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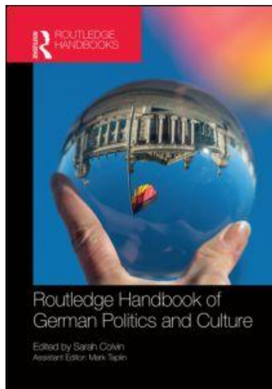


# The Routledge Handbook of German Politics & Culture

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# The German approach to finance in the European context

Publication details
https://test.routledgehandbooks.com/doi/10.4324/9781315747040.ch22
Lothar Funk
**Published online on: 08 Dec 2014**

**How to cite :-** Lothar Funk. 08 Dec 2014, *The German approach to finance in the European context from:* The Routledge Handbook of German Politics & Culture Routledge
Accessed on: 27 Mar 2023
https://test.routledgehandbooks.com/doi/10.4324/9781315747040.ch22

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# 22

# The German approach to finance in the European context

*Lothar Funk*[1]

Hans Magnus Enzensberger has been extremely dissatisfied with the state of Europe recently. On 15 May 2010, he expressed his disappointment and anger in an interview with *The Guardian*: 'Europe is a great achievement but they are messing it up [. . .] it is anti-European because they antagonise people without any reason for doing so. [. . .] it is rolling back liberties which we have acquired.'[2] But who is to blame? For many observers, particularly outside Germany and those northern European countries with a similar financial 'stability culture', the answer appears to be obvious: Germany is at fault.

> Germany has become a major player in this gamble of 'antagonizing Europe', the Europe of ordinary people and political elites alike. The Greek quasi-bailout, the euro turmoil, and the current crisis management among the EU Member States all reveal that 'messing up Europe' is nowadays a – intended? – consequence of German EU policy.
>
> (Morisse-Schilbach 2011: 26)

For such critics, the crisis has been first and foremost a crisis of Germany in the context of both the European Union and the European Monetary Union (EMU) or eurozone. To understand this view, one needs to recall that European integration from the early 1950s was based above all on the idea 'that the only way of taming post-World War II Germany was to link it as closely as possible to its European partners through the intermediary of international institutions' (Morisse-Schilbach 2011: 27).

British experts on German politics suggest that 'it is difficult to understand Germany without reference to the EU' (Miskimmon, Paterson, and Sloam 2010: 496). In an op-ed article in December 2013, the German finance minister Wolfgang Schäuble – paraphrasing the historian Fritz Stern – seemed to agree: 'the Germans have understood that European integration gives us a second chance'. Schäuble emphasised Germany's ongoing 'European vocation' in a well-known mantra that had its origins in West Germany but is still part of the DNA of a huge majority of Germans now: 'We only have a future to the extent that Europe is successful. Germany, too, will do well only if Europe does well' (Schäuble 2013a).[3] The German finance minister, then – as one of the architects of the renewal of financial architecture in the eurozone – continues to believe strongly in the merits of the E(M)U. Experts from abroad nonetheless

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observe that 'deeper European integration (in particular, with the Single Market and the Single Currency) has led to the Europeanisation of domestic policy and the domestication of European policy' (Miskimmon, Paterson, and Sloam 2010: 497).

Conflict is inevitable when public finances come under stress, as has recently happened in the context of globalisation, Europeanisation, and, in Germany, unification. According to critics of current German economic and financial policies at the European level, there has been a structural break in the way Germany approaches EU economic and financial issues since the financial crisis. One might, however, counter that the basic values that inform German economic policies have, at least in principle and after a passing turn to Keynesianism (Funk 2012: 26–7), hardly changed since the initial phase of the social market economy (SME). This chapter will begin by sketching German economic policy in terms of its 'iron triangle' and social market economy approach. It then analyses the two pillars – political and economic – that support Germany's European vocation, and deals briefly with the Federal Republic's traditional focus on the export market and on price stability. Another brief section considers the limited role of Keynesian demand management ideas in the Federal Republic. From there I move to a discussion of the popular notion of German hegemony, before concluding with an analysis of progress towards a new financial architecture for the EMU.

## The pillars of the Federal Republic's economic model

At least in terms of its total economic strength, Germany has been the most populous and most powerful EU member state since unification in 1990.[4] The social market economy was initially the economic programme of the Christian Democratic and Bararian Christian Social parties (CDU/CSU) in the first postwar election. The SME aims at combining individual freedom with a functioning and efficient economic system in a humane social order. In several coalitions (usually with the Free Democrats or FDP) until 1966, the CDU/CSU promoted and defended its emerging main features: an optimal delegation of tasks according to which

1 the central bank should be independent, that is, primarily responsible for keeping inflation down, but not responsible for employment;
2 representatives of employees and employers should have a basic right to freedom in collective bargaining;
3 the state should be limited but strong (Funk 2000: 20–1).

With regard to (3), the state has to be 'limited' to ensure that (a) public expenditure is kept at an efficient, rather low level (the primacy of budgetary discipline, which also supports price stability and prevents the crowding out of private investment); (b) there is no discretionary intervention in response to lobbying by sectoral and other sectional interests; (c) privatisation is implemented wherever reasonable; and (d) market-friendly supply side measures are favoured, in order to promote economic growth and employment in contrast to discretionary demand-side interventions that are regarded as counterproductive most of the time. Ensuring stability also implies a rejection of the idea of ex ante macroeconomic policy coordination (Dyson and Quaglia 2012: 195); but the state has to be 'strong', particularly to create the right conditions for effective competition to decrease inefficiency and unwanted distributional effects of ongoing market power based on artificial entry and exit barriers.

