to pretend. Better information about the true extent of Ireland's problems had two consequences. First – it meant that Irish banks had to rely ever more on the European Central Bank's emergency liquidity support system to raise any money at all – by the end of October, Irish banks held almost a quarter of total ECB loans. This generated increasing unhappiness within the ECB, which started to make public noises about the need to find an exit strategy. Second, the spread between German and Irish government bond rates began to widen ever more as lenders priced in the cost to the government of dealing with losses.

While the Irish government hoped to bluff it out until after an election, markets took fright when Angela Merkel suggested that any permanent EU crisis resolution mechanism would involve haircuts for holders of senior debt. This led to an accelerating spread, and enormous pressure from Germany and other EU member states on Ireland to apply for a bailout, in the hope that this would prevent financial uncertainties from infecting the eurozone as a whole. The result – agreed on November 22 2010, was a package of loans administered by the EU (through EMU-focused emergency mechanisms and bilateral loans from non-EMU members the UK and Sweden) and the IMF of approximately 85 billion euro. Of this sum, 50 billion will support government spending as it seeks to reduce its deficit (on the assumption that the Irish government will have extreme difficulty in raising money on international markets) and 35 billion to allow the Irish government to further support the Irish banking system through effective nationalizations, majority shares, and the allocation of bad debts to a 'bad bank' arrangement (NAMA).

This package did not calm markets. This is at least in part because it is shot through with contradictions, which are in large part consequences of difficulties in extending the German model. If Germany is not responsible for lowering the boom on Ireland, it has much to do with the obvious inadequacies of the purported approach to getting Ireland out of trouble.

Germany's strong preferences for austerity have reshaped European economic policy since mid-2010. The package agreed by the IMF and EU includes a bridging loan, which is however conditional on continued sweeping budget cuts. Yet this is

obviously likely further to depress domestic demand, and spur renewed emigration. At the very least, German and ECB suggestions that austerity would calm market expectations and lead to a swift return to growth appear likely to be falsified in Ireland. Although Ireland would have little choice but some form of austerity, it appears that ECB preferences (which likely reflect thinking in the Bundesbank and Germany) would have been to impose an even larger set of cuts than the €15 billion cutbacks mandated in the final package. Rather unusually, it was the IMF that pressed for more generous terms for Ireland.

More importantly, the specific form of the rescue package has been dictated by German beliefs and domestic imperatives. Karlsruhe looms large – the continued desire to avoid a Constitutional Court veto of any European rescue arrangements mean that the European Union is again lending above the market rates that Ireland and other EMU members once enjoyed. This means that Ireland will have extreme difficulty in escaping its debt burden in the future, except under extraordinarily optimistic assumptions about future growth. As Willem Buiter and his colleagues put it recently:

> Ireland provides a microcosm of the challenges facing the [euro area]. Accessing the official external sources of funds that have been made available will likely not mark the end of Ireland's troubles. The reason is that, in our view, the consolidated Irish sovereign and Irish domestic financial system is insolvent — the Irish banks are 'too big to save' for the Irish sovereign. The Irish sovereign cannot 'bail out' the banks from its own resources and make its own creditors — the owners of Irish sovereign debt — whole. In addition, a bail-out (permanent fiscal transfer) from EA/EU partners or the ECB on a scale sufficient to fill the solvency gap is most unlikely. Therefore, either the unsecured and non-sovereign-guaranteed creditors of the banks, or the creditors of the sovereign (including holders of sovereign-guaranteed bank debt), or both, will likely eventually have to accept sovereign debt ...

