The German Rescue of the Eurozone: How Germany Is Getting the Europe It Always Wanted

DAVID ART

THE EUROZONE CRISIS HAS CONSTITUTED THE MOST SERIOUS economic, political, and ideological challenge to the project of European integration since the founding of the European Economic Community in 1957. The European Union (EU) and the common currency have certainly been through swoons before, but the possibility of a member state giving up the euro as a result of either international economic pressure, a political backlash against the EU, or a combination of the two never looked as high as it did during several junctures between 2010 and 2012. That political forces in states with both good and bad credit ratings were threatening to exit the Eurozone was bad enough; that seemingly fundamental questions about the immediate future had no ready answers unsettled markets even further. Could a member state leave the Eurozone and stay a member of the European Union? Could such an exit be managed without catastrophic disruptions to the state's economy? Would the exit of one country—Greece, most likely, but potentially even a country such as the Netherlands—lead to a series of exits and the rapid unravelling of the common currency? Facing such uncertainty, firms invested millions in contingency planning for a reinstitution of national currencies, and think tanks sponsored contests for the best idea on managing a euro breakup. The wisdom of the crowds, or at least the wisdom of Intrade, set the odds of a state exiting the Eurozone within a year at 50 percent for much of 2012.

DAVID ART is associate professor of political science at Tufts University. He is the author of *The Politics of the Nazi Past in Germany and Austria* and *Inside the Radical Right: The Development of Anti-Immigrant Parties in Western Europe*.

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Five years since the onset of the crisis, the Eurozone is still intact. Both Ireland and Spain ended their bailout programs with the EU, the European Central Bank (ECB), and the International Monetary Fund (IMF) and returned to the international bond markets in January 2014. Despite all the anti-EU rhetoric and the rapid rise of political parties committed to renegotiating pieces of economic rescue packages at the minimum, and EU exit at the maximum, national-level elections have thus far produced pro-European governments—albeit ones based on narrow majorities or unstable coalitions—in critical states such as Greece and the Netherlands. Two new states—Estonia and Latvia—adopted the euro in 2011 and 2014, respectively, and while both were obligated to do so as a result of their accession agreements, it is telling that neither tried to delay adoption despite the prognostications of a euro collapse swirling around them. Although it is too soon to tell how the dramatic events in Ukraine will shape European integration in the long run, in the short term, they have certainly pushed most states in the post-Soviet space further toward the West.

It is no doubt possible that what appears now as a successful economic rescue operation is in fact a temporary stay of execution for a condemned idea. Indeed, a group of scholars have long argued that monetary union among sovereign states with diverse political and economic structures is unlikely to succeed even under the most auspicious circumstances. According to some economists, the states of the Eurozone never came close to meeting the requirements for an optimum currency area, and the fact that the Eurozone survived the recent crisis tells us little about its long-term survival.[1] One can also proceed from a political logic and contend that because sovereign states are ultimately unwilling to transfer the degree of political sovereignty required to reach a level of economic convergence necessary to make a monetary union viable, it is only a matter of time until state interests reassert themselves over European ones.[2] In either case, the breakup of the European Union—or at least a major transfer of sovereignty away from supranationalist institutions and back to the nation-state—is inevitable.

It is also possible to view the rescue operation as worse than the original problem of misguided, or perhaps simply mismanaged, monetary union. According to this view, austerity measures have failed to restore economic

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[1]Martin Feldstein, "The EMU and International Conflict," *Foreign Affairs* 76 (November/December 1997): 60–73.

[2]For a synthesis of both pessimistic and optimistic predictions for the EU drawn from political theories of EU integration, see Douglas Webber, "How Likely Is It That the EU Will *Dis*integrate? A Critical Analysis of Competing Theoretical Perspectives," *European Journal of International Relations* 20 (June 2014): 341–365.

growth not only in those states that agreed to undertake them as a condition of loans from the EU and the IMF, such as Greece, Portugal, and Ireland, but also in states such as the United Kingdom, which adopted such policies on its own. Because these misguided policies will cast a long shadow on economic growth, they may yet produce a political counterreaction that succeeds, either through its own policies or by sparking yet another panic in international financial markets, in destroying the underpinnings of the common currency.[3]

Scholars of Europe will be debating the causes, consequences, and legacy of the Eurozone crisis for a long time. As the title of this article suggests, my view is that the Eurozone has indeed survived the crisis and that we are witnessing a major institutional redesign of the European Union. Rather than articulating this broad claim here, my goal is to analyze the actions of the drama's most important player. There can be little debate that Germany has played an outsized role. The rise in Germany's relative economic power in relation to most other member states in the Eurozone, France in particular, has given Chancellor Angela Merkel of the Christian Democratic Union (CDU-CSU, Christian Democratic Union/Christian Social Union of Bavaria) an unprecedented amount of leverage in redesigning the institutional underpinnings of monetary union. She is not just one of the only European leaders who were not voted out of office—or muscled out of government, as was the case with Silvio Berlusconi—since the beginning of the financial crisis; she also has turned her management of the sovereign debt issue in particular into a source of political strength. Her positioning on the entire Eurozone question was so popular within Germany that the Social Democratic Party essentially decided not to challenge it during the parliamentary elections of September 2013. In fact, the Social Democrats found themselves taking the same tough position as the chancellor as the crisis spread to Cyprus during the heart of the campaign. Merkel's Christian Democratic Union won the parliamentary elections, although the electoral collapse of the party's smaller coalition partner, the Free Democratic Party, led her to form a grand coalition with the Social Democrats. Yet given that the Social Democrats have largely failed to offer credible alternatives to Merkel's approach, one would not expect Germany's basic positions on Eurozone matters to change soon.

Germany's management of the Eurozone crisis raises a question so familiar to students of modern Germany that it is simply referred to as

[3]See, for example, Marc Blyth, *Austerity: The History of a Dangerous Idea* (New York: Oxford University Press, 2013).

the "German question." The question has taken different forms in different decades, but one can follow Timothy Garton Ash's formulation of the "new German question" as follows: "Can Europe's most powerful country lead the way in building both a sustainable, internationally competitive Eurozone and a strong, internationally credible European Union?"[4] At least three broad answers to this question have developed among professional observers of Germany.

The first ties into a long-standing narrative that Germany is "normalizing" its relationship both with Europe and with the international environment more broadly.[5] According to one articulation, the crisis has demonstrated the extent to which Germany has "fallen out of love with Europe" as Germany has abandoned its reflexive Europeanism of the past to an unprecedented degree.[6] Whether this dramatic reorientation in Germany's relationship to European integration is a result of generational change, an aftereffect of German unification, or a result of Merkel's East German perspective on the European question, the upshot is that Germany can no longer be expected to support the European project at all costs.

A second view also offers a negative outlook for the new German question, although for different reasons. Germany's response to the crisis has been marked more by confusion and instability resulting from short-term political calculations and dissonance among German decision makers than by some larger process of normalization.[7] There are also many critiques that highlight the particular incompetence of the crop of European politicians—German and otherwise—who were on hand to deal with the Eurozone crisis as it unfolded. In some sense, both the academic and the popular version of the argument lead to the same conclusion: that Germany's European policy, in the words of former chancellor Helmut Kohl, has become *unberechenbar* (unpredictable).[8] This "preference instability" in Germany's relationship to Europe has led it to adopt policies

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[4]Timothy Garton Ash, "The New German Question," *New York Review of Books*, 15 August 2013. Ulrike Guérot and Mark Leonard use this formulation as well (see note 6).

[5]Beverly Crawford, *Power and German Foreign Policy: Embedded Hegemony in Europe* (Basingstoke, UK: Palgrave Macmillan, 2007); and Simon Bulmer and William E. Paterson, "Germany as the EU's Reluctant Hegemon? Of Economic Strength and Political Constraint," *Journal of European Public Policy* 20 (2013): 1387–1405.

[6]See, for example, Wolfgang Proissl, "Why Germany Fell Out of Love with Europe" (Bruegel Essay and Lecture Series, Brussels, Belgium, 2010); and Ulrike Guerot and Mark Leonard, "The New German Question: How Europe Can Get the Germany It Needs," European Council on Foreign Relations, April 2011, accessed at http://www.ecfr.eu/page/-/ECFR30_GERMANY_AW.pdf, 21 March 2015, 1–15.

[7]Kai Oppermann, "Nation Role Conceptions, Domestic Constraints and the New 'Normalcy' in German Foreign Policy: The Eurozone Crisis, Libya and Beyond," *German Politics* 21 (December 2012): 502–519.