This was based on an 'ordoliberal' paradigm that has had a renaissance within Germany since the financial crisis spread to the Federal Republic in the autumn of 2008 and in 2009. Following the financial and economic shocks in many other countries, that paradigm regained some strength

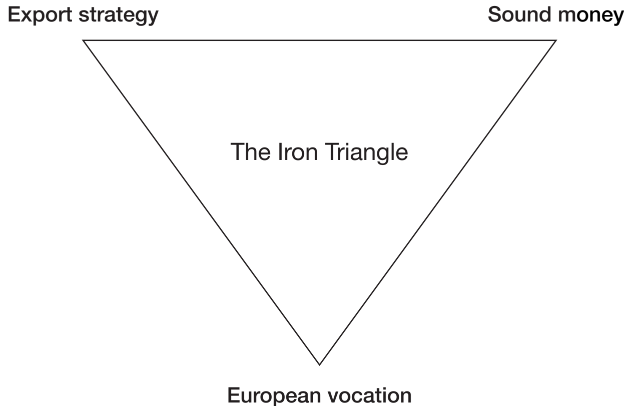


*Figure 22.1* The Iron Triangle of the German Model (based on Paterson 2011: 48)

as an alternative to the 'casino capitalism' (Sinn 2010) of the United States; it has even spread into academic debates, at least in Anglo-Saxon countries (Bonefeld 2013; Siems and Schnyder 2013). Its acceptance remains limited (Blyth 2013: 135–43); but even in the (pre-unification) 'Bonn Republic' the relevant actors usually accepted only the first and second pillars of the ordoliberal SME. The accompanying fundamental regulatory inadequacies had negative effects on Germany's national economic performance that could not be compensated for even by the strengths of the (West) German economy. (The latter included the corporate governance system, vocational training, and other institutional features resulting in 'long-termism' and incremental innovation resulting from 'corporatist' bargains among trade unions, employers' representatives, and the state; Funk 2000: 21.)

In retrospect, the SME has proven more or less compatible with three key principles, namely, an unwavering commitment to price stability; maintaining a large share of exports and imports; and a European vocation in the governing class that prevailed until the current crisis in the eurozone. These features of the (West) German economy have been called a 'self-reinforcing iron triangle' (Figure 22.1), because 'the key principles were derived from the traumatic failures of earlier German polities, notably the Great Inflation of 1923 and murderous and ultimately self-destructive Nazi regime' (Paterson 2011: 48–9).

Indeed, the Federal Republic's economic performance very often benefited from the pick-up of economic growth in the rest of the world, as Siebert observes:

> Traditionally, in the German case an upswing in the business cycle is stimulated by an increase in export demand, which is then followed by a pick-up of investment and eventually leads to less uncertainty, in terms of employment, and to higher income, so that consumer demand increases as well. In the long run, and viewed from the supply side, trade has an impact on growth through different channels.
>
> (Siebert 2005: 7)

Moreover, access to a widening European market has long proved to be a decisive factor for German export successes (Neal 2007: 221–9), and the deepening of European integration has helped increase German exports, especially since the introduction of the euro (Young and Semmler 2011: 10). Losing open markets poses great risks to Germany precisely because of its



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strong European and international economic involvement. And the country's comparatively strict counter-inflationary policies have resulted in one of the lowest national inflation rates worldwide since the launch of the (West) German currency, the Deutsche Mark or DM. This factor also helped to improve German export strengths.

But to understand the particular role of exports for Germany we must also consider other factors (Gerber 2013: 5f.), not least its geographical position in the centre of Europe with many borders to other nations. Steady innovation and high-quality systems in dominant export industries such as the automobile and metal and electrical industries (Hüther 2011: 13ff.) contribute to good value for money from a foreign customer's point of view; this is true despite high absolute labour costs in industry (corresponding to high labour productivity in German industry) and other factors behind rising prices of German goods for foreign buyers. In a nutshell, one might exaggerate and suggest with Young and Semmler (2011: 12) that 'regardless of whether the Deutsche Mark or the EURO appreciated, German exports are internationally competitive'.

The 'iron triangle' has contributed to Germany's persistently high external competitiveness and ongoing trade surpluses (with the exception of an adjustment period after German unification, which slowed the surge in German exports; Whittock 2008: 8–9). A somewhat broader analysis takes account of further factors, such as the role of demographic factors in societal savings decisions that affect net capital flows and thus net exports to the rest of the world (for a more detailed analysis, see Falke 2009: 202 ff. and Kindleberger 1976 for his structural explanation).

## The (limited) impact of Keynesianism

The traditional SME governance model consisted of a set of general guidelines for economic policy rather than precise goals and instructions for policy. This changed, however, during the 1960s, when Keynesian thinking gained some influence in Germany. The goals included in the German Law on Stability and Growth of 1967 still often structure economic policy debates in Germany, even though the law has hardly been applied in practice since the 1970s. It was passed after the first cyclical economic crisis of 1966–7 in West Germany, and was meant to start a shift towards Keynesian demand-side strategy. A law for promoting stability and growth obliged government to smooth out the business cycle (for more detail, see Funk 2012: 12–15).

A high level of employment (often measured in practice by low unemployment) as well as price stability, steady economic growth, and a 'sound' balance in foreign trade (the equilibrium of imports and exports in the medium and longer term) are the four principal economic policy objectives of the government, the so-called 'magic quadrangle' (Figure 22.2). Alongside certain other responsibilities (such as setting and fulfilling ecological goals), the government's task is to ensure an equitable distribution of income and wealth – the 'magic polygon'. The 'magic quadrangle' or rectangle is called magic because of the short-term target conflicts arising in this context (see Figure 22.2). For example, according to the traditional Keynesian trade-off/target conflict view, it was assumed that economic policy could choose between a combination of lower unemployment plus higher inflation, or vice versa. That assumption was proved wrong by the dynamics of the wage bargaining process. As a rule, in the longer term, expansionary monetary and fiscal policies will affect the price level, but not employment. Empirical evidence demonstrated that employees will build inflation forecasts into their expectations and the price level and cost of labour will usually – all other things being equal – rise at a similar rate, at least in the longer term, in labour markets. Thus there is no longer a trade-off between inflation and unemployment – a result that is again in line with orthodox ordoliberal ideas (see Funk 2012: 42).

