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The limits to German power in the Eurozone

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Theme[1]

Although Germany appears to be an uncontested hegemonic power in the post-crisis Eurozone, its power is more limited than is commonly understood.

Summary

This paper challenges the view that Germany has become an uncontested hegemonic power in the post-crisis Eurozone. It shows that the trade and financial interdependence amongst Eurozone countries created by the Economic and Monetary Union (EMU) made the German government's approach of deflecting the burden of adjustment onto the debtor countries self-defeating, preventing it from reforming the EMU in ways that simultaneously advanced all the domestic societal interests underpinning its creditor preferences. This strategy also encouraged deflationary pressures, which further weakened peripheral countries' debt servicing capacity. While these negative feedback loops put pressure on creditor states to accept some mutualisation of debt in a banking union, the German government could only minimise the exposure of the German taxpayer by allowing the ECB to adopt increasingly unconventional expansionary measures to stabilise sovereign bond markets and reduce deflationary pressures. In sum, a less orthodox ECB has been the price that the German government has so far been willing to pay for making EMU more sustainable. However, given the enormous sunk costs of European monetary integration for Germany, its government might be willing or forced to go beyond in the future.

Analysis

Introduction

The asymmetry of power between 'creditor' and 'debtor' countries in the management of the euro area (EA) crisis and the on-going institutional reform process of the Economic and Monetary Union (EMU) have brought the issue of

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German dominance in Europe back to the forefront of academic and political debates. According to the leading narrative, Germany –supported by the other creditor countries– has been able to set the terms of several key reforms of the EMU regime in ways that correspond to its creditor interests (Blyth & Matthijs 2011; Bulmer & Patterson 2013; Thompson 2013). Moreover, Germany's creditor position would have been key to reinforce its institutional power in an increasingly intergovernmentalist Europe. Finally, according to this view, the power of 'hyper-competitive' Germany is central to the problem of intra-regional macroeconomic imbalances, making it impossible to solve the EA crisis in the longer term without a more symmetrical distribution of adjustment costs between creditor and debtor countries.

In this paper we draw on the insights of Historical Institutionalism (HI) to show that the German government is more constrained than these analyses of its dominance imply. First, we argue that the increased sunk costs of European monetary integration have reduced the attractiveness of the exit option and pushed the German government to adjust the EMU regime in order to make it more sustainable. Sunk costs are defined in terms of the increased returns of the EMU for various domestic groups in Germany, which became increasingly linked to the rest of the EA both in trade and financial terms as a result of the adoption of the euro. Secondly, we draw attention to the domestic institutional sources of its creditor preferences, which reflect four clusters of domestic societal interests deeply rooted in the institutional structure of its coordinated market economy: trade interests of the export-oriented sectors, fiscal interests of its taxpayers, monetary interests of the Bundesbank and financial interests of the banking industry. Third, we maintain that the German government's pursuit of these interests during the key institutional reforms produced unintended negative feedback loops –(1) the escalation of sovereign bond spreads and the fragmentation of the European financial system from 2011 to 2012 and (2) the intensification of deflationary pressures between 2013 and 2015– that could only be mitigated through the implementation of increasingly unconventional monetary policies by the ECB. We analyse the reactive sequences through which these two negative spill-overs were mitigated, thereby exposing the difficulties the German government encountered in accommodating the domestic societal interests underlying its creditor preferences.

Germany and the euro's irreversibility

While it is commonly acknowledged that the importance of exit costs explain why European leaders preferred to reform the EMU regime rather than leaving the euro, HI goes further by clarifying how barriers to a German exit have *intensified* as a result of the societal actors' previous institutional investments in the euro project and the 'increasing returns' associated with these investments.

From an HI perspective, it can be argued that the establishment of the EMU and its non-accommodating macroeconomic policy regime –featuring restrictive fiscal rules and an orthodox central bank prohibited from monetary financing of public deficits and a sole mandate to maintain price stability– increased the relative benefits for key actors in Germany. Germany's coordinated wage-setting institutions were highly conducive to maintaining the cost competitiveness of its manufacturing firms and provided them with a key adjustment advantage within EMU's non-accommodating macroeconomic policy regime.

The euro eliminated the possibility of the debtor countries using periodic nominal devaluation as a strategy to regain competitiveness, allowing German export-oriented firms to turn an overvalued real exchange rate into a substantially undervalued one. As a result, the ability and determination of German export-oriented employer organisations and trade unions to exert wage restraint became even more pronounced after the euro's introduction.