Despite statements from Angela Merkel and the Bundesbank that private bondholders should share the pain of future banking bailouts, there is some evidence that the failure to impose a haircut on holders of senior Irish debt reflects the preferences of France, Germany and the UK as well as those of the European Central Bank. An interview with Irish Central Bank governor Patrick Honahan suggests that Ireland's decision not to pursue these bondholders was a "quid pro quo" for continued ECB support and that there had been "no enthusiasm" in European capitals for forced writedowns. This reluctance is plausibly motivated in part by the fear of contagion

spreading to other Eurozone members. However, it also possibly reflects the fact that prominent and influential French, German and UK banks are among those debt holders. The perception, whether justified or otherwise, that Irish taxpayers will have to repay enormous sums which are being lent to them for the primary purpose of protecting the interests of foreign banks has done little to endear the bailout to Irish taxpayers. Nor, for that matter has the requirement that the Irish government invest pension funds that were previously firewalled off in banks which are widely perceived as worthless.

Conclusions

The crisis in Ireland and other peripheral Eurozone members was in large part (although certainly not entirely) the product of institutions that were intended by Germany to enforce fiscal rectitude on EMU participants. Not only did they fail to do this in Ireland and Greece, but they plausibly provided positive incentives for imprudent behavior. The Stability and Growth Pact served not as a spur towards scrupulous fiscal policy, but as a replacement for it. Because eurozone governments were perceived as safe borrowers, they could maintain levels of borrowing that would otherwise have been unachievable. Rigid and simple rules on government spending proved completely inadequate to guarantee domestic fiscal sustainability in the absence of any mechanisms for monitoring private activities and stringent financial regulations. A stripped down version of *Modell Deutschland* proved a poor basis for regulating a monetary union made up of diverse economies. German institutional preferences proved an inadequate basis for securing German policy goals.

The contradictions in Germany's stance towards bailing out other European economies are even more apparent. German-imposed preferences for austerity, as mediated through the ECB, appear far more likely to hurt recovery than to help it. German's domestic policy constraints prevent the EU from offering loans at rates that would allow states in trouble to recover credibility on markets, let alone to recover properly.

This is arguably less the product of conscious state strategy on Germany's part, than the playing out of domestic politics in a situation where Germany is uniquely powerful and where the definition of Germany's international interests is still quite malleable. Even so, Germany's new role is generating much resentment. Irish political commentators such as the prominent economist Morgan Kelly argue that ECB policy has been dominated by the "overriding concern" of ensuring the solvency of French and German banks and complain that:

> Since September, a permanent team of ECB "observers" has taken up residence in the Department of Finance. Although of many nationalities,

> they are known there, dismayingly but inevitably, as "The Germans."

Ireland's Finance spokesman for the main opposition party (and probable senior figure in the next Irish government), Michael Noonan suggested in the Dáil (the Irish Parliament) that Germany had directly profited from the crisis.

> It is probably not known in this country that Germany has gained a lot from the crisis. German bonds are a safe haven for the savings of Europeans, particularly in peripheral countries. A reasonable calculation would suggest that German debt servicing has gone down by between €15 billion and €20 billion since the start of this crisis because of the inflow of funds from elsewhere. This pitch is very uneven at present and I am growing increasingly concerned about the weight of what is being imposed on Ireland and the lack of understanding, in particular, on the part of the European institutions although the IMF, which has experience in this area, seems to be taking a more tolerant view.

The long term consequences of Germany's successful push towards austerity have yet to play out. However, initial results from the Irish case would suggest two lessons. The first is that the contradictions within Germany's policy towards Europe are leading to bad policy. The second is that as a result, Germany is likely to receive the political blame in target countries both for the economic pain that its mandated measures are causing, and for many of the adjustment pains that they would surely have suffered in any event. Germany's asymmetric power is reshaping European economic politics in a direct, and arguably even a brutal fashion. It is not clear that German politicians and economic policy makers have any appreciation of the resentment and hostility that they are likely to incur as a result.

Nine

Sheri Berman - Germany: The Necessary But Not Sufficient Nation?

During the global economic crisis, Germany has received more attention than probably most scholars and observers would have predicted. Early on, much attention was paid to the country's purported decision to go the "austerity" rather than the "Keynesian" route; more recently scrutiny has been focused on its purportedly obstructionist role in the European Union's meltdown. While both of these claims have some truth on the surface, neither really captures fully what is going on.