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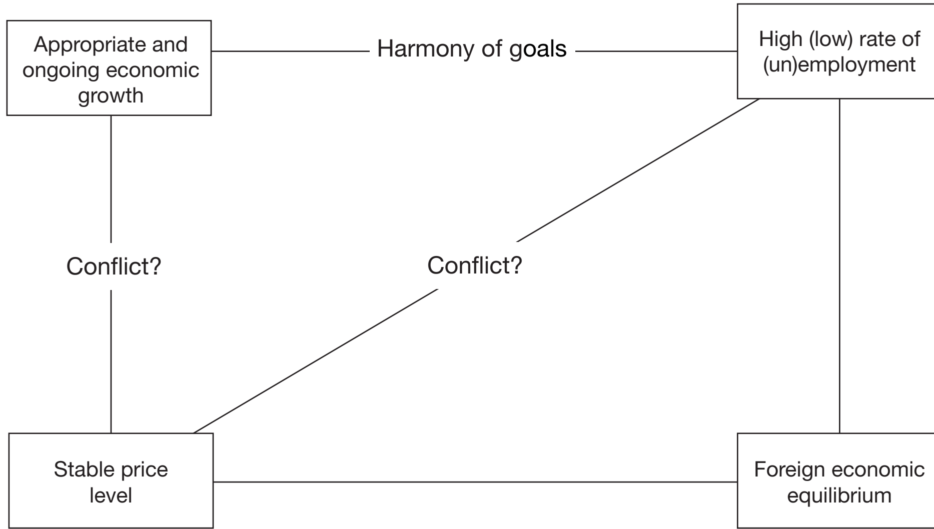


*Figure 22.2* Economic stability goals in Germany – a magic rectangle or quadrangle (see Funk 2012: 14)

## The two pillars of Germany's European vocation

The EMU, as well as the entire European integration policy within the EU, rests on a political and an economic pillar. James (2012: 1) has argued that

> the quest for European monetary coordination and then for union was a response to genuine (and still existing) problems of currency instability and misalignments at the international level. It was not simply – as it has often been represented – a fundamentally political project. [. . .] That a currency union can be driven by an urgent political concern, overriding economic logic, was demonstrated in a costly way by the case of the 1990 German-German currency union that preceded political unification; but it will be clear in the subsequent account that there was a clear economic as well as political logic behind the creation of a single European currency.

The EMU was expected initially to help overcome the low growth and high unemployment of the 1980s ('eurosclerosis'); in other words, the euro was envisioned with a clear function well before German unification (Hampe 2013a). The contention that unification was the primary factor in Germany's willingness to relinquish the leading European currency, the DM, in favour of a common currency is, therefore, contradicted by the timing, and conspiracy theories that suggest that giving up the DM was the price of unification appear dubious. The situation may nonetheless have suited other member states of the European Community quite well as a way of ending the dominance of both the DM and the German central bank (Bundesbank). Europeanisation had become the Western solution to the 'German problem', by which an untrustworthy former enemy had to be turned into a friend (Birckenbach 2011: 318). German governments concurred, arguing repeatedly that the primary political purpose of the EMU was to make a future European war impossible and uneconomic (James 2012: 1).

In order to demonstrate its political loyalty to the West, the Federal government bid farewell to the so-called coronation theory, by which a joint currency should be established only at the end of a process of integration towards a real political union. The government agreed to a fixed date for the implementation of the single currency based on concrete stability criteria and common institutional rules. By adopting this course of action, it hoped to demonstrate that the unified Germany would be a 'European Germany' and would pursue political integration on the path to political union. At the request of the Federal Constitutional Court (Bundesverfassungsgericht), the German constitution or Basic Law (Grundgesetz) acquired a fresh impulse to European integration in a new Article 23, which states that the EU should become 'committed to democratic, social, and federal principles, to the rule of law, and to the principle of subsidiarity' and that it should guarantee 'a level of protection of basic rights essentially comparable to that afforded by this Basic Law'. All this can be read as an expression of the German will to strengthen the political institutions of the EU, but, as Birckenbach (2011: 328) notes, 'it can also be read as an expression of a German will to export its own political system to the European level. Not every member state has been in favour of such attempts.'

From an economic perspective, the EMU aimed at resolving the trilemma (see Figure 22.3 below) of currency policy within the EU by abolishing nominal exchange rate changes. Since the worldwide depression that started in 1929 and led to the abolition of the gold standard, no convincing solution had been found to the accompanying problems. Neither the Bretton Woods system of adjustable fixed exchange rates nor the flexible exchange rates after 1973 nor the European Monetary System (EMS) after 1979 had convincing results. In principle, an internal market with highly intensive free trade and capital controls can function well even if it is segmented, so long as nominal exchange rates are relatively stable. In order to ensure such stability, the renunciation of nationally autonomous economic policy is needed. This is because such national economic policies usually lead to differing interest and inflation rates that would require changes to nominal exchange rates (Hampe 2013a, 2013b).

The EMS was initiated by Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing in spring 1978 in order to achieve more stable exchange rates, at least in the European common market, and stronger economic growth. The exchange rate mechanism (ERM) aimed at improved trade relations among the member states, since the constant changes in floating member state currencies were regarded as harmful to international trade within the European economic union, while the participating currencies were to float jointly against the currencies of third countries. According to the European Council of December 1978, the ERM was designed to contribute to more growth while simultaneously maintaining price-level stability; it was also expected to help reduce unemployment and to enhance European integration. One of its pillars was an increased convergence of economic policy. Participants initially included eight member states; southern European countries and the United Kingdom entered later.