[8]Abraham Newman, "Flight from Risk: Unified Germany and the Role of Beliefs in the European Response to the Financial Crisis," *German Politics and Society* 95 (Summer 2010): 151–164.

that have come too late, offered too little, or have made the crisis much worse than it had to be.[9]

A third view is that Germany is not normalizing its relationship with Europe but rather transitioning into a particular type of hegemon. Some scholars attach "embedded" or "benign" to the term to make clear that they are not suggesting a return to German militarism. Others, most notably William Paterson, suggest that Germany is behaving like a "reluctant hegemon," and in this sense its lack of familiarity with its role could manifest itself as "preference instability." More recently, Simon Bulmer and William Paterson have stepped back from the hegemony claim somewhat by arguing that Germany has not provided the degree of public goods that hegemonic stability theory suggests a hegemon should.[10] Still, it is clear that Germany's economic power has given it an unprecedented degree of political influence. "When the German position changes on an issue," lamented one EU official, "the kaleidoscope shifts as other countries line up behind them. That's unprecedented in the history of the EU."[11]

In this article, I take issue with both the first and second views of the new German question in the context of the Eurozone crisis. I argue that the normalization narrative, at least as it pertains to Germany's foreign economic and monetary policy, is based on a questionable reading of German behavior since the collapse of the Bretton Woods system. There was never really a time that Germans deviated radically from their preferences on monetary matters in order to push forward the European project. While Germany may have behaved like a "tamed power" in postwar Europe when it comes to security affairs, and while Germany has long been a proponent of deeper political integration, German elites have long bargained hard and, in most cases, successfully to create monetary institutions that conform as closely as possible to ordoliberal ideas.[12] In this sense, they have never been particularly "European" when it comes to monetary matters. Thus, whereas some might view Germany's behavior in the Eurozone crisis

[9]Erik Jones, "Merkel's Folly," *Survival* 52 (June/July 2010): 21–38. A somewhat more balanced view is found in Brigitte Young and Willi Semmler, "The European Sovereign Debt Crisis: Is Germany to Blame?," *German Politics and Society* 29 (Spring 2011): 1–24.

[10]Bulmer and Paterson, "Germany as the EU's Reluctant Hegemon?"; see also Webber, "How Likely Is It That the European Union Will *Dis*integrate?"

[11]"Europe's Reluctant Hegemon," *The Economist*, 15 June 2013.

[12]Peter J. Katzenstein, ed., *Tamed Power: Germany in Europe* (Ithaca, NY: Cornell University Press, 1997); Andrei S. Markovits and Simon Reich, *The German Predicament: Memory and Power in the New Europe* (Ithaca, NY: Cornell University Press, 1997); Thomas Berger, *Cultures of Antimilitarism: National Security in Germany and Japan* (Baltimore: Johns Hopkins University Press, 1998); Thomas Banchoff, *The German Problem Transformed: Institutions, Politics, and Foreign Policy, 1945–1995* (Ann Arbor: University of Michigan Press, 1999); and Yinan He, *The Search for Reconciliation: Sino-Japanese and German-Polish Relations since World War II* (New York: Cambridge University Press, 2009).

as an abrupt departure from its "European vocation" or part of longer process of normalization, one of my central arguments is that it is more revealing, and ultimately more accurate, to stress the historical continuities in German ideas, preferences, and negotiating strategies.

A synthesis of the literature on monetary union also suggests that the brinkmanship and elite division that some analysts consider new developments in internal German bargaining over monetary policy in fact have a long lineage. Yet, to a greater extent than the normalization narrative, "preference instability" offers a plausible explanation for the dramatic twists and turns of the Eurozone crisis. Given the magnitude of the debt already at play and the genuine uncertainty about the additional amount of toxic debt waiting to be uncovered in national accounts or bank asset sheets, it was probably unreasonable to expect that politicians would be able to calmly and soberly reassure markets that they had the situation under control. Yet it was not preordained that they would act in exactly the opposite manner, and it is reasonable to hypothesize that divisions in German domestic politics prevented the most powerful state in the EU from acting with a single voice.

I argue that what may appear to have been policy missteps on the part of the German government were in fact part of an overall strategy that Merkel had decided on very early in the crisis. It was a strategy that demanded a high degree of market turbulence in order to overcome serious constitutional challenges to any German participation in the evolving rescue packages for debtor states. Merkel needed to define the crisis as one in which the crucial issue was the stability of the common currency, not the maintenance of European solidarity or the compelling need to combat massive unemployment through economic growth. She calculated that this would give her legal cover when German litigants challenged her rescue package in the German Federal Constitutional Court, for ensuring price stability at the European level appeared to be a legally sanctioned activity, while simply aiding member states was not. Her decisions to involve the IMF, to enforce rigorous conditionality, and to set loans at near-market rates can also be understood as tactics to insulate her policies against legal challenges. That they were also designed to limit "moral hazard" and to cater to public opinion only made them that much more appealing. The main outlines of Germany's response to the sovereign debt crisis were thus set by the winter of 2010, and while there have been a couple of minor departures along the way, Merkel has pursued her strategy doggedly. She has largely gotten her way.

The argument I develop in this article thus has the most in common with the third perspective on the German question. Simply put, Merkel has taken the unwelcome opportunity of the sovereign debt crisis to reassert long-standing German preferences on fiscal and monetary policy, and the German rescue of the Eurozone has come under German terms. There is something to the argument that Germany is becoming a European hegemon. But in attempting to reshape European institutions in its own image, the character of that hegemony is likely to be much more rule based and probably much more deeply tied to a specifically German conception of political economy. In the final section of this article, I ask whether this state of affairs is either economically or politically sustainable, and I offer a few reasons for believing that a Germanization of the EU's fiscal and monetary architecture will not soon be rolled back.

ORDOLIBERALISM AND GERMAN MONETARY POLICY IN HISTORICAL PERSPECTIVE

Germany has been charged by many observers with forcing a neoliberal austerity program on the rest of Europe.[13] In this reading, Angela Merkel appears as the second coming of Margaret Thatcher: her initial refusal to raise German contributions in order to defend the euro won her the nickname "Frau Nein," meaning the "No Woman." Like the moniker "Iron Lady," this was meant as a complement, at least by many domestic observers. Merkel's decision to involve the IMF in the sovereign debt crisis also adds ammunition to those who see a neoliberal ideology at work in her policy responses. But scholars of German politics know that Merkel is simply the latest German chancellor both to hew to the broad outlines of ordoliberalism and to be constrained by forces within the country that view themselves as the defenders of this economic paradigm. Here is not the place to explain why ordoliberalism became hegemonic in Germany or to examine its features in detail.[14] But a brief statement of its core propositions is necessary because it is not widely understood outside of Germany and because it is so often equated with a simple policy of austerity.[15]

[13]See, for example, Abraham Newman, "Austerity and the End of the European Model: How Neoliberals Captured the Continent," *Foreign Affairs,* 1 May 2012, accessed at http://www.foreignaffairs.com/articles/137611/abraham-newman/austerity-and-the-end-of-the-european-model, 21 March 2015.

[14]For an excellent treatment of why ordoliberalism emerged as the dominant economic paradigm in Germany, see Chris Allen, "The Underdevelopment of Keynesianism in the Federal Republic of Germany," in Peter A. Hall, ed., *The Political Power of Economic Ideas: Keynesianism across Nations* (Princeton, NJ: Princeton University Press, 1989), 263–289.

[15]For a synopsis of ordoliberalism, see Ralf Ptak, "Neoliberalism in Germany: Revisiting the Ordoliberal Foundations of the Social Market Economy," in Philip Mirowski and Dieter Plehwe, eds., *The Road from Mont Pelerin: The Making of the Neoliberal Thought Collective* (Cambridge, MA: Harvard University Press, 2009), 98–138.

Unlike the neoliberalism of Margaret Thatcher, which seeks to reduce the role of the state in the economy to an absolute minimum, ordoliberalism envisions a central and somewhat active role for it. The founders of this tradition criticized the laissez-faire doctrine of classical liberalism for its naive faith in the power of market mechanisms alone to ensure optimal economic outcomes. Without a state creating legal and ethical rules, market activity alone will, in the words of one influential ordoliberal, "degenerate into a vulgar brawl" between narrow class and personal interests that threaten both the political order and free competition.[16] At the same time, ordoliberals depart from the statist tradition in German economic thought, in which the state directly manages many aspects of the economy.[17] The role of the state is "limited" to the critical tasks of providing the legal framework and managing fiscal policy. An independent central bank is responsible for setting interest rates and ensuring price stability, while questions of employment and wages are negotiated by representatives from labor and capital with the state playing the role of facilitator.

Ordoliberalism differs from neoliberalism in a second crucial sense. Whereas neoliberal thinkers and politicians consider the welfare state to be a threat to individual initiative and freedom, ordoliberals consider social policy and redistributive taxation as necessary complements to the market economy.[18] Indeed, the term "social market economy" is often used synonymously with both ordoliberalism and coordinated capitalism to describe Germany's political economy.