A number of analysts (including Paul Krugman[1]) have already discussed the relative balance between Keynesianism and austerity in contemporary German economic policy, so there is no need to go into this in much depth. What is worth noting, however, is that Germans have never been fond of Keynesianism, even during its heyday in Europe's postwar period. For a variety of historical reasons (not all of them valid) Germans have had an allergy to Keynesianism, avoiding it even during its miraculous economic recovery after the war and while building up an extremely generous welfare state. That Germany therefore once again proved unwilling to embrace Keynesianism–at least openly–should therefore be no surprise to those who know something about Germany's 20th century economic history.

But equating a lack of enthusiasm for Keynesianism with austerity or worse[2] seems silly, since whatever the Germans have said, they continue to spend way more than the U.S. on their welfare state, have carefully managed unemployment by paying firms to keep workers rather than firing them, and have no intention whatsoever of letting their deeply troubled banks fail. It is also worth noting that behind all the rhetoric of Germany's "austerity" generating a "miraculous" economic recovery, a much more troubling reality lurks (again, see Krugman). Most strikingly, although

[1]Paul Krugman, "What About Germany?" *New York Times*, August 24, 2010.

[2]Noam Schreiber, for example, has described German economic policy and preferences as "gratingly reminiscent of Republican talking points."

Germany's exports have been doing quite well of late, Germans themselves have not benefitted concomitantly from this: their incomes and purchasing power remain surprisingly stagnant and the relative health of the employment market is (as noted above) still dependent on government efforts and potentially developing some potentially serious flaws.

Far more interesting and surprising then Germany's stand against Keynesianism has been how the financial crisis has revealed a larger problem with contemporary Germany–namely its role in the European Union. As many, especially, George Soros have noted,[3] as the Euro zone's most powerful nation and economy, Germany has played an outsized role in determining political and economic developments over the past years–and here's where things get interesting.

Much talk has been heard of late of the basic flaw in the EU–the disjuncture between its political and economic development. The early architects of the European project hoped (and expected) that politics would catch up with economics: that the continent's political institutions would become as integrated as its economies, but alas this has not happened. The dangers of this disjuncture became clear during the current crisis when the common currency created differential problems for European countries and the EU more generally was unable to come up with a coherent response to a barrage of problems. But the current crisis has brought up a second flaw in the EU's design–its heavy dependence on a Germany that was bound to disappear.

EU institutions and functioning were, to a large degree, premised on a Germany willing to subsume its national interests to those of its neighbors' and pay a disproportionate share of the bill for constructing the new Europe. What we have seen in this crisis is that this may be as fundamental a flaw in the European projects as is the disjuncture between its political and economic development. During the current crisis Germany has made clear that it a) will not go along with policies that seem good for the EU (in the short term) but directly go against what its views as its own national interests (like bailouts of profligate countries like Greece) without at least raising a fuss; similar and related, b) it will no longer foot the bill for new programs just because it is asked (see same). What is now painfully clear is how much of European integration's progress over the postwar period was based on just these assumptions being true–i.e. that Germany would willingly adopt (or at least accept) the preferences of its neighbors (mainly France) and pay the bill for policies that would facilitate the growth and extension of the European project. That Germany is no longer willing to do these things should be neither surprisingly nor lead to predictions of some sort of German reversion to Evil Empire status. What this all represents is, of course, nothing more than the normalization of Germany, helped

[3]George Soros, "The Crisis and the Euro," *New York Review of Books*, August 19, 2010.

along by a changing of the guard at the leadership level and a financial crisis that has cruelly highlighted how different the economies and attitudes of Germans and many other Europeans are.

Just as anyone who knew anything about German political and economic history during the twentieth century should not have been surprised by Germany's initial discomfort with the (fleeting) enthusiasm for Keynesianism exhibited by many countries and policy-makers in the West, anyone with any knowledge of international relations or recent Germany history should not be surprised by Germany's current discomfort with or ambivalence about shouldering a disproportionate burden in powering the European engine. The signs have been there for a long time, but it has taken the financial crisis to highlight not only this shift in Germany's stance but how important it is.