An unintended consequence of the adoption of wage restraint was that the German economy became increasingly export-led throughout the EMU era and gradually more dependent on a growing intra-EA trade surplus, which was substantially higher than its extra-EA trade surplus. The elimination of exchange-rate risk also increased the German banks' incentive to earn huge carry-trade profits by investing the trade surpluses in higher-yielding assets issued by debtor countries in the region, leading to a net creditor position for Germany vis-à-vis the rest of the EA of more than 20% of GDP. The deepening of these trade and financial linkages therefore suggests that German export sectors, financial institutions and taxpayers have much to lose from European monetary disintegration: the euro has shielded German manufacturing firms from the currency appreciation that would normally have resulted from persistent external surpluses, the recycling of which by the German financial system exposed banks (and eventually taxpayers) to massive financial losses that would be associated with an EA break-up (Kirkegaard, 2014).

These material costs –which are the flipside of the increasing returns of European monetary integration– have made the exit option increasingly unmanageable, pushing the German government to make the EMU sustainable rather than allowing European monetary disintegration.

Germany's management of the euro crisis: negative feedback and the incongruity of German domestic interests

Throughout the crisis, the German government's creditor preferences have actually aggregated and reflected four different clusters of domestic societal interests that are supported by the main political parties and are also strongly embedded in the German export-led coordinated market economy and its associated institutions. The central role played by export-oriented manufacturing firms in the German socio-economic model made the government intrinsically wary of adopting reflationary policies to ease the burden of adjustment onto debtor countries, as these policies weaken the cost competitiveness of these firms. The German government also aimed to preserve the stability of the German banking system –particularly the publicly-owned state banks (*Landesbanken*) and savings banks (*Sparkassen*) that play a key role in financing the small and medium enterprises (SMEs)– by avoiding as much as possible the prospect of default by debtor countries and a substantial restructuring of their foreign liabilities. In its desire to avoid debt mutualisation, the German government also invoked the 'interests of the German taxpayer' to guarantee that there would be 'neither regular nor permanent transfers', making sure that every debtor state 'must do its homework' and that 'assistance must always be tied to strict conditionalities' (Angela Merkel quoted in Opperman, 2012, p. 511). Finally, the German government defended the interests of the Bundesbank, which prefers the ECB to comply as much as possible with its ordoliberal principles of 'sound' money, by repeatedly stressing its disapproval of outright purchases of sovereign bonds by the ECB.

The German government's pursuit of these creditor interests during its management of the EA crisis produced unintended 'negative feedback loops', which refer to the 'consequences of policy that tend to undermine rather than reinforce the political, fiscal, or social sustainability of a particular set of policies' (Weaver, 2010, p. 137).

The key problem for the German government is that the high issue density of the EMU regime and the deepened trade and financial linkages between its member states have heightened the likelihood of negative feedback loops between those issue-areas that get to the heart of its creditor interests. While the increasing returns and sunk costs of European monetary integration have pushed Germany to agree on various reforms that have saved the euro in the short to medium term, making the EMU sustainable in the longer term required a combination of policies in the following three issue-areas: (a) a more symmetrical distribution of macroeconomic adjustment costs between debtor and creditor countries, whereby the internal devaluation measures in the former countries would be matched by internal revaluation measures in the latter; (b) some scheme of debt mutualisation involving either a one-time default/restructuring of debtors countries' foreign liabilities or more permanent fiscal transfers between creditor and debtor countries; and (c) a more accommodating monetary policy by the ECB. We show that the German government refused to ease the burden of macroeconomic adjustment onto debtor countries by adopting internal revaluation measures and accepting any significant debt mutualisation, only at the cost of generating various negative feedback loops that eventually forced the ECB to adopt increasingly unconventional measures.

The asymmetrical distribution of macroeconomic adjustment costs generated two interrelated negative spill-overs. First, the escalation of sovereign debt yields of debtor countries between 2010 and 2012 can be traced back to the refusal of the German government and the other creditor countries to adopt reflationary measures to reduce their current account surpluses. The key reason why these yields increased during the period is that international financial markets doubted the ability of debtor countries to produce the economic growth necessary to repay loans. In a monetary union with high trade density the adoption of internal devaluation measures is bound to be self-defeating in the absence of compensating internal revaluation policies in the creditor countries. If the creditor countries do not adopt follow strategies to reduce their external surplus in order to assist the debtor countries in their attempt to reduce their external deficit, the EA's aggregate current account balance moves to a surplus and creates upward pressure on the euro's exchange rate in ways that undermine the latter countries' endeavour to pursue export-led growth. Secondly, the asymmetric distribution of the burden of macroeconomic adjustment intensified deflationary pressures. Weak domestic aggregate demand translated into low inflation in the creditor countries, thereby increasing the pressure on debtor countries to improve their relative competitiveness vis-à-vis the creditor countries by means of outright deflation. However, deflation further weakened the debt sustainability of these countries by increasing real interest rates and the real value of their liabilities as well as by depressing the economic growth necessary to service their debts.