When it comes to Germany's economic policies—and positions on monetary union are particularly relevant here—no German leader has ever seriously sacrificed ordoliberal principles for the greater good of building European solidarity. Monetary integration was a tangential issue in the bargaining that produced the Treaty of Rome in 1957, and a serious discussion about monetary union did not begin until the late 1960s, when the collapsing Bretton Woods system led both Germany and France to think about a European alternative to the dollar peg.[19] The two states clearly had different motives. France was concerned that Europe was

[16]Wilhelm Röpke, "The Guiding Principles of the Liberal Programme," in H.F. Wünsche, ed., *Standard Texts on the Social Market Economy* (Stuttgart, Germany: Fischer Verlag, 1982).
[17]On the statist tradition, see Keith Tribe, *Strategies of Economic Order: German Economic Discourse, 1750–1950* (New York: Cambridge University Press, 1995).
[18]This emphasis is particularly evident in the writings of Alfred Müller-Armack. See, for example, "The Meaning of the Social Market Economy," in Alan Peacock and Hans Willgerodt, eds., *Germany's Social Market Economy: Origins and Evolution* (London: Macmillan, 1989), 82–86.
[19]Kathleen R. McNamara, *The Currency of Ideas: Monetary Politics and the European Union* (Ithaca, NY: Cornell University Press, 1998).

turning into a de facto deutsche mark zone in which Germany, because of the size of its economy and the stability of its currency, would increasingly dictate French monetary policy. In his memoirs, former French foreign minister Michel Debré noted that "[i]n November 1968, the strength of the Mark permitted Germany *for the first time* to speak with a very loud voice. This strength ensured it of the economic supremacy that made it the master of Europe for a very long time."[20] As this quotation suggests, current arguments about an assertive Germany have a long lineage in the politics of European integration.

The Germans, for their part, were becoming increasingly worried that the United States was importing inflation—the chief evil to be avoided, according to ordoliberal doctrine—to their country. As an export-driven economy, moreover, German firms were in favor of avoiding the wild swings in currencies that were both a symptom of the collapse of Bretton Woods and a harbinger of the turmoil that would follow its demise.

The first serious attempt to outline a road map for the European Economic and Monetary Union (EMU)—the Werner Report of 1970—revealed the gap between the French and German approaches to the issue. The report is now remembered for two things: first, instilling a three-step approach toward the EMU into the cognitive schemas of the policymakers who designed the Maastricht Treaty two decades later and, second, exposing the rift between the "economist" and "monetarist" approaches to monetary integration. The choice of terms is somewhat confusing, as the monetarists had little in common with the monetarist paradigm that underpinned Thatcher's economic policy, and the adjective "economist" is too vague to be of much help. In a nutshell, the monetarists argued that Western European economies would need to converge around a core set of economic indicators before monetary union could be achieved. This was also termed the "coronation" approach to the EMU. The economists reversed the sequencing, arguing that monetary integration would inevitably lead to convergence and could thus begin before states had coordinated their fiscal policies and achieved similar levels of inflation, public debt, and other economic indicators.

The French, Italians, and Belgians pushed for monetary union before convergence. These were all "soft currency" countries that were unwilling to sacrifice expansionary fiscal policy at the altar of ordoliberalism. French politicians in particular were eager to address the asymmetries following

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[20]Quoted in David Marsh, *The Euro: The Battle for the New Global Currency* (New Haven, CT: Yale University Press, 2011), 56 (emphasis added).

from deutsche mark dominance as quickly as possible rather than engaging in what would be painful restructuring of their domestic economies in return for the possibility—but not a promise—of monetary union. The Germans took the opposite position and were the primary proponents of coronation theory (although the Dutch, who had long since recognized that the German juggernaut gave them precisely zero choice in setting their own interest rates, supported this position as well).

There is some debate about whether the Germans—and particularly the most orthodox defenders of ordoliberalism in the Bundesbank and in the economics profession—were ever serious about "coronation theory" or whether they considered it a convenient way of raising the hurdles to monetary union to such heights that the French would drop the idea entirely. What one can say is that German perspectives toward monetary union during this period look remarkably similar to those today. As Andrew Moravcsik summarizes,

> German officials were particularly concerned about a situation of moral hazard, in which unlimited support would encourage other countries to run indefinite deficits while forcing Germany to accept higher inflation. The result was the economist position: Germany agreed to accept constraints on its own monetary policy only if other countries fulfilled two preconditions: macroeconomic convergence to low inflation, and capital liberalization. The German government first announced this policy in 1965.[21]

Chancellor Willy Brandt and Economics Minister Karl Schiller adopted the hardline negotiating position of the Bundesbank, the Federal Bank of Germany, following the publication of the Werner Report in October 1970. Brandt's instructions to Schiller make clear that even a Socialist politician—and one with little expertise in economic affairs—believed that any future monetary union should be constructed primarily on German terms. "We should be careful to stamp our hallmark on future work to implement the Werner report in Europe," Brandt told Schiller, adding that "this offers the best guarantee that, throughout the Community, our monetary views prevail in the widest possible fashion."[22]

The Werner Report led to very little in the short term. But important for the argument of this article is that there is no evidence that the Germans ever considered deviating from their core position on the EMU in order to

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[21]Andrew Moravcsik, *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* (Ithaca, NY: Cornell University Press, 1998), 248.
[22]Quoted in Marsh, *The Euro*, 61.

further other goals, even something as important as Brandt's signature policy of *Ostpolitik*. The Bundesbank succeeded in framing its position toward the EMU and drawing a line in the sand for politicians who would try and deviate from it.

Here the attempt of Chancellor Helmut Schmidt to design a "symmetric" European Monetary System (EMS) is instructive. Unlike Brandt, Schmidt was trained in economics and confident in his ability to master the technicalities of exchange rate coordination. Although he accepted the tenets of ordoliberalism, Schmidt became convinced that monetary integration needed to be accelerated and came to view the hardline ordoliberal coalition as an unacceptable hurdle in this effort. Certainly, Schmidt's contrarian nature and self-confidence were factors that helped direct him on a collision course with the Bundesbank. Yet a politician as perceptive as Schmidt would never have risked a confrontation with the defenders of ordoliberalism had he not believed that changes in the international economy required such a move. With the collapse of the short-lived "snake" (an initial attempt to manage exchange rates) and the collapsing value of the dollar—a development that Schmidt attributed to U.S. president Jimmy Carter's ignorance of economics—Schmidt decided that German industry required "a major step toward monetary union."[23] His argument that the rising value of the mark would decrease German competitiveness and lead to more job loss resonated with representatives of both German industry and the trade unions. French president Valéry Giscard d'Estaing, like his predecessor Georges Pompidou, was open to any change in German monetary policy that would address the enduring problem of asymmetry that the snake had failed to do. Knowing that a German offer of a "symmetric" exchange rate system would draw a furious and powerful reaction from the Bundesbank, Schmidt and Giscard worked in secret to agree on the outlines of the European Monetary System before the ordoliberal coalition caught wind of the plan.

When it did, the Bundesbank marshaled the same set of arguments that it had during the debate over the Werner Report. The ordoliberals emphasized two points—both of which are still relevant to the contemporary debate about the sovereign debt crisis. First, a symmetric exchange rate regime (one based on a currency basket in which the relative weight of the mark would be less than it was under the snake) would mean that inflation from soft currency countries could be imported into Germany, a situation

[23]Schmidt was openly disparaging toward Carter, referring to him variously as the "peanut farmer," "Jimmy the Carter," and the "nitwit."

that was worse than the present one in which the Bundesbank could still revalue the mark to ensure that Carter's economic policies did not threaten domestic price stability. Second, Schmidt and Giscard's idea of creating a European Monetary Fund raised the specter of the Bundesbank intervening frequently and directly in currency markets to help defend weak currency countries. The Bundesbank reasoned that it, as the de facto anchor of the system, would need to move before weak currency countries to lower the value of the deutsche mark. In sum, it viewed Schmidt's proposals as leading down the road of an "inflation community" in which the ability to create marks would be, according to Bundesbank president Otmar Emminger, taken "fully out of our hands."[24]

As Karl Kaltenthaler persuasively argues, the Bundesbank adopted a policy of "brinksmanship" to water down Schmidt's proposals for a symmetric EMS. Emminger made clear that he would effectively veto any design for the EMS that diverged from the Bundesbank's position. When Schmidt went to Aachen to negotiate the terms of the EMS with Giscard, he did so "knowing that he faced a major political battle at home if he agreed to the French president's preferred EMS design." Kaltenthaler, like other scholars who have examined the episode closely, concludes that the strength of ordoliberal resistance "led Schmidt to essentially replicate the Bundesbank's policy coalition's position."[25] As a result, the EMS was ordoliberal in design, a fact that was not lost on the French. As the socialist politician Jean-Pierre Chevènement put it, "we cannot accept the fact that the EMS is nothing more than a thinly veiled deutsche mark zone."[26] Yet even when something as ostensibly critical as Franco-German reconciliation was at stake, the Bundesbank refused to back down. Helmut Kohl's attempts to commemorate the twenty-fifth anniversary of the 1963 Élysée Treaty (officially known as the Treaty of Franco-German Friendship) by acceding to French demands to create a Franco-German Economic and Finance Council were rebuffed by the ordoliberals, who argued that such an institution would give the French increased control over German monetary policy.