Helmut Kohl was the last German leader to equate Germany's interests fully with Europe's. German unification temporarily solidified this equation as Kohl and other German elites recognized that assuaging many Europeans' fears of a united Germany required once again placing Germany's commitment to a European future front and center. But the structural underpinnings of this position were shifting and so it was only a matter of time before superstructure caught up. Already under Gerhard Schröder (Kohl's successor), this change was clear. Germany was under a leadership for whom the Second World War was no longer the only factor defining German foreign and domestic policy; Schröder's government therefore had no problem criticizing Brussels, cozying up to the Russians, or breaking with the Americans in ways that would surely have made their predecessors cringe. And since Schröder's time, this trend has only continued. Germany has become less backward looking, less defined by its past. The problems topping the German political agenda are the problems of other European countries: unemployment, competition with China, immigration. It is true, as Jürgen Habermas has said that Germany is developing a more "inward looking national policy." This does not mean that its commitment to Europe is or will evaporate or that leaders no longer recognize how valuable the European Union is to Germany. It just means that alongside these concerns, other concerns now take on a higher profile among German elites (and the public) than they did a generation ago. We can see how these different imperatives have pushed Germany to act in a somewhat erratic and unpredictable fashion over the past years. Rather than continually and routinely sprouting a generic commitment to the European project, Germans now qualify that with criticism of their neighbors, demands for their own interests to be taken more forthrightly into account, and the occasional unilateral utterance or policy move that others have reacted to with what can only be called shock. All of these trends are to be expected, and should have been expected.

In relatively good times the full implications of this shift in German position and attitudes were obscured. Now of course, Europe is at a critical juncture and successfully maneuvering through it will require leadership and powerful course corrections. In the past, the Germans (along with the French) would have stepped in, coming up with a compromise that satisfied the key players and managed to keep Europe moving forward, if at a plodding pace. But the Germans aren't so willing to play this role anymore. They won't unflinchingly accept the extra burdens, feel scornful towards many of their neighbors who have not made the same "sacrifices" they have, and the chemistry between the German and French leaders is weak, to say the least. Just as the crisis has highlighted the gap between economic and political integration so too has the crisis highlighted how dependent Europe was on its most powerful country acting in an historically and comparatively peculiar way.

So, what does this all mean–for Germany and the EU's future? Well, fortune telling is always a risky business, but what seems clear is that some long-standing shibboleths have finally reached the end of their natural lives. Most importantly that the flaws built into the European project will take care of themselves–that over time the disjuncture between politics and economics will be reconciled and that Germany can be countered on to willingly shoulder a disproportionate share of the political and economic cost of integration for the foreseeable future. Once we recognize that neither of these things is likely to be true, the European project looks both harder and more exciting. Harder, because the real problems or flaws in the project can no longer be avoided; more exciting, because dealing with them can no longer be avoided. Germany remains the necessary nation for Europe but Europeans must realize that it is no longer sufficient.

Ten

Tobias Schulze-Cleven - Discovering the Limits of *Ordnungspolitik*

As the Euro crisis deepened, the German government's crisis management became the object of increasingly intense criticism. Being perceived to have "fallen out of love with Europe." the country seemed to be "making a huge profit at the expense of the other Europeans, while simultaneously, at the political level, relinquishing its European responsibility." [1] Many of the individual charges directed at Germany were right on the mark, particularly those about the one-sidedness and self-serving nature of German discourse about the country's economic renaissance, which largely failed to acknowledge the strongly positive impact of the Euro on the economy. But other accusations were remarkable for their own biases. With the often clearly defined drawbacks of German actions, it has been relatively easy to criticize them. However, given the complexity of the challenges facing the Euroarea, it is far harder to say what German positions should actually be.