While the increasing returns and sunk costs of European monetary integration induced the German government to prioritise making the euro more sustainable over exiting EMU, we show that these negative spill-overs induced it to accept solutions that collide with some of these domestic interests. Moreover, the lack of embedded German interest groups in the decision-making structures of European monetary policy made it more likely that the German government would accept adjustments in the ECB's monetary policy strategy than in the other two issue-areas.

Addressing escalating sovereign bond yields during 2011-12

Intergovernmentalist accounts of the crisis rightly point out that the reforms in the euro area's governance adopted since the beginning of the crisis predominantly reflected the creditor interests of Germany and the other core countries.

From an HI perspective, however, these accounts offer an incomplete view. The initial reforms locked-in suboptimal institutional arrangements: they were not only ineffective in containing the crisis, they also sowed the seeds of a further escalation of sovereign debt spreads between Germany and the debtor countries, whose own growth prospects were undermined in the face of asymmetrical adjustment costs. In the absence of debt mutualisation and/or a more accommodating monetary policy by the ECB, the debt servicing capacity of the debtor countries could only be guaranteed by redressing their competitiveness problem in a manner that would allow decreasing their debt levels based on substantial economic growth. However, estimates by the OECD suggested that '[f]or Spain and Portugal, the current balance changes required to reduce net external debt to 35% of GDP over 20 years [required] improvements in cost competitiveness against the rest of the euro area of about 30%, and by more than double that for Greece' (Guillemette & Turner, 2013, p. 6). Because relying only on this mechanism was neither realistic nor desirable, at least part of the necessary competitiveness adjustments had to occur in the creditor countries.

Reducing the export surplus via such a sizeable internal revaluation would not be consistent with the German socio-economic model, which crucially depends on its external competitiveness. Moreover, the adoption of a debt brake in the German constitution in the summer of 2009 introduced legal constraints on fiscal reflation.

In this context, and given that the initial EMU reforms clearly revealed that debt mutualisation was not an option for Germany and the other creditor countries, the international financial markets remained in doubt about the debt servicing capacity of the Italian and Spanish governments, which ultimately forced the ECB to adopt unconventional measures aimed at preserving financial stability in the region. The ECB's principle means of intervention was the provision of long-term cheap liquidity to EA banks, which were offered €1,020 billion in loans with a maturity of 36 months at a 1% interest rate via two rounds of unconventional long-term refinancing operations (LTROs) in December 2011 and February 2012. The main purpose of the ECB's LTROs was to prevent a collapse of peripheral banking systems. The European System of Central Banks (ESCB) had to replace a dysfunctional interbank market in the EA. Reliance upon the ECB's LTROs was highly asymmetric across EMU member states: banks from the southern countries accounted for 70% of the LTRO, whereas northern banks mainly accounted for the €700 billion parked at the ECB deposit facility (Pisani-Ferry & Wolff, 2012).

These liquidity programmes clashed with the orthodox preferences of the Bundesbank, which remained convinced that '[n]either providing life support to ailing banks nor propping up the solvency of sovereigns falls under the remit of monetary policy' (Weidmann, 2012).

The ESBC's liquidity facilities offset capital flight by cross-border credits to debtor-country central banks, which were extended by creditor-country central banks (mainly by the Bundesbank) as part of the ESCB's Target2 payment system –the tool used by the ESCB for the settlement of cross-border transactions in the EA and for the calculation of debt obligations between the region's national central banks–. Whereas peripheral central banks accrued massive liabilities, the Bundesbank's creditor position within the Eurosystem increased exponentially from 2010 to 2012, reaching €695 billion in September 2012. The ESCB's liquidity provision therefore indirectly redistributed existing stocks of claims to the periphery from the private sector to the Bundesbank, making the German government more exposed to the risk of redenomination. In this way, widening Target2 imbalances locked Germany into monetary integration by further reducing the attractiveness of the exit option.

These unanticipated effects therefore cast strong doubts on the claim that the ECB's liquidity programmes merely promoted the interests of the German government by protecting German banks from default. Furthermore, the programmes set the stage for the next step in European monetary integration: the creation of a banking union.