It is sometimes forgotten that this French initiative ended in shambles precisely during the opening rounds of the debate over the Maastricht Treaty. For those in search of evidence that Germany has sacrificed its

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[24]Marsh, *The Euro*, 88.

[25]Karl Kaltenthaler, *Germany and the Politics of Europe's Money* (Durham, NC: Duke University Press, 1998), 55.

[26]Quoted in Kaltenthaler, *Germany and the Politics of Europe's Money*, 60.

monetary autonomy in the service of European integration, the swirl of negotiations in the midst of game-changing events such as the collapse of communism and German unification is the conventional place to start. Even those scholars who argue that the primary driver of European integration in general is the pursuit of national economic advantage are forced to concede that "Kohl and [Hans-Dietrich] Genscher pushed German domestic economic interests to the limit in the interests of a clear commitment to EMU."[27] Yet this observation is, of course, a long way from endorsing the popular account of Maastricht as a bargain between François Mitterrand, who was desperate to reign in the Germans through the EMU, and Kohl, who needed French acquiescence in order to seize the window of opportunity and proceed quickly with unification. Most accounts draw a more nuanced picture, one in which massive changes in the international environment were an undeniable factor in getting to the EMU, but reject the notion of a simple quid pro quo between Mitterrand and Kohl (for which the evidence is scant at best). What is clear is that Kohl was more successful than Schmidt in outmaneuvering the most obdurate elements of the ordoliberal coalition and in taming the Bundesbank by binding them into the negotiations over the EMU from the moment that he decided to push forward.[28]

In the end, the EMU reflected German preferences. To be sure, the Germans did make some sacrifices, the two most important being the only symbol of nationalism Germans allowed themselves, the mark, and the autonomy of their most respected institution, the Bundesbank. These issues mattered deeply to many Germans. Yet, as in the current crisis, politicians could use their nation's quasi-metaphysical attachment to their currency and central bankers to their advantage. As Marsh notes, "The deep misgivings about the currency transition in German public opinion, persuasively relayed by the media and the Bundesbank, allowed Kohl to set a high price for sacrificing the D-Mark."[29] In addition to getting an ECB modeled on the Bundesbank as opposed to the French Central Bank, which was more permeable to political manipulation, the Germans got agreement on a tough set (at least in theory) of convergence criteria and the explicit rejection of a lender of last resort that would open up the possibility of "bailouts." They also succeeded in making the convergence criteria permanent through automatic penalties to discourage potential violators

[27] Moravcsik, *The Choice for Europe*, 470.
[28] For more on this strategy, see Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999).
[29] Marsh, *The Euro,* 139.

as part of the Stability and Growth Pact.[30] That both the convergence criteria and the Stability and Growth Pact did not achieve their desired effect, and that the latter in particular appears as a paper tiger in lieu of the Greek debacle, should not blind us to the fact that they represent further examples of the power of the ordoliberal coalition.

Two continuities in Germany's monetary policy are worth emphasizing before moving on. First, prior to the Werner Report and at numerous junctures thereafter, politicians in France and elsewhere argued that Germany was behaving in a new, nationalistic, egoistic, and otherwise un-European way. Contemporary observers who claim that some process of "normalization" is driving Germany's response to the sovereign debt crisis would be well advised to study these episodes in order to see what, if anything, is novel about Germany's recent behavior. Second, while the broad contours of monetary systems from the snake to the EMS to the EMU have conformed to ordoliberal prescriptions, there have been vigorous internal debates that match the intensity of the current one between Merkel, Finance Minister Wolfgang Schäuble, Bundesbank Chairman Jens Weidmann, members of the Free Democratic Party, and other relevant actors. Kohl's contention that Germany has become "unpredictable" as a result of internal disagreement over responses to the sovereign debt crisis appears somewhat hypocritical given the fierce—and public—divisions over the Maastricht Treaty that he negotiated.[31] Like some observers, he is invoking a historical memory of Germany that the historical record does not support.

GERMAN PREFERENCES IN THE SOVEREIGN DEBT CRISIS

When we consider Germany's actions in the context of its current preference toward the outcome of the sovereign debt crisis, its contemporary behavior appears much more coherent than most analysts would have it. By definition, Germany would prefer that the sovereign debt crisis be "resolved" in a manner that is most favorable to Germany's interests, but what exactly might that mean? A full answer would require one to uncover, aggregate, and balance a wide range of preferences—preferences that include economic and political calculations at both the domestic and international levels—among key actors in German society. In lieu of

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[30]See Martin Heipertz and Amy Verdun, *Ruling Europe: The Politics of the Stability and Growth Pact* (New York: Cambridge University Press, 2010).

[31]"Altkanzler Kohl nennt Deutsche Aussenpolitik unberechenbar" [Former chancellor Kohl calls German foreign policy unpredictable], *Die Zeit*, 24 August 2011.

running this exercise, one can plausibly rank German preferences in the following manner:

- Avoid precipitating a "Lehman moment" that would have immediate and potentially disastrous consequences for the international financial system and the German economy.
- Avoid the type of massive defects in institutional design that occur when leaders face massive pressure and respond hastily to crises.
- If the preceding two scenarios can be avoided, create a system of economic governance within the EU that conforms as closely as possible to ordoliberal parameters.

For the last several years, German and European leaders have been focused on preventing the outbreak of an uncontrollable panic in financial markets. They have acted much like firefighters with enough water to prevent a conflagration but not enough to extinguish the flames in any one place. To be sure, the firefighter analogy is somewhat misleading because German leaders in particular have an incentive to allow some fires to continue to burn (this dynamic is explored further later in the article). Yet it is striking that at every moment in the crisis when some sort of response was called for, the Germans—either by their own actions or through the tacit support they gave to other actors—pledged enough resources to avert a meltdown.

Even before the collapse of Lehman Brothers, Merkel had dealt with two potential banking crises involving Commerzbank and Salomon Oppenheimer.[32] One can reasonably surmise that she gained some sense of the scale of the problem during these discretely conducted rescue operations. As Michael Lewis aptly puts it, German bankers "had lent money to American subprime borrowers, to Irish real estate barons, to Icelandic banking tycoons, to do things that no German ever would do."[33] Yet Commerzbank and Salomon Oppenheim were mere trifles in comparison to Hypo Real Estate (HRE), which the government learned on 26 September 2008 had off-balance sheet activities—concentrated in toxic assets—of one trillion euros, enough to bring down the entire German banking system and, with it, the international financial system. As the head of its parent company HypoVereinsbank told an inquiry commission of the German parliament, "If Lehman was a tsunami, then HRE should be

[32]Bastasin, *Saving Europe: How National Politics Nearly Destroyed the Euro* (Washington, DC: Brookings Institution Press), 32.
[33]Michael Lewis, *Boomerang: Travels in the New Third World* (New York: W.W. Norton, 2011), 146.

described as Armageddon."[34] The leaders of German banking were called on to come up with a solution to the problem over the weekend of 26–29 September before markets opened in Asia on early Monday morning. They failed, and Merkel was forced at the last minute to intervene and commit more than 100 billion euros of taxpayer money to rescuing HRE.[35] Thus, one year before the Greek announcement that precipitated the sovereign debt crisis, Merkel was already deeply concerned about the stability of the German banking system, and her first priority was to prevent another Lehman moment.

One can argue that the German strategy of pledging "just enough" at particular moments in the sovereign debt crisis ultimately ended up costing them more in the long run, and therefore was not a rational response. Yet to have gone beyond what Germany judged to be the minimum amount necessary to prevent a self-reinforcing panic with unpredictable consequences would have led it in the direction of the second type of scenario it has been seeking to avoid. Chancellor Merkel has referred frequently to the "design defects" of the Maastricht Treaty and has repeatedly warned the rest of Europe that repairing them will take time. Given the choice of rapidly erecting a new economic foundation for Europe that would massively expand German commitments or building no architecture at all, any German chancellor would clearly take the latter option. Here the legacy of Maastricht is not the only cautionary tale: the travails of German unification provide an even stronger warning against taking bold decisions under time pressure. The common narrative of unification within Germany is that Kohl's decision to value the East German mark at parity with the West German deutsche mark doomed the East to two decades of economic stagnation that has only been partially offset by a deeply unpopular "solidarity tax" and trillions in direct transfers. When Germans raise cries of alarm at the EU developing into a "transfer union," it is in no small part because they have already experienced one in their own country.[36]

German preferences have thus produced a crisis response focused primarily on firefighting and on ruling out a series of bad plans for would-be architects of a new European economic system. At the same time, there is considerable evidence that the Germans are using the crisis to not only "stamp their hallmark on future work," as Brandt wanted, but to remake

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[34]Quoted in Bastasin, *Saving Europe,* 35.