However, the system remained fragile as ongoing differences in inflation prevented the desired stability of exchange rates. The gain in convergence was probably much smaller than previously expected by the proponents of the EMS. Between 1979 and 1987, the number of necessary realignments amounted to 14. Overall the DM appreciated against Spain and Italy by 105 per cent, while against the UK and France the appreciation amounted to 65 and 45 per cent respectively. In 1983 France changed course to a 'franc fort' policy in support of increased price stability. That meant that France accepted the DM as the anchor of the system, and thus the policy of the Bundesbank. Politically this subordination was regarded as barely acceptable from the French government's point of view. Fundamental differences in macroeconomic policy after German unification produced currency imbalances that in 1992 led to the exit of Italy and the United Kingdom from the ERM (Owen Smith and Funk 1994: 541–2). As a result, the level



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of permitted fluctuations in exchange rates had to be increased from ±2.25 per cent to ±15 per cent. Effectively, this meant almost a return to flexible spot rates. In other words, the fundamental solution to the problem the ERM was supposed to address could hardly be achieved with fixed but adjustable exchange rates.

More generally, the analysis of exchange rate regimes shows that it is impossible to achieve all the goals regarded as beneficial for a country at once. This problem is called an 'impossible trinity' (Reinert 2012: 274ff.) and it reveals a fundamental trilemma. The term trilemma 'describes a situation in which someone faces a choice among three options, each of which comes with some inevitable problems' (Mankiw 2011: 712). The trilemma in international finance stems from the fact that it is impossible for a nation to have fixed nominal exchange rates with other countries, free capital flows, and an independent monetary policy at the same time, even if achieving those national economic policy goals simultaneously would be beneficial (Mankiw 2011: 712). This becomes obvious when taking account of the benefits of each of these goals:

- Fixed nominal exchange rates with other countries enable business and households to make better plans for the future, while fluctuating exchange rates caused, for example, by speculation can be a source of broader economic volatility and problems.
- Free capital mobility allows, from a microeconomic perspective, the movement of capital to its most profitable uses and can generally be regarded as welfare-enhancing for societies as a whole.
- Independent national monetary policy is regarded as nationally useful, as decreasing nominal interest rates can help to stabilise an economy in a recession, while raising them can help to deal with a situation of overheating.

The trilemma implies that it is impossible to have it all at once, and that a country must choose one side of the triangle in Figure 22.3 while giving up the opposite corner.

A first important implication is that 'if you pick two of these goals, the inexorable logic of economics forces you to forego the third' (Mankiw 2011: 712); a second is that there is no obvious best way of dealing with this impossible trinity, and 'economists should be cautious

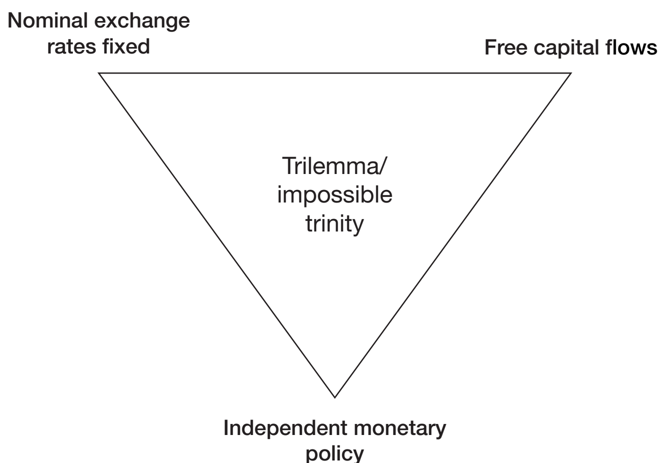


*Figure 22.3* The trilemma of international finance or impossible trinity (based on Mankiw 2011: 379; Reinert 2012: 274)

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when recommending exchange-rate policy, because it is far from obvious what is best' (Mankiw 2011: 713). One option is to allow free flows of capital and to conduct an independent monetary policy; the United States exemplifies this choice, which implies a floating nominal exchange rate to equilibrate the foreign currency exchange market. A second option chosen, for example, by China, is to restrict the in- and outflow of capital, so that domestic forces decide upon the national interest rate; this allows government both to fix the nominal interest rate and to conduct an independent monetary policy. The third option is the one taken, for example, by the member states of the eurozone: they have eliminated all nominal exchange rate movements within the European monetary union, while capital is free to move at the same time. This has, however, implied all member states relinquishing control over national monetary policy. The US economist N. Gregory Mankiw (2011: 713) notes wisely that 'Americans shouldn't be too harsh when other nations facing the trilemma reach conclusions different from ours. In this area of economic policy, as well as many others, there is room for reasonable nations to disagree'. From a European point of view and with the benefit of hindsight, however, the conclusions reached by the eurozone have proved untenable, as the introduction of (temporary) restrictions on capital movements in the case of the rescue package for Cyprus has demonstrated recently. In other words, more institutional change on this matter can be expected in order to achieve a stable eurozone.

## The German hegemony hypothesis re-examined

In spite of experiencing Germany's largest fall in real gross domestic product (GDP) since World War II (–5.1 per cent of real GDP in 2009), the German economy has proved particularly resistant to recent crisis pressures (Funk 2013, 2014). Many German commentators argue that the successful implementation of supply side reforms during the last decade, combined with more traditional elements of its SME, are responsible for Germany's continuing success while much of the euro area's periphery has fallen into deep recession.

The German recession was short-lived and has hardly shown up in the labour market. In contrast to many neighbouring economies, Germany recouped the losses sustained during its recession (limited mainly to 2009) in a subsequent process of strong recovery (an increase in real GDP of 4.2 per cent in 2010 and 3.3 per cent in 2011). Total employment reached record levels in 2010 (and again in the succeeding years), with the highest level of persons employed since unification. The registered unemployment level fell to new lows unequalled since 1991, while simultaneously the number of jobs fully subject to social contributions rose to 28.4 million in 2011, the highest level in the last 15 years. The German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) particularly emphasises the 'remarkable [. . .] almost continuous rise in employment since the middle of the past decade and [. . .] the fact that the situation is actually better than before the crisis' (German Council of Economic Experts 2011: 19). The pattern of steadily rising structural unemployment was broken for the first time in decades, even though external cooling factors (the crisis in the eurozone and the accompanying tensions in the financial markets, as well as the consolidation efforts in many countries) led to a short-term dip in economic growth to only 0.7 per cent in 2012 and 0.4 per cent in 2013.