A key problem was that the LTROs further encouraged peripheral banks to engage in carry trades by borrowing from the ESCB at very low interest and investing a significant part of the funds in higher-yielding sovereign debt. As a result, the LTROs reinforced the vicious bank-sovereign loop by increasing the 'home bias' in peripheral banks sovereign debt holdings. Since these banks held a significant amount of bonds issued by their government on their balance sheets, escalating sovereign bond yields generated an inherent risk of mutually reinforcing sovereign debt and banking crises. Although the LTROs temporarily reduced the yields on Spanish and Italian sovereign debt between December 2011 and March 2012, these disruptive dynamics were exposed when these yields started rising again after this period. When on 9 June 2012 the Eurogroup was forced to commit up to €100 billion in EFSF funds to the Spanish government to recapitalise its banks, on 28 June 2012 EA-country leaders launched negotiations on a European banking union and opened the door to possible direct bank recapitalisations through the ESM in order to break the vicious circle between banks and sovereigns.

However, the real game changer was Mario Draghi's speech 'to do whatever it takes' to save the euro' on 26 July 2012 and his pledge on 6 September 2012 to engage in outright monetary transactions (OMT), whereby the ECB would buy an unlimited amount of distressed-country bonds in the secondary market once a government had formally applied for a bail-out programme at the ESM. The OMT pledge was deemed necessary to address the risk of redomination, which had fragmented European financial markets and obstructed the proper transmission of its monetary policy. While being in clear conflict with the doctrines of the Bundesbank –whose President voted against the decision– the German government backed the OMT decision on the basis of its conditionality. This reflected a cautious move towards increased pragmatism with respect to monetary policy making.

Mitigating deflationary pressures 2013-15

While proving critical in stabilising sovereign bond markets, the ECB's unconventional measures failed to address the other negative spill-over of the asymmetric distribution of adjustment costs: deflation. The main problem was that the focus on generating internal devaluation in debtor countries via reduction in prices and wages without compensating internal revaluation measures in creditor countries contributed to *disinflation* in the region, putting pressure on the ECB to adopt additional expansionary measures to fulfil its mandate. By December 2013, the annual inflation rate averaged 0.9% as inflation had already dropped to 0.6% in debtor countries and 1.5% in creditor countries. Between 2010 and 2013 the southern EA countries had made substantial efforts in realigning their real effective exchange rates by means of deflationary declines in unit labour costs vis-à-vis creditor countries, resulting in a substantial improvement of their trade balance. However, the restoration of Germany's trade surplus over the same period moved the EA's aggregate current account towards a surplus of €221.3 billion (2.3% of GDP), further intensifying deflationary pressures by pushing up the euro's exchange rate. Such a high euro, which was also the result of an environment of currency wars, was much more problematic for manufacturing firms in the southern countries –which tend to make price-sensitive standardised goods with low-to-medium added value– than for those in Germany –which tend to be specialised in quality differentiated, high value-added goods–. Given that these debtor countries already had made substantial efforts in realigning their real effective exchange rates by means of declining unit labour costs vis-à-vis creditor countries, a nominal depreciation of the euro was urgently needed to promote extra-regional rebalancing.

However, deflationary pressures in the EA deepened as a result of the specific features of the ECB's previous unconventional monetary measures. In fact, the ECB's OMT pledge provided global investors with an insurance device against EA break-up and almost certainly contributed to the euro's significant nominal appreciation between the third quarter of 2012 and the second quarter of 2014.

A notable institutional response to the problem of macroeconomic adjustment and decreasing inflation has been the supranational entrepreneurship of the Commission, which became increasingly critical towards Germany's persistently high current-account surplus. In its 2013 Alert Mechanism Report the Commission openly acknowledged that excessive surpluses can have negative implications for debtor countries through the common exchange rate. Increasingly concerned about the problems potentially caused by Germany's persistently high surplus, the Commission even conducted a first in-depth review in 2014 in which it reiterated that 'spillovers from higher domestic demand in Germany could support overall aggregate demand in the EA' (European Commission, 2014, p. 95). The Commission´s increased activism reflected a move from being an agent representing the interests of the creditor countries towards becoming a more balanced player in its approach of macroeconomic imbalances.

However, since the Commission does not have the legal instruments to impose internal revaluation measures onto Germany, the ECB remained the only supranational institution that could fight deflation. The fall of EA inflation to 0.5% in June 2014 prompted the ECB to implement a new arsenal of unconventional monetary measures. It was the first major central bank to adopt a negative deposit rate of -0.1% and launched a new 'targeted' €400 billion LTRO programme. Apart from further lowering its deposit rate to -0.2%, the ECB announced in September 2014 that it would purchase a broad portfolio of asset-backed securities (ABSs) and euro-denominated covered bonds in order to steer its balance sheet back to the level it had at the beginning of 2012. However, given the limited size of the European market for high-quality ABSs and covered bonds, it was clear that purchases of sovereign bond would also be required.