[35]In the final deal, the German government committed to paying 40 percent of the cost of bailing out HRE, while the major German banks agreed to pay 60 percent, with a cap on losses of 8.5 billion euros.

[36]For a balance sheet on the economic consequences of unification, see the series of essays on Germany's political economy in Jeffrey Anderson and Eric Langenbacher, eds., *From the Bonn to the Berlin Republic: Germany at the Twentieth Anniversary of Unification* (New York: Berghahn, 2010).

the system in Germany's image. The Fiscal Stability Treaty agreed to in March 2012 by all EU member states except the United Kingdom and the Czech Republic enshrines ordoliberal principles at the European level.[37] The treaty calls for the European equivalent of American balanced budget amendments and automatic penalties for violators. Political influence will, in theory, play no role in identifying and punishing violators: the European Commission and the European Court of Justice will act as the monitors and ultimate arbiters, respectively. As in ordoliberal theory, the adherence to strict rules will create stable expectations by dramatically limiting the ability of the state to use fiscal policy for its own ends.

GERMAN POWER AND LEGAL CONSTRAINTS

Given the degree to which the national economic ideologies of most other EU member states conflict with ordoliberal principles, why did only two states offer serious resistance to Germany's new fiscal architecture? The answer is that Germany is in a far better bargaining position than at any other moment of major institutional change in the EU. Looking back at the history of the grand bargains that have driven European integration, Germany has always needed to compromise with other states—most notably, France. In negotiating the Treaty of Rome, Germany conceded to French demands for agricultural protection in return for the common market. Maastricht resulted in a much more abbreviated convergence toward fiscal and monetary targets than Germany would have preferred. And even while it may have been mostly rhetorical, the Germans met French demands and included a commitment to economic expansion in the Stability and Growth Pact. Yet the current version of the Fiscal Stability Treaty contains very little in the way of concessions to other states because Germany's relative power has increased, particularly in relation to France. This power is, first and foremost, a consequence of Germany's economic strength, but it is also a product of Germany's domestic consensus on ordoliberalism and the adoption of many features of the German model by other EU members.

Germany has clearly weathered the Great Recession better than France and, indeed, better than nearly every other country in Europe, as the fall in the euro has benefited Germany's export-oriented economy. After contracting by 5.1 percent in 2009, Germany grew at a rate of 3.6 percent in 2010 and 3.1 percent in 2011. France's economy contracted by less in 2009

[37] "Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union," accessed at http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf, 21 March 2015.

(2.6 percent) but grew more slowly in both 2010 (1.4 percent) and 2011 (1.7 percent). While the overall public debt to gross domestic product (GDP) ratio for 2011 was similar in the two countries—86.5 for France and 82.5 for Germany—the most worrying statistic for France was the annual budget deficit to GDP ratio: 8.6 percent in 2010 and 5.4 percent in 2011. The corresponding figures for Germany were 5.3 percent and 1 percent.[38] When one takes a longer-term perspective, the gaps between the two states in terms of most economic indicators do not appear nearly as dramatic, and it is easy to forget that Germany was considered the "sick man" of Europe around the turn of the century. But the timing of the divergence is obviously what matters most: France's bargaining position relative to Germany's from 2009 to the present has been undercut by its inferior economic performance and, perhaps most importantly, by concerns over its sovereign debt.[39] With rating agencies threatening, and then moving, to downgrade France's sovereign debt from AAA to AA status, Nicolas Sarkozy had little leverage over the Germans. Markets correctly viewed the Germans as the key player in the politics of constructing rescue packages for the simple reason that the French literally could not afford to play an equal role given the perilous state of their own public finances.

Germany's bargaining position is also strengthened by the lack of serious domestic cleavages over economic ideology. Compared with countries such as the United States or Great Britain, where long-standing tensions between Keynesians and neoliberals have exploded and become interwoven into partisan political conflict, there are no serious challenges to ordoliberal hegemony.[40] The anticapitalist views of the Left Party are barely relevant, and the perpetual weakness of extreme right parties means that Germany is facing no right-wing populist backlash in the form of the True Finns or Geert Wilders.[41] The Social Democrats and Greens have tried to differentiate themselves to some degree from the CDU/CSU in their support of Eurobonds, but it is unclear whether this is merely political

[38]Statistics from the Organisation for Economic Co-operation and Development, accessed at http://www.oecd-ilibrary.org/statistics, 21 March 2015.

[39]During the summit at Deauville, for example, the French Finance Ministry supported the German position in large part because of rumors that the credit rating agencies were contemplating a downgrade to France's credit rating; see Bastasin, *Saving Europe*, 243.

[40]On why Keynesianism never found fertile soil in Germany, see Allen, "The Underdevelopment of Keynesianism."

[41]For differing explanations for the weakness of far-right parties in postwar Germany, see David Art, *Inside the Radical Right: The Development of Anti-Immigrant Parties in Western Europe* (New York: Cambridge University Press, 2011); Simon Bornschier, *Cleavage Politics and the Populist Right: The New Cultural Conflict in Western Europe* (Philadelphia, PA: Temple University Press, 2012); and Antonis A. Ellinas, *The Media and the Far Right in Western Europe: Playing the Nationalist Card* (New York: Cambridge University Press, 2010).

posturing or reflects a consequential policy difference. The only significant debates concerning monetary policy in Germany are those that pit the ordoliberal purists (the Bundesbank, some economists, the Free Democratic Party, and wings of the CDU/CSU) against the ordoliberal compromisers, the most important of which are Chancellor Merkel and Finance Minister Schäuble. As in past episodes of interstate bargaining, the German government's negotiating position is enhanced by the vocal and respected Bundesbank, as Merkel can credibly claim that she has little room to maneuver.

A third component of German power is that central aspects of its economic model have been embraced by other Eurozone countries. The Netherlands pegged its currency to the German mark several decades ago and effectively committed itself to a hard currency policy that required improved competitiveness and noninflationary growth.[42] The Austrians and Belgians—at least in Flanders—have acted similarly.[43] German economic ideas have also spread to central and eastern Europe. Thus, while Germany has at times appeared isolated in interstate bargaining, it actually has a fair degree of support among both current and aspiring Eurozone members.

If one accepts the analysis thus far, then the claim that Germany has recently discovered its national interest and has adopted a more assertive stance toward Europe—in short, that it has "normalized"—appears misguided. The key change has not been in German positions toward monetary cooperation but rather in its capacity to negotiate outcomes that are closer to its own preferences than in the past. Yet to say that Germany's bargaining power has increased does not imply that the German government can dictate terms to its European partners: there are serious international and domestic limitations on the German government's freedom of action. Both the glacial speed of decision making within the EU and the fact that many important decisions are still subject to national vetoes would have rendered it difficult for any rescue package to have been decided on and implemented in enough haste to reassure markets. Within Germany, domestic opinion was not far from the *Bild*'s position of "no bailout, no transfer union." With state elections occurring at regular intervals over the course of the sovereign debt crisis, and with federal

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[42]Paulette Kurzer, "The Dutch 'Polder Model': What Accounts for Its Surprising Resilience in the Wake of the Global Crisis?" (paper presented at the conference on "European Responses to Economic Crisis: Lessons for the US," Bloomington, IN, 7–8 April 2011).
[43]Eric Jones, *Economic Adjustment and Political Transformation in Small States* (New York: Oxford University Press, 2008).

elections scheduled for September 2013, the ability of the German government to play the role of both firefighter and architect was also certainly affected by electoral calculations.

Yet the most serious constraint on the German government's action is neither public opinion nor the EU. Rather, it is the Federal Constitutional Court, the only institution in Germany that is more respected than the Bundesbank. Armed with the power of judicial review, the Constitutional Court in Karlsruhe is responsible for protecting the democratic principles enshrined in the Basic Law. This has increasingly involved it ruling on the legality of EU treaties, most recently the Lisbon Treaty. While on 30 June 2009, the court unanimously confirmed the compatibility of the treaty with German law, the ruling contained a critical assessment of the state of democracy within the union: "The Lisbon treaty, extending the powers of the EU, has increased, not reduced, the democratic deficit."[44] It also drew a clear line on those powers that could not be transferred to the European level in the absence of significant moves toward political union. Crucially, these included "fundamental fiscal decisions on revenue and expenditure." Thus, while German politicians—Merkel included—were initially relieved by the court's ruling, they also interpreted it as striking down the possibility of fiscal integration. It also meant that Merkel's first reaction to any proposal to deal with the sovereign debt crisis was how the judges in Karlsruhe would view it.