This is the dilemma of German policymakers, who have to both chart a course in the face of great uncertainty internationally and also maneuver within the treacherous waters of domestic politics. Understanding Germany's seemingly egoistic policy stances and the country's vacillating positions on Euro governance during 2010 requires an appreciation for the tensions between the *increasing limits* and the *continuing force* of ordo-liberal thinking in Germany's engagement with the European Union.

Firmly entrenched at the center of Germany's social market economy, ordo-liberal ideology stresses the importance of stability and stipulates that governments should restrict themselves to creating a proper legal framework (*Ordnungspolitik* or "ordering policies") for ensuring a healthy level of competition in the economy. At Germany's

[1] The first quote is taken from Wolfgang Proissl. 2010. *Why Germany Fell out of Love with Europe.* Brussels: Bruegel. The second quote is from Ulrike Guérot. 2010. "Germany is Europe. But why have the Germans not noticed?" *IP Global* 6/2010: 64.

insistence, these ideas made it into the heart of European Monetary Union, with the ECB being modeled on the German Bundesbank, a no-bailout clause and the Stability and Growth Pact (SGP) aiming to assure national-level fiscal rectitude, and strict limits on European-level fiscal policies keeping the majority of formerly soft-currency countries in the Eurogroup from establishing a "transfer-union."

A "Leap of Faith" Gone Sour

By institutionalizing a common monetary policy for a set of countries with heterogeneous business cycles, fiscal policies and wage-bargaining institutions, the introduction of the Euro was truly a leap of faith. When the Euro was introduced, it was widely understood that over time new institutions would have to be developed to compensate for the loss of national monetary authority. But it remained unclear how these institutions would look or could be built.

A decade later, with new institutions still largely elusive, the Euro has produced the predicted problems: While the interest rates set by the European Central Bank (ECB) have successfully kept Europe-wide inflation rates below the inflation target of two percent, individual countries' inflation and growth rates have continued to differ. For instance, while inflation in German was below the target for eight out of the ten years 1999-2008, the inflation rates in Ireland, Greece, Portugal and Spain exceeded the target every year. This translated into a strongly pro-cyclical monetary stance in much of Europe, with rising real interest rates (i.e. nominal rates minus inflation) that further depressed domestic demand in Germany, and falling rates for the higher-inflation Southern European countries, which fueled a consumption and housing boom.[2] National wage-bargaining institutions further amplified these differences, with Northern European countries' more coordinated wage-bargaining better suited to delivering wage moderation than the decentralized systems in Southern Europe and Ireland. As Fritz W. Scharpf had foreseen two decades ago, Germany and a few Northern countries became increasingly cost-competitive and trade imbalances *within* the Eurozone increased.[3]

In theory, the European countries should have used their fiscal policies to compensate for the monetary policy mismatch, but with welfare state growth having crowded out discretionary fiscal policy, this proved difficult. Instead, counter-cyclical fiscal

[2] For a detailed discussion of the mechanisms, see Henrik Enderlein. 2004. *Nationale Wirtschaftspolitik in der Europäischen Währungsunion.* Frankfurt/Main: Campus.

[3] See Fritz W. Scharpf. 1991. *Crisis and Choice in European Social Democracy. Ithaca, NY: Cornell University Press.* A very accessible discussion of the pro-cyclical dynamics and their effects on trade can be found in Martin Höpner. 2010. "Warum der Euro nicht funktioniert." *Die Mitbestimmung* 56(7/8): 48-50.

stimulus in those countries suffering from deflationary monetary stances quickly put them in violation of the SGP, as happened with Germany under the Schröder government. At the same time, in those countries with loose monetary stances, fiscal tightening would have required policymakers to raise taxes, cut popular welfare state programs and/or refrain from tapping into the world's financial markets at historically low interest rates, all of which policymakers had little incentive to pursue.