The main drivers of the surprisingly stable labour market developments in Germany included – apart from certain direct fiscal policy measures (car scrapping subsidies) in the spirit of Keynesian short-term demand management – a large amount of labour and thus skills hoarding, and the use of short-time work (*Kurzarbeit*). These instruments have been used since the 1970s in western Germany for labour market adjustment purposes, but their widespread use particularly in 2010

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was unprecedented in recent decades. The approach worked well because it was based on employers' and government's expectations of a short recession, which proved to be the case. Many of the most affected companies correctly anticipated that the structure of their products was fundamentally appropriate to meet future demand in global markets as well as within Europe and Germany. The increased flexibility of the strategically restructured German labour market (Funk 2003, 2010) contributed considerably to this success, due to the elevated profitability of production prior to the 2008–9 downturn and the accompanying decreased uncertainty for successful entrepreneurship in Germany.

A widely held view within Germany is that the current 'labour market in Germany goes along with a mix of more external flexibility (due to labour market reforms) and more firm-specific internal flexibility (in the course of crisis management)' (Walwei 2011: 563). These factors in particular are held to explain the resilience of the German labour market even despite the steep decline in international trade that depressed German exports in the core areas of machinery and automobile manufacturing. The upswings of 2005 and 2008, combined with wage moderation and increased flexibility as well as the high profits in those sectors before the collapse in demand, were the basis for this rather unique German mode of adjustment. The specific internal experience and mainstream belief within Germany was that controversial structural reforms of the last decade were finally paying off, shortening crisis situations and strengthening the economy. More generally, this may explain why many Germans think that some of the basic lessons of the German experience (such as successfully pursuing supply side orientated measures) should serve as a guideline for national reform efforts in the crisis countries of the euro area (Funk 2012, 2013).

However, the debate outside Germany – particularly among some British commentators as well as leading US Keynesians – was rather different. According to this alternative view, the macroeconomic outlook in Germany brightened after 2004 not only because of the structural reforms that were undertaken but particularly as a result of the simultaneous boom in much of the rest of the eurozone. The latter came about partly because of interest rate convergence after the introduction of the euro, which supported countries with formerly weak currencies (Buti and Sapir 2008: 254) and partly because of the ECB's expansionary monetary policy, which was largely due to macroeconomic imbalances in Germany: 'In short, the ECB's ultralow policy rate had little impact in Germany [. . .] but it was too accommodative for other economies in the eurozone. The result was widely divergent rates of inflation' (Koo 2013: 116). Lack of demand for loans within Germany to finance consumption and private and public investment

> led to capital outflows from Germany, which contributed to the bubbles in the peripheral countries [. . .]. With German producers becoming increasingly competitive relative to those in the booming economies of southern Europe, German exports grew sharply, pulling the nation out of recession. While Germany overtook Japan and China to post the world's largest trade surplus, the growth in the trade surplus was driven mainly by exports to other European countries rather than Asia or North America. This suggests that it was primarily the intra-European inflation differential that gave Germany such a large competitive advantage. In other words, if the ECB had not inflated other Euro zone economies to the extent it did, the German trade surplus would have been much smaller.
>
> (Koo 2013: 116)

Furthermore, a different macroeconomic and structural policy mix in Germany during the post-2000 recession could have limited the monetary effects of Germany's role as the 'sick man of Europe'. Germany was, however, limited also by the rather strict annual budget deficit

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conditions of the Stability and Growth Pact. If German banks had been able to buy more government bonds at home, they would possibly have bought fewer US subprime papers and fewer bonds in the booming eurozone countries. Koo echoes other critics when he suggests that 'a significant part of today's "competitiveness problem" is attributable to the treaty's 3-percent cap on fiscal deficits, which places unreasonable demands on ECB monetary policy during this type of recession'; the current loss of competitiveness in some countries is to be read in this light, and not (as so often in German official circles) merely as 'the result of poor domestic policy choices (Koo 2013; 117, 111). In other words, according to these critics, Germany contributed at least indirectly to current problems in other European countries and should openly accept this responsibility.

What does all this mean for the contention that Germany is trying to gain hegemony in Europe and shape a 'German Europe'? Even spectators from outside Germany appear to agree that Germany has experienced a turnaround. Since the Federal Republic was established in 1949,

> Germans have embraced a political system and culture in which the values of liberalism, tolerance, openness, and democracy are deeply anchored. Germany has become 'normal' – fundamentally similar to other highly developed western countries like the UK, France, or the United States. [. . .] fundamental structures and values are now shared throughout the West. Thus the old fears that the German 'special path' fostered – the German question – are part of the 'dustbin of history'.
>
> (Conradt and Langenbacher 2013: 363)

In the recent past, Germany has been regarded in a very different, positive sense: 'Many authors even refer to Germany as exemplary – Modell Deutschland' (Conradt and Langenbacher 2013: xi).

Germany's current economic dominance is more likely the unintended consequence of changes and challenges since the adoption of the euro. There are hardly any signs that Germany's current success largely depends on more selfish behaviour than one would find in other member states of the E(M)U. An explanation for the development of the current German position is offered by David P. Conradt and Eric Langenbacher in their recently updated textbook on the German polity. Going back to the German idealist philosopher Georg Wilhelm Friedrich Hegel, they note that his 'cunning reason in history' describes unintended outcomes that may even have an element of irony. Although economists in Germany occasionally saw the euro as a vehicle for greater German export strength (e.g. Eibner 2008: 297), in fact the competitive battle for 'economic superiority' in Europe intensified, and initially Germany lagged behind badly. It is true that German politicians could have done better, but conspiracy theories again seem far-fetched (Norris 2012). Conradt and Langenbacher describe the recent, more elevated German role in the EU as not easily predictable around 10 or 15 years ago, and as an unintended result on (probably) all sides:

> the Euro was supposed to truncate German sovereignty and forever contain German power. [. . .] At first, this is exactly how things played out. Germany had a lacklustre decade after the effects of the immediate postunification economic boom weakened. [. . .] Moreover, the early years of the Euro (after its physical introduction in 2002) produced exactly the wrong monetary policy for the needs of the anemic German economy. [. . .] Under such circumstances, there was little capacity to exert more influence and power.
>
> (Conradt and Langenbacher 2013: xii–xiii)[5]

Since then things have changed, mostly as a result of the delayed positive effects of flexibility-enhancing German reform efforts combined with a good record in terms of emergency measures and longer-term stability-guided policies. The hosting of the football World Cup in 2006 demonstrated a more positive German mood to the rest of the world (see Chapter 27). Despite a growth figure of –5.1 per cent in 2009, Germany was the most positively assessed country in a BBC poll of 27 states (Conradt and Langenbacher 2013: xii). Compared to a decade before that, opinion seemed to have turned around: now there were 'numerous examples of countries emulating German practices, policies, and institutional structures' (Conradt and Langenbacher 2013: xiii). That left Germany well positioned to assume a leadership role in the eurozone crisis. Indeed, Conradt and Langenbacher argue, 'contrary to the intentions of its creators, the Euro has enabled Germany to regain the leading position that it had on the European continent prior to World War II', even if it is now, in William Paterson's phrase, a rather 'reluctant hegemon' (see Chapter 20). Whether that reluctance is 'rapidly falling away', as Conradt and Langenbacher suggest (2013: xiii), will be considered in depth below.

## Crucial dilemmas prior to and during the eurozone crisis

Against this background of renewed German strength – at least in the short term, as the problems of an ageing society may soon dominate (Funk 2004) – many academics are warning against German complacency (Eichengreen 2013; Fratzscher 2013). The German economic hegemony hypothesis can hardly be justified when we take into account both the country's record in terms of economic growth (see Table 22.1) and its persistently high and apparently ever rising unemployment until 2005 (details in Funk 2012: 9–10).

Alongside Ireland, some southern member states showed particularly strong economic growth, while – contrary to the oft-repeated claim that Germany benefited particularly from entering the euro – Germany as the largest EMU country exhibited an inferior economic growth performance. Italy performed especially badly, with a worse economic growth performance than Germany and, at the same time, a price level increase almost as high as in Ireland and Portugal, which had the highest average inflation rates in that period, while Germany experienced the lowest.

After reunification and the break-up of the EMS, real currency appreciation had had disastrous effects for the German economy, 'which had to be squeezed for 15 years to restore competitiveness' (Artus 2010: 7). In line with the pillars of the SME and the iron triangle, Germany therefore insisted, initially at least, on rather strict fiscal requirements for entry into

*Table 22.1* Total real economic growth and price level increases between 1995 and 2009 in selected countries of the E(M)U

| *Country* | *Real economic growth in per cent* | *Price level increase in per cent* |
|---|---|---|
| Ireland | 105.0 | 47 |
| Greece | 55.6 | 67 |
| Spain | 50.2 | 57 |
| Portugal | 29.5 | 48 |
| France | 27.4 | 25 |
| Germany | 16.2 | 12 |
| Italy | 11.4 | 44 |

Source: Hampe 2013a



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the EMU and during its operation (in the end, entrants were not actually required to fulfil those strict criteria). It asked in particular for adherence to a Stability and Growth Pact (SGP) adopted by the European Council in 1997, and was adamant that 'no bailout' should be allowed if countries experienced fiscal distress due to disregarding the fiscal straitjacket, which was implemented to ensure medium- and longer-term stability (Buti and Sapir 2008: 254). Many critics nowadays assert that the failure of the SGP was easily foreseeable, but this is not necessarily true. At the start of EMU, the approach was lauded even in Britain; Artis (2002: 155) called the SGP 'one of the most remarkable pieces of policy coordination in world history. Its construction makes it in some respects comparable to the founding of the Bretton Woods system'. Although the mention of Bretton Woods seems a premonition of potential failure, the rationale behind the approach seemed to make sense:

> the 3 per cent of GDP reference value for triggering the excessive deficit procedure should be treated as much as possible as a 'hard ceiling', the breaking of which would put in motion 'a quasi-automatic' mechanism [. . .] for imposing sanctions, with escape clauses defined as narrowly as possible and legally binding deadlines imposed for taking decisions for the countries to implement corrective measures.
>
> (Buti and Sapir 2008: 243–4)

The 3 per cent criterion, which became part of the Maastricht treaty, was hedged later on with discretionary qualifications, and what actually happened differed considerably from what had been planned (for details, see Buti and Sapir 2008: 244–57). Nevertheless, the SGP aimed at enduring stability-orientated fiscal and financial policy, and contained the obligation to achieve a balanced budget at least in the medium term. An early warning system was provided by the duty to submit annual stability and convergence programmes, which would be followed up with recommendations from the Council. Sanctions threatened in the case of excessive budget deficits. In 2005, however, after Germany and France in particular had repeatedly failed to keep to the rules, the pact was reformed. According to critics, the new pact lost its 'bite' and was weakened because additional factors were given consideration and the deficit procedure was prolonged (Hampe 2013b: 335–6).

In January 1999, the currencies of the different member states were linked irrevocably to the euro. After three years of operating as a shadow currency, on 1 January 2002 the new currency finally took the shape of coins and notes, with €1 equal to DM1.95583. Beyond the advantage that there was no longer any nominal exchange rate volatility among member states, the economic advantages of the euro were seen particularly in an ongoing reduction in transaction and information costs, and in expected gains in economic growth. Moreover, there were potential gains due to the euro's use as an international reserve currency with a larger capital market and, all else being equal, lower average interest rates. And the E(M)U and its political representatives, as a unified player, became a more powerful actor in the globalised world.