MERKEL'S MOVES

It remains to explain Germany's response to the sovereign debt crisis in light of its past behavior toward monetary union and the combination of opportunities and constraints that existed when the crisis first broke. The rest of this article focuses on three critical junctures. The first, and most consequential, was Merkel's initial response to the Greek crisis during the first six months of 2010. While most analyses interpret her resistance to bailouts through the narrow lens of electoral politics, the following section argues that constitutional considerations were of equal, if not greater, importance. It also suggests that Merkel developed her long-term strategy for the sovereign debt crisis during the winter and early spring of 2010 and that she has, by and large, held to this strategy since. The second juncture occurred when Merkel was required to respond to the spread of the crisis to Ireland during an EU summit at Deauville in October 2010. There, her

[44]Bundesverfassungsgericht BVerfG, 2 be 2/08 vom 30.6.2009, Paragraph-Nr. (296), accessed at http://www.bverfg.de/entscheidungen/es20090630_2bve000208.html.

efforts to shift the cost of the bailouts from European taxpayers to bondholders through the mechanism of "private sector involvement" created market instability in the short run and, like the rest of her moves, can easily be interpreted as a concession to German public opinion. Yet of equal importance was the need to address the problem of moral hazard as Germany adapted to its new role as the European lender of last resort. Constitutional considerations also shaped Merkel's negotiating tactics at Deauville, as she needed to get other states—particularly the French—to agree to the possibility of an EU treaty change to protect the Eurozone's new financial institutions from challenges at the Federal Constitutional Court. The third juncture is the transformative decision by the ECB to engage in outright monetary transactions (OMT). Although Mario Draghi is the architect of this policy, it would never have been possible without Merkel's tacit agreement. It was also her dogged insistence on conditionality over the first several years of the crisis that made this extraordinary ECB decision politically possible.

Setting the Course

The proximate cause of the sovereign debt crisis was the announcement by the incoming Greek government in October 2009 that its fiscal deficit was 12.5 percent of GDP instead of the 3.7 percent figure that the previous government had been reporting. Greek borrowing rates immediately rose to unsustainable levels as Prime Minister George Papandreou's series of austerity measures failed to reassure markets. It would take seven months before European leaders would agree to bail out their most profligate member.

The most common reading of those critical months in late 2009 and the first half of 2010 is that Chancellor Merkel "dithered" as the crisis exploded. In this view, a myopic concern with public opinion polling ahead of critical state elections in 2010, combined with an insufficient understanding—particularly in the early stages of the crisis—of financial markets, explains why Merkel acted so cautiously and allowed the crisis to burn out of control.[45]

As previously noted, Germany's most widely read paper, the *Bild,* launched a campaign against any bailout of Greece with headlines such as "Sell your islands, you bankrupt Greeks."[46] Members of Merkel's own

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[45]A typical example is "Dithering at the Top Turned EU Crisis to Global Threat," *Wall Street Journal*, 29 December 2011.

[46]"Verkauft doch eure Inseln, ihr Pleite-Griechen" [Sell your islands, you bankrupt Greeks], *Bild,* 27 October 2010, accessed at http://www.bild.de/politik/wirtschaft/griechenland-krise/regierung-athen-sparen-verkauft-inseln-pleite-akropolis-11692338.bild.html, 21 March 2015.

party (CDU), to say nothing of the more conservative politicians in the party's Bavarian wing (CSU), similarly emerged as vocal opponents of support for Greece. With German public opinion solidly against any type of bailout, Merkel was on firm political ground during the winter of 2010 when she earned the nickname "Frau Nein."[47] Her party was also facing a state election in North Rhine-Westphalia (NRW) that was critical in three senses. First, NRW is Germany's largest state and therefore of inherent political importance. Second, it is considered a bellwether from which politicians and pundits draw conclusions about the national mood. Third, the CDU/CSU-led government needed to win the state to preserve its majority in the Bundesrat, the upper chamber of parliament, and therefore avoid a situation in which the opposition would be able to act as a veto player through this critical institution. Many commentators noted that Merkel had a strong incentive to delay any action on Greece until after the NRW elections on 9 May 2010. In the event, market turmoil forced her hand, and European leaders agreed on the outlines of a bailout package one week before voters in NRW cast their ballots. But this was clearly not the sequencing that she preferred.

Yet focusing on electoral politics to explain Merkel's strategy ignores considerations that were far more consequential. The first was to make any eventual bailout safe from a challenge brought to the Federal Constitutional Court. Any German citizen could bring a complaint to Karlsruhe that the no-bailout clause of the Maastricht Treaty had been violated and ask for a ruling on the constitutionality of a financial transfer to Greece. Given the court's decision on the Lisbon Treaty, it was by no means clear that the court would find in the government's favor if it went through with a bailout. The financial and political costs of such a rebuke would have been tremendous—probably higher than the costs of allowing the Greek situation to fester until a viable solution could be found.

Merkel's second consideration was to adapt German policy to what was becoming a new role for it in Europe; Germany was no longer simply the "paymaster" of Europe, it was also emerging—like it or not—as its lender of last resort. As paymaster, Germany was expected to make disproportionate contributions to the EU's budget. Although Germans had long objected to this, the financial implications were not large, as the entire EU budget was less than 1 percent of Germany's GDP. Moreover, the only way in which German largesse affected the behavior of other states was that they ended up contributing less. But assuming the role of lender of last resort involved

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[47]Reuters, 14 February 2010, accessed at http://www.reuters.com/article/idUSTRE61DoZC20100214.

financial commitments and policy implications of far greater magnitude. The European Central Bank is ultimately underwritten by sovereign guarantees, and Germany is not only the largest economy in the Eurozone but also one of the few that still maintains a AAA credit rating. Thus, it plays a disproportionately large role in supporting the common currency.

But the policy implications are even more important. As Charles Kindelberger and others have noted, the rational strategy for a lender of last resort is to maintain a certain degree of ambiguity about its threshold for intervening in crises, and even about its commitment to serving as the backstop of the financial system.[48] The core dilemma here is one of moral hazard: if the lender of last resort clearly signals its willingness to intervene, market actors will engage in riskier behavior than they otherwise would. In the context of the European sovereign debt crisis, the primary fear on the part of the Germans was that debtor states such as Greece would feel no further pressure to reform (and thus continue to behave "hazardously") once a bailout was agreed to.

Merkel thus needed to find a means of circumventing a constitutional challenge and crafting a response to the crisis that would force the Greeks and others to change their ways. Her solution involved two key elements. The first was a justification for loans within the EU treaties that effectively trumped the famous "no-bailout" clause of the Maastricht Treaty. Merkel argued that action was necessary to preserve the stability of the euro as laid out in Article 88 of Germany's Basic Law: "The Federation shall establish a note-issuing and currency bank as the Federal Bank. Within the framework of the European Union, its responsibilities and powers may be transferred to the European Central Bank, which is independent and committed to the overriding goal of assuring price stability." Thus, so long as Germany was acting to preserve the stability of the euro—and not simply to keep the Eurozone as presently constituted intact—Merkel could sidestep the no-bailout clause. But, as Carlo Bastasin persuasively argues, this strategy all but ensured that the crisis would become more acute.[49] While clearly not Merkel's first choice—like other leaders, she would have preferred that the Greeks resolve the crisis on their own—the crisis had to assume a magnitude where the stability of the euro was at stake before Germany could act. Tellingly, the phrase she seized on was *ultima ratio,* or "last resort."

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[48]Charles Kindelberger, *Manias, Panics, and Crashes: A History of Financial Crises*, rev. ed. (New York: Basic Books, 1989).
[49]Bastasin, *Saving Europe*, 160–173.

The second element was conditionality, which helps explain her decision to involve the IMF in the crisis against the protests of the European Commission and other member states. IMF participation was a clear signal that the money would come with strings attached, as the organization had developed a worldwide reputation for enforcing austerity on wayward governments. It was also convenient that Papandreou had threatened to go the IMF in March when aid from Europe was not forthcoming, so Merkel could claim to be respecting the preferences of the Greek government in effectively calling Papandreou's bluff. Merkel may also have calculated that IMF involvement would provide a degree of political cover for her demands, although, in the event, public anger in debtor countries could hardly said to have been diverted away from Germany.