One month later, in January 2015, the ECB announced the launch of its widely expected QE programme, consisting of combined monthly purchases of public and private sector securities amounting to €60 billion –intended to be carried out until the end of September of 2016–. Remarkably, the programme would be *open-ended* and 'be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term' (Draghi, 2015).

The Bundesbank's main concerns, which were shared by the German Ministry of Finance, were that sovereign-debt purchases would reduce the pressure on debtor governments to implement fiscal and structural reforms and increased the ESCB's exposure –and therefore the German taxpayer– to debtor default. These concerns gained widespread traction within German society, leading several politicians to submit a motion with the Federal Constitutional Court (FCC) to investigate the legality of the ECB's OMT. In February 2014 the FCC reinforced these apprehensions by claiming that the ECB's OMT is contrary to European law, deferring a definite ruling on the legality of OMT to the European Court of Justice (ECJ). Finally, the ECB's decision to lower the deposit rate below zero also attracted general condemnation from the German media for penalising German savers.

Hence, the ECB's monetary policy adjustments again revealed the constraints on the capacity of the German government to accommodate the domestic societal interests underpinning its creditor preferences. The interim ruling of one of the ECJ's advocate-general that the ECB's OMT 'in principle' adhere to EU law –on the condition that it refrains from any direct involvement in the OMT programme– was widely considered to have cleared the final legal hurdle to engage in an ambitious QE programme. While its specific features –whereby 80% of the asset purchases and the ensuing default risks would remain on the balance sheets of the national central banks– meant bowing to the pressure of Germany and other creditor countries to minimise the mutualisation of risk, it also demonstrated the inconsistency between Germany's veto on debt mutualisation and its preference for an orthodox monetary policy that does not engage in sovereign debt purchases. In this regard, Germany has been forced to approach European monetary policy with increased pragmatism. The ECB's latest monetary decision again demonstrated that Germany's desire to minimise debt mutualisation only came at the price of additional unconventional monetary accommodation.

Conclusion

This paper shows how the issue-density and interdependencies created by the EMU made the German government's approach of deflecting the burden of adjustment onto the debtor countries during the euro zone crisis self-defeating, preventing it from reforming EMU in ways that simultaneously advanced all the domestic societal interests underpinning its creditor preferences. The unwillingness of Germany and the other creditor countries to adopt reflationary policies to ease the burden of adjustment onto the debtor countries made growth in the Eurozone increasingly dependent on the attainment of an extra-regional trade surplus, which weakened the competiveness of debtor countries by putting upward pressure on the exchange rate of the euro. It also encouraged deflationary pressures, which further weakened their debt-servicing capacity. While these negative feedback loops put pressure on creditor states to accept some mutualisation of debt in a banking union, the German government could only minimise the exposure of the German taxpayer by allowing the ECB to adopt increasingly unconventional expansionary measures to stabilise sovereign bond markets and reduce deflationary pressures.

A less orthodox ECB has been the price that the German government has so far been willing to pay for making the EMU more sustainable and advancing the interests of its export-oriented manufacturing sectors, major banks and taxpayers –an adjustment that was the most likely to occur, in light of the fact that these domestic societal groups are not strongly embedded in, and have less influence over, European monetary policy processes than the other issue-areas–. The question remains, however, whether ECB accommodation will be sufficient for the euro's long-term survival. Although the euro's depreciation might lead to increased tensions with the EA's trading partners if its aggregate current-account surplus keeps rising, the ECB's policies could also lead to a more symmetrical distribution of adjustment costs by encouraging higher inflation in creditor countries (although in that case, other domestic societal interests –particularly the export-oriented German industry– can be expected to mobilise against the ECB). In any case, in the long term, the institutional incompatibility between the EMU regime and the labour-market institutions in debtor countries would remain, making it possible for regional imbalances to re-surface after the crisis. The asymmetrical vulnerabilities associated with these imbalances would be mitigated by the presence of a more accommodating central bank by making it less likely that debtor countries can be pushed into a 'bad equilibrium', yet it is uncertain that the euro will be sustainable in the longer term without a more structural mutualisation of debt –for instance, via a banking union with a more adequate common backstop–. We believe, nevertheless, that the sunk costs of European monetary integration are too high for Germany to *a priori* exclude the possibility of domestic political support for such a potent backstop.

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