But the potential disadvantages of the EMU for the respective actors at national level have to be considered as well. Adopting the euro meant renouncing national monetary, interest rate, and exchange rate policies; the adjustment burden in the case of economic imbalances is on public fiscal and structural policies as well as wage and welfare state policies in the different countries. The question was how to achieve the necessary discipline and microeconomic flexibility of production factors at national level (Hampe 2013b: 336–7). Beyond financial and fiscal issues, the adaptability of national production as well as the resources it required had to be addressed through structural policies, in particular wage and social policies. Countries' room for manoeuvre was affected by the Stability and Growth Pact as well as by the no-bailout clause and productivity

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*Table 22.2* Institutional framework of policy determination in the pre-crisis E(M)U – different levels of actors for microeconomic and macroeconomic policies

| | *National* | *E(M)U* |
|---|---|---|
| Microeconomic | Labour market regulation | Product and capital market regulation |
| Macroeconomic | Fiscal policy | Monetary policy (EMU only) |

Source: based on Sapir 2006: 382; slightly amended

growth developments (which set the leeway for the distribution of real production). The latter depend on the capacity of production factors to adjust to new situations, and on investment in skills and human capital, in particular. All in all, the rules of the game changed considerably with the adoption of the euro.

Beyond budgetary and financial stability at the macroeconomic level, which was addressed by an independent central bank as well as stability-guided fiscal policy, the EU's Lisbon strategy tried to improve microeconomic flexibility by giving incentives for structural reforms at the national level. The ambitious goal set in March 2000 with the Lisbon strategy was to make the EU 'the most competitive and dynamic knowledge-based economy in the world' by 2009–10 (Papadimitriou 2012: 1). A clear division of labour, as set out in Table 22.2, was meant to achieve this goal (for details, see also Owen Smith 2008: 266–9). However, with the weak governance mechanism, based on the open method of coordination (which relied heavily on voluntarism and peer pressure for its implementation), the incentives set largely failed. An interim assessment suggested that

> the Lisbon method was simply too weak to deliver. Five years after its launch in 2000, it has delivered neither a major thrust towards completing the single market nor significant labour market reforms. [. . .] there is little evidence of a link between initial conditions and subsequent reform efforts over the past ten years, with some countries taking only modest measures despite a low starting point and others carrying out ambitious programmes even though their initial conditions were already relatively favourable. [. . .] Moreover, there is no evidence of an acceleration of reforms during the second half of the period, after the launch of the Lisbon strategy, on the contrary.
>
> (Sapir 2006: 386)

Attempts to improve microeconomic flexibility, above all at the national level, have not been successful: 'Since the introduction of the Euro in the late 1990s, the competitiveness gap between the Eurozone's "core" and "periphery" has been growing steadily' (Papadimitriou 2012: 1). Koo's hypothesis that inadequate German fiscal policy has to be regarded as a potential key source for the current crisis in the eurozone needs to be assessed alongside missing microeconomic reform efforts, particularly in the countries that needed reforms most urgently. At the same time, the macroeconomic framework in place before the current crisis proved unable 'to "police" fiscal discipline amongst its Member States' (Papadimitriou 2012: 1). That problem can be traced back to the blurring of incentives in the original Maastricht public finance requirements:

> Meeting the convergence criteria enabled budgetary laggards to join the virtuous countries in the new policy regime, while failure to comply carried the penalty of exclusion from the euro area. Market incentives were also crucial. Countries with high deficit and debt

> levels that adopted a credible adjustment programme were able to enjoy a reduction in interest rates which helped lower their public finance imbalances. The structure of incentives changed with entry into the euro area; the convergence of interest rates meant that the market incentives were reduced, the carrot of the prospect of entry was eaten, and the stick of the risk of exclusion was replaced by the much weaker threat of uncertain and delayed sanctions under the SGP. The experience of the early years of EMU showed that the Council was not ready to use the 'nuclear option' of pecuniary sanctions, especially against large countries.
>
> (Buti and Sapir 2008: 254)

Despite an often rather positive interim assessment of the single currency on its tenth birthday, experts knew of the covert structural problems. Table 22.3 summarises important policy fields related to the E(M)U level and the respective governance structures prior to the recent crisis-related reforms.

For many observers, especially in Germany, the crisis in the eurozone is largely the result of failure to observe the explicit and implicit 'rules of the game' of EMU (see also Hampe 2013a, 2013b: 336–41). The trigger was the dramatic interest rate spread against German governmental bonds (bunds) after Greece's admission of a much higher sovereign debt than had been generally assumed until then. The rating agencies 'failed' as guardians of the financial markets, at least in the sense that they did not lead to sufficiently differentiated interest rates, despite differences in countries' risks prior to the crisis. One reason for this was probably that the financial markets never really regarded the no-bailout clause as credible, because the Stability and

*Table 22.3* Institutional framework of policy determination in the pre-crisis E(M)U – features of different policy fields and respective levels

| *Policy field* | *Features* | *Level responsible* |
| --- | --- | --- |
| Monetary policy | • Primary objective of price stability<br>• The eurosystem contributes to financial stability and supervision | Euro area-wide level |
| Fiscal policy | Fiscal surveillance in order to rule out unsustainable developments<br>• No-bailout rule<br>• Stability and Growth Pact<br>– Excessive deficit procedure<br>– Stability and convergence programmes | National level with 'hard' rule-based co-ordination |
| Structural policy | • Economic policies matter of common concern<br>• Integrated guidelines<br>– Broad economic policy<br>– Employment<br>• National reform programmes<br>• 'Lisbon strategy', followed by 'Europe 2020' | • National level with 'soft' co-ordination<br>• Open method of co-ordination |
| Prudential policy | Micro-prudential supervision: limit distress of individual institutions | National level |

Source: based on Coene 2012: 105; Brunetti 2014



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Growth Pact was never in fact enforced (despite 97 cases to 2010 where annual budget deficits were above 3 per cent).