By March 2010—only a couple months into the crisis—Merkel had achieved her two core aims. She had vastly increased the odds that the Federal Constitutional Court would not strike down any emergency package to Greece or other debtor countries by defining German objectives as preserving the stability of the euro. Indeed, when the inevitable constitutional challenge arose in May 2010 and the court was forced to rule on the issue, it delivered a verdict in favor of Merkel's policy in September 2012. Second, she had made conditionality the centerpiece of any financial rescue mechanism. The joint statement following the EU's summit of 24–25 March 2010 represented a triumph for Merkel and would set the trajectory for the rest of the Eurozone crisis:

> Euro area member states reaffirm their willingness to take determined and coordinated action, if needed, to safeguard the financial stability in the euro area as a whole, as decided the 11th of February. As part of a package involving substantial International Monetary Fund financing and a majority of European financing, Euro member states, are ready to contribute to coordinated bilateral loans. This mechanism, complementing IMF financing, as to be considered ultima ratio, meaning in particular that market financing is insufficient. Any disbursement on the bilateral loans would be decided by the euro member states by unanimity, subject to strong conditionality and based on an assessment by the European Commission and the European Central Bank.[50]

Merkel may have hoped that this statement would make a bailout unnecessary, or at the least delay the moment of the ultima ratio until after the elections in NRW. But on 27 April, Standard & Poor's lowered

[50]"Statement by the Heads of State and Government of the Euro Area," 25 March 2010, accessed at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf, 21 March 2015.

Greece's debt to junk bond status and thereby sparked a sell-off that pushed the yield on Greek 10-year bonds to more than 10 percent, far past the 7 percent that most market analysts believed represented the upper threshold of sustainability. Policymakers had been well aware of the risk of the crisis spreading from Greece to other European countries since the crisis first broke, but by May 2010, contagion appeared to be imminent, and there was talk of Europe reaching its own "Lehman moment." During a chaotic weekend of negotiations, European leaders agreed on the details of the Greek rescue package.[51] It was determined that 440 billion euros in loans would be provided through a temporary European Financial Stability Facility by Eurozone countries, with the IMF contributing an additional 250 billion euros. These loans would be distributed in tranches and subject to the Greek government meeting targets in reducing its deficit through a combination of cutting government spending, raising revenue through privatizing state assets, and increasing economic growth (in the long term) by reforming its labor markets. The European Central Bank also agreed to begin buying debt directly from the governments of embattled Eurozone states.

Each of these steps was transformative in its own right. The creation of the European Financial Stability Facility, which was to be become permanent in the form of the European Stability Mechanism in 2013, circumvented the no-bailout clause of the Maastricht Treaty. By buying bonds directly from distressed states, the ECB sacrificed a large degree of its political independence, for although the decision to ease borrowing costs for Eurozone states in trouble could be construed as an economic decision, keeping the common currency intact was ultimately a political one. Both of these steps were anathema to ordoliberal hardliners within Germany, and by agreeing to them, Merkel opened herself up to challenges from within her own political ranks and from an influential circle of economists. But by this stage in the crisis, Merkel had succeeded in insulating herself from her critics by her refusal to cave over the previous six months and by her insistence on conditionality and austerity. The final product of the negotiations in May 2010 also conformed to the framework (quoted earlier) that Merkel had outlined during the March summit. Much like Helmut Kohl during the negotiations over Maastricht, Merkel was able to leverage domestic opposition and stamp Germany's imprint on the rescue effort.

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[51]For a detailed account of these negotiations, see Matthew Lynn, *Bust: Greece, the Euro, and the Sovereign Debt Crisis* (Hoboken, NJ: Bloomberg Press, 2011), 149–182.

Deauville in Perspective

Although the markets were temporarily calmed, in the fall of the 2010, the Eurozone once again came under attack as the crisis spread to Ireland. Unlike Greece, Ireland's problems did not stem from a bloated public sector but rather from a property bubble fueled by reckless lending by Irish banks, most notably, Anglo-Irish ones.[52] Yet, like Greece, Ireland's borrowing costs were pushed to unsustainable levels after the markets decided that the government's decision to bail out its banking system left it vulnerable to default. Merkel and Sarkozy, along with other Eurozone politicians, met at the French seaside town of Deauville to craft another rescue.

Deauville is now remembered as the site where Merkel made her greatest mistake in the entire sovereign debt crisis by insisting on "private sector involvement" (PSI) in any future rescue packages. Up to that point, the sovereign debt of Eurozone states was considered to be guaranteed in full by the Eurozone as a whole. Clearly, it was this assumption that had led markets to consider all sovereign Eurozone debt on equal terms with German debt and created the low interest rates in peripheral countries that fueled public borrowing in Greece, Italy, and Portugal and property bubbles in Ireland and Spain. Although signaling risk premiums made sense theoretically, Merkel's timing was poor in that markets began dumping even more sovereign debt of distressed Eurozone states once she signaled that private actors would suffer "haircuts" in the event of debt restructuring. The resulting market turmoil would be labeled the "Merkel crash."

Why did Merkel insist on private sector involvement? Part of her calculation surely involved domestic politics, as there was rising clamor in Germany to make the banks that had knowingly taken risky bets to pay and not leave the entire bill to German taxpayers. Yet the political benefits of PSI only reinforced Merkel's broader strategy of creating a new European financial architecture. Now that the Eurozone had effectively created a lender of last resort, it was necessary for Merkel to signal to market actors that they would need to price in different levels of risk; failure to do so would have invited moral hazard. Like nearly all of her moves, Merkel was willing to risk temporary market turbulence to achieve her longer-run institutional objectives. Although she ended up backing away from PSI after Deauville, the notion that "haircuts" were now a possibility has changed market calculations. It is also worth noting that private actors

[52]Simon Caldwell, *Anglo-Republic: Inside the Bank that Broke Ireland* (New York: Penguin, 2011).

ended up accepting a haircut on Greek debt in the negotiations following Deauville.

While Deauville is now linked to PSI in narratives of the Eurozone crisis, there was a larger issue at stake for Merkel that once again stemmed from constitutional concerns. The chancellor needed a change in the EU treaty in order to make the creation of a permanent financial rescue mechanism (the European Stability Mechanism) legal under German law. The French in particular were initially opposed to a treaty change, as bad memories persisted of the failure to ratify the initial version of the Lisbon Treaty that called for a Constitution for Europe and was the pet project of French statesman Giscard. Merkel had initially pushed for automatic sanctions and the suspension of EU voting rights for countries violating the fiscal rules initially laid out in Maastricht, violated in the Stability and Growth Pact, and resuscitated in the response to the sovereign debt crisis. To get the French to agree to a treaty change, Merkel backed away from the voting rights issue and temporarily softened her stand on automaticity. This represented yet another instance in which French bargaining strength was undercut by fears about their own economic position. Officials at the French Finance Ministry admitted that they were fearful of losing their AAA credit rating at the time of the Deauville summit and were willing to support German initiatives before the crisis engulfed them.[53]

Merkel would ultimately realize her goal of enshrining both conditionality and austerity in the Eurozone's financial architecture with the signing of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (commonly referred to as the Fiscal Pact) in December 2011. Agreed to by all members of the EU with the exception of Great Britain and the Czech Republic, the Fiscal Pact imposes quasi-automatic sanctions on countries that exceed EU budget limit deficits. It also requires that all EU members follow the Germans in writing a "debt brake" into their national laws to prevent their structural deficit from exceeding 1 percent of GDP. Although there are doubts about just how the "quasi-automatic" sanctioning mechanisms will work in practice and whether member states would actually take the unprecedented step of taking another member to the European Court of Justice to exact fines, there is no doubt that the treaty represents the imposition of German ordoliberalism on the rest of Europe.

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[53] Bastasin, *Saving Europe*, 243.

Outright Monetary Transactions

The Fiscal Pact did not address the immediate problem of what to do with the sovereign debt that already existed, and the Eurozone crisis entered what was perhaps its most dangerous phase in the winter of 2012 when Spain and, to a lesser extent, Italy became the targets of market speculation. Although it was problematic politically, each of the three smaller Eurozone states with unsustainable levels of debt (Greece, Ireland, and Portugal) could in theory be bailed out without bankrupting the rest of the Eurozone. But Spain and Italy were truly "too big to fail." Not even Germany could underwrite a rescue package that would be sufficient to bail them out, and even a partial bailout probably would have undercut Germany's credit rating and therefore the viability of the loan. When the magnitude of Spain's banking crisis became evident to all observers, it became necessary to involve the only institution with enough firepower to make a difference.

This was the European Central Bank, and although it had already assumed a central role in the crisis by purchasing bonds directly from embattled states to lower their borrowing costs, the announcement of Draghi's program of outright monetary transactions marked a radical break with the past. By agreeing to buy an unlimited amount of bonds of sovereign governments on the secondary market, Draghi raised alarm in Germany that the ECB had lost both its political independence and its mandate of ensuring price stability. Jens Weidmann, the president of the Bundesbank, was reputedly the only member of the ECB's board that voted against the measure.