Toward New Forms of Economic Governance for EMU

With Germany's and France's violation of the SGP after 2003, the deficit rules lost any legitimacy that they might have had on the European level. Unfortunately, this fact was apparently lost on many members of the German economics profession as well as German tabloid journalists, who spent much of 2010 riling up the German population against the profligate spending of "deficit sinners" in Southern Europe. With the old governance rules largely in tatters, it was far from clear how to move forward.

Even though German Chancellor Angela Merkel is reported to have warned in October that Germany could abandon the Euro, a German exit from the common currency remains highly unlikely. Not only are there are no treaty provisions and little infrastructure to see it through. Most importantly, it would bring back the problems that had originally prompted European monetary integration. For example, a reintroduced Deutschmark would immediately appreciate, putting in danger German export performance. Other countries are equally unlikely to exit EMU. Even in Greece, companies need the Euro to create the growth that is needed to enable the state to service its debt.

With the exit option off the table for all practical purposes, calls for a "real integration" or "political union" abound. But how would such a scenario look? Particularly from a German standpoint (but also for other European countries), European-level economic governance with control over wage-setting and member-states' fiscal policies would be highly problematic, for it would infringe on Germany's constitutionally protected principle of wage-bargaining free of state interference (*Tarifautonomie*) and would also constrain the democratically-legitimized power of national parliaments, which Germany's constitutional court has also already ruled out.

Without a new master plan for the long-term governance of the Euro, the German government has concentrated on addressing international investors' short-term fears about Europeans' inability to manage their currency. In doing so, it has largely reacted to events, rather than proactively taken steps toward a new governance structure. Thus, the government has more or less muddled through, with a tendency

to come down on issues when outside events put them on the agenda, and with a timing that has often put further stress on other European countries. For example, while Merkel's push to make private debtors assume costs after 2013 was a reasonable one, pursuing it in the middle of worries about Ireland's deficit could only increase the risk markup that investors demanded for holding Irish bonds.

Throughout, the government has been pulled in different directions, constrained by ordo-liberalism's legacy in domestic politics, yet feeling compelled to openly break with the approach. For example, even though German Finance Minister Peer Steinbrück had acknowledged in the spring of 2009 the need to deal with Greece's financial situation, it took until May 2010 to pull together a package for Greece, as well as to establish a broader temporary stabilization mechanism. It appears that the Chancellor wanted neither to attract the anger of voters about becoming Europe's "paymaster" before the important regional elections in North Rhine-Westphalia, nor to engage in protracted battles with proponents of a maximalist interpretation of the no-bailout clause in article 125 (1) TFEU. At the same time, the entirely "un-ordo-liberal" desire to avoid putting further strain on German banks, which were exposed in both Greece and Ireland, pushed the German government toward preventing those countries from defaulting.

The tensions between the German desire to prevent moral hazard for highly indebted countries and the commitment to spare investors have produced problematic rescue packages that end up effectively strangling Greece and Ireland. Moreover, given that Greece and Ireland are charged higher interest rates than those at which Germany can borrow, the packages are structured in a way that might make them quite profitable for Germany. Indicating the government's ambivalence about its own course, it has not even used the profitability argument to sell the rescue packages to the public.

Through much of the remainder of 2010, Germany and France have moved in lock step, seeking to work toward better economic governance. There appear no hints on Germany's part of the former paranoia about potential French schemes to undermine stability. So, admittedly, progress has been made. But the threat of contagion has not been contained: By seeking to reverse the market logic of protecting new over old bondholders, the envisioned rules for a haircut in the stabilization mechanism after 2013 provide the ground for a domino effect playing out in slow motion. Similarly, with neither the economics nor the politics working out, the Greek and Irish packages are not sufficient for the long term.

However one cuts it, a lot more institutional innovation will be needed. Putting European economic governance on a more secure long-term footing will likely require Germany to get "ready to trade money for power" and involve further breaks with

Ordnungspolitik.[4]

[4]The quote is taken from Jean Pisano-Ferry. 2010. "Foreword." In Wolfgang Poissl. 2010. *Why Germany Fell out of Love with Europe.* Brussels: Bruegel, 3-4.