Draghi's maneuver paralleled Merkel's in two senses. First, just as Merkel redefined the sovereign debt crisis as a threat to the stability of the euro (which German law recognized as a duty) rather than to European solidarity (which German law did not recognize at all), Draghi needed to reframe the crisis to insulate his policy from legal challenges. This was particularly important because the ECB's only mandate is to ensure price stability, a legacy of the Bundesbank influence on the Maastricht negotiations. Draghi argued that market speculation on the breakup of the euro had created a fragmentation of financial markets and impeded the ECB's ability to transmit its monetary policy. Essentially, Draghi was arguing that betting against the irreversibility of the euro constituted a "severe distortion" in financial markets that the ECB needed to correct in order to fulfill its primary mandate of ensuring price stability. This was a creative interpretation, but one that critics had a difficult time contesting. Second, Draghi made OMT conditional on governments agreeing to a package of domestic reforms to be determined and monitored by the ECB and the IMF. Like all the rescue packages before it, this was designed to make sure that politicians did not simply take the money and refuse to enact painful measures.

It is difficult to imagine that Draghi could have followed through on OMT without Merkel's support. The chancellor defended Draghi's unconventional policy even as Bundesbank Chairman Weidmann continued to rail against it in public. Draghi certainly helped his case first by continuing with Merkel's insistence on strong conditionality, and second by taking the unprecedented step of appearing before the German Bundestag to explain and defend OMT. Yet the move in the direction of unlimited bond buying—and the monumental threat to Germany's stability culture that entailed—constituted such a dramatic violation of ordoliberal orthodoxy that Merkel's decision requires further explanation.

Interviews with participants and evidence from official documents, it is hoped, will shed light on this question when scholarly histories of the sovereign debt crisis begin to appear, but in the absence of those sources, one can still try to interpret Merkel's support for Draghi. One reasonable possibility is that OMT finally offered a means of mutualizing debt that Merkel could work with. Like many EU policies before it, Draghi's initiative had the virtue of requiring technical knowledge in order to understand it, much less explain it in clear terms to the voting public. Most ordinary Germans knew they were against "Eurobonds," but asking them to form an opinion on the efficacy of OMT and its implications for the German economy was clearly beyond them. Moreover, the fact that the ECB rather than the German government became the face of the operation added an additional layer of complexity. Much like the IMF, involving the ECB also opened up the possibility of blame shifting if Merkel chose to do so.

Second, Merkel probably recognized that she had pushed other Eurozone states as far in her preferred direction as was possible without inviting a real—as opposed to a rhetorical—backlash. It was one thing for politicians in Greece and Spain to rail against German-inspired austerity during electoral campaigns; it was quite another for the Italian prime minister, Mario Monti, and the Spanish prime minister, Mariano Rajoy, to form a balancing coalition against Germany—one potentially involving France—at the EU level. There were indeed signs that such a coalition was forming in the spring of 2012. Having already created a stingy rescue operation that forced unwanted reforms on debtor states, and having already instituted ordoliberal principles at the EU level through the Fiscal Pact, Merkel could not enforce austerity indefinitely without the prospect of some relief. Again, one of the virtues of OMT was its conditionality, as well as the very real prospect that domestic politicians would make reforms on their own instead of involving the ECB, the EU Commission, and the IMF even more deeply in their affairs. Put another way, it was possible that OMT would never be used. Having redesigned the institutional architecture of the Eurozone and pushed other Eurozone states toward convergence with German practices, if not yet toward German results, Merkel was finally ready to sign off on the massive funding required to backstop Italy or Spain should it become absolutely necessary—ultima ratio—while at the same time calculating that OMT might turn out to be the cheapest of all possible solutions.

When the histories of the Eurozone crisis are written, it may very well become clear that Draghi's move proved its turning point. As of the spring of 2014, it certainly appeared that OMT had worked to calm markets to a far greater degree than any other ECB policy over the past five years. If the pattern holds, Draghi deserves enormous credit for his radical break with ECB orthodoxy. But so, too, does Merkel, for, as I have argued, her response to the Eurozone crisis structured Draghi's to a large degree.

CONCLUSION

The central conclusion of this article is that German behavior during the sovereign debt crisis was neither new nor inconsistent. Merkel has used the last several years to refashion the Eurozone in a manner that conforms with Germany's past preferences toward monetary union, its priorities during the sovereign debt crisis, and its legalistic culture. While one should not discount Merkel's skills as an element of this successful outcome, much more important were the structural factors that gave her greater negotiating power than at any other period in the history of the EU. She stamped Germany's imprint firmly on the EU because she could.

Is it possible that Merkel has overreached and that a political backlash against Germany may yet threaten the Eurozone? With unemployment reaching postwar highs in several peripheral states and politicians of many political stripes waging anti-German electoral campaigns, the prospect of meaningful political backlash against Germany—one in which politicians do not simply hurl charges of neo-Nazism at German leaders but actually make good on their promises to resist the German *diktat*—cannot be ruled out. Yet there are at least two reasons to believe that Germany's very success in crafting the Europe it wants will not necessarily lead to its unraveling. The first is that the practice of railing against German demands can be interpreted as what scholars have referred to as the "scapegoat strategy" of blame avoidance.[54] While it is an open question whether such strategies

[54] Leslie A. Pal and R. Kent Weaver, *The Government Taketh Away: The Politics of Pain in the United States and Canada* (Washington, DC: Georgetown University Press, 2003).

work,[55] politicians in soft currency countries have routinely blamed powerful external actors for unpopular reforms that many would privately concede are necessary. Throughout the 1990s, for example, Italian politicians pursued a deliberate strategy of *vincolo esterno* (external tie) that involved citing pressure from Europe as a means of enacting policy reforms they could not achieve if left to their own devices.[56] French politicians have blamed globalization for the limited, although nevertheless unpopular, reforms they have made to the welfare state.[57] One could easily add other examples to this list. The fact that Euro-skepticism might be directed more toward Berlin than Brussels over the coming years does not necessarily increase the odds that nationalism will succeed in breaking apart European institutions. Merkel and future German chancellors will most likely be perfectly happy to let politicians vent voter frustrations, so long as they continue to follow through on reforms.

The second, and by far the more important, reason to believe that European states will ultimately accept economic institutions that bear a strong resemblance to German ones is that they have little other alternative. The economic options available to European states have only narrowed since the late 1960s, when the collapse of Bretton Woods forced them to devise a solution to the problem of exchange-rate instability. It may well be that German-inspired austerity ends up worsening the economic crisis not only over the short term—which it clearly is—but over the long term as well. Yet how credible was the option of pursuing a radically different set of policies? Ever since Mitterrand's famous U-turn in the early 1980s, European politicians have recognized the degree to which international capital flows preclude their ability to engage in fiscal stimulus.[58] The French themselves played a key role in liberalizing capital rules after the U-turn to a degree that further constrained their room for maneuvering.[59] The United States was virtually alone in adopting Keynesian measures during the financial crisis, and it was only the "exorbitant privilege" that

[55]Nathalie Giger and Moira Nelson, "The Electoral Consequences of Welfare State Retrenchment: Blame Avoidance or Credit Claiming in the Era of Permanent Austerity?," *European Journal of Political Research* 50 (2010): 1–23.

[56]For an account of this strategy, see Dyson and Featherstone, *Road to Maastricht*, 485–507.

[57]See Timothy B. Smith, *France in Crisis: Welfare, Inequality, and Globalization since 1980* (New York: Cambridge University Press, 2004).

[58]Mitterrand attempted to introduce a radical leftist program of government spending while, at the same time, keeping the franc within the EMS. The mobility of international capital led him to abandon this effort after several years. On the U-turn, see the essays in George Ross, Stanley Hoffman, and Sylvia Malzacher, *The Mitterrand Experiment: Continuity and Change in Modern France* (New York: Oxford University Press, 1987).

[59]Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Cambridge, MA: Harvard University Press, 2007).

derives from the dollar's status as global reserve currency that allowed it to behave differently than other advanced industrialized countries. And even the United States may not be able to behave this way for long.[60]

Still, it would have been conceivable for a state to abandon the euro and seek growth through currency devaluation. But even for the state most likely to take this route (Greece), the predictable consequences were very unattractive. Greece's debt burden would have been increased massively through devaluation, much private wealth would have been destroyed, and the weakness of its export sector did not promise to bring much growth. It arguably would have been forced to engage in even more austere reforms as a result of international market pressure. Put another way, it would have been exposed to the full brunt of globalization.

In sum, while the European Union may appear to be a straightjacket to ordinary Greeks, it remains one of the only existing mechanisms through which small states might attempt to "manage globalization" in a way that preserves, as much as possible, a set of core European values.[61] German ordoliberalism may appear at first blush to be indistinguishable from the neoliberalism of international capitalism, but the former recognizes the need for a welfare state and a fair degree of wealth redistribution, while the latter makes no such provisions. Given a choice between accepting German conditions or going it alone, politicians until now have taken the safer option. It would be a truly radical step for them to choose otherwise, and until they do, Germany will continue to grudgingly construct the Europe it has always wanted.

[60]Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (New York: Oxford University Press, 2011).
[61]Wade Jacoby and Sophie Meunier, "Europe and the Management of Globalization," *Journal of European Public Policy* 17 (2012): 299–317.