## The main causes of the crisis in the euro area and how to cure it

In order to prescribe an appropriate therapy, a parsimonious diagnosis has to be made. The discussion so far has highlighted several issues behind the crisis in the eurozone: first, the very high public debt levels prior to 2009–10 and their dramatic increase especially in Ireland, Italy, Portugal, Greece, and Spain after 2008–9; and second, the increasing divergence (rather than the expected convergence) in the competitiveness of the individual member states. Problems were caused by demanding too much of the available distributional margin based on productivity growth. That implies, third, a failure of national governments to enforce much needed structural reforms to break up the still existing insider-outsider problems, which led to an overburdening of the distributional leeway limit and caused economic distress both for national economic actors and abroad. As one observer has aptly put it: 'the crisis of the southern European euro countries is not simply a sovereign debt crisis; it is also a growth and competitiveness crisis resulting from insider power' (Iversen 2013: 77). This is a neglected factor in the current debate; it mirrors the Federal Republic's experience after the 1980s, until the German insider-outsider problem was overcome in the context of globalisation and Europeanisation, combined with measured reforms of the welfare state and labour markets (Funk 2000, 2010).

The dramatic rise in interest rates for the sovereign debt of the countries in crisis endangered their ability to pay, and the risk of those countries' insolvency threatened the stability of the entire European banking system with its transnational web of loans. With the help of massive rescue measures that critics in Germany, in particular, regard as out of line with the European treaty on monetary union that was agreed at Maastricht in 1991, it has so far been possible to avoid the insolvency of states and systemically important banks. The justification for those measures – buying time to implement the required structural reforms – was accepted by the governments of Germany and of other countries, and to some extent by the German Bundesbank and the German Constitutional Court (Deutsche Bundesbank 2012: 22–3; Sinn 2014). Nevertheless, this approach meant the gradual substitution of private creditors by taxpayers, whereby the latter are bearing more burdens than are probably justified. The crisis is by no means finally resolved. Potential solutions are still being hotly debated. The countries in crisis need to regain their competitiveness – their 'national business models' prior to the crisis have proved unsustainable. The adjustment process must continue, even though the crisis and the adjustment measures taken so far have caused huge losses in the countries particularly affected. A few months of positive economic growth cannot compensate for losses of per capita incomes between 2007 and 2013 of 8 per cent in Spain, 12 per cent in Italy, and almost 24 per cent in Greece, which went hand in hand with very high unemployment (Brunetti 2014). Public and private debt need to reach sustainable levels, and the banking systems have to be both stabilised in the short term and made sustainable in the longer term.

The dilemma is that all the current resolution mechanisms lead away from other important objectives. Thus for many observers there appears to be no 'ideal path' from the perspective of all the countries and actors involved. The following list outlines some of the interrelated problems (Hampe 2013a):

- The euro crisis risks aggravating divisions between the EMU's member states. Promising and ensuring unlimited aid to weakened countries could potentially calm the financial markets, but the strategy might backfire because it is likely to weaken the reform efforts of the countries in crisis and thus to increase the liability risks for stronger countries. The euro crisis may, then, aggravate a splintering of the EMU's member states, and we may

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well see a further strengthening of anti-euro parties. That will put the parties at the centre under pressure to toughen already tough aid policies, even though the opposite may be needed, at least for some weaker countries. A frightening scenario with sovereign insolvencies due to populist policies is less likely if the necessary austerity measures in the countries in crisis are carried out within a realistic time scale; but putting less pressure on the countries in crisis by offering a more generous timetable may slow down the required structural reforms (Smaghi 2013: 70–4).

- Only a geographically stable EMU offers the lasting advantages of a single currency in the medium and longer term. Stopping financial aid to Greece and its subsequent insolvency would probably lead to a Greek exit from the EU and force creditors to forgo considerable financial demands. Such a situation would increase speculation that other crisis countries could follow suit and might thus contribute to a domino effect that would worsen the situation of other member states.
- A break-up of this kind might do long-term harm to the EU's position in the world. Even if only a few isolated countries whose non-compliance with reform demands was quite obvious were to leave, the EU's reputation might be damaged by its inability to solve a comparatively small problem such as restructuring a country like Greece (with only 2.5 per cent of the gross domestic product of the eurozone as a whole). Proposals for how to deal with such a serious situation remain quite controversial among economists (Sinn 2013). And there is further cause for concern: if large countries within the EMU and countries with populist governments refused to implement the necessary sweeping structural reforms, a break-up might eventually ensue as creditor nations such as Germany with current account surpluses and comparatively sound public budgets lost interest in participating. At least some calculations show that taking the risk of 'Germexit' – Germany leaving the eurozone (possibly followed by other creditor nations) – might pay off for such countries after only a few years (Mayer 2013).

This helps to explain why Chancellor Merkel ignored demands for mutualisation of debt through Eurobonds and decided instead to pursue the step-by-step approach of solidarity for stability. In terms of game theory, this approach can be regarded as a 'chicken game', in which the 'players' seek through their specific interactions to gain at the expense of the other actors involved (Smaghi 2013: 70–4). There is an overall 'super-dilemma' in such situations:

> a choice that seems optimal in the short term becomes counterproductive because it creates perverse incentives in the medium term. This is why the economic policy cannot be subject to too much discretion and should preferably be subject to rules, even if those rules may appear too rigid when the effect is evaluated on a case by case basis.
>
> (Smaghi 2013: 71)

Trying to overcome such problems is at the heart of the German ordoliberal school of thought, which focuses on institutionalising sanctions against (short-term) misbehaviour or free-riding at the expense of others, as this is likely otherwise to cause 'revenge' and thus destroy mutually beneficial gains from economic interactions. If short-term gains hurting others are forgone, in the medium and longer term all actors are usually better off. This approach also explains why German ordoliberals are so reluctant to adopt short-term expansionary fiscal policy to stimulate the economy in a short-term recession, as the result is usually only a passing fancy without lasting positive effects on economic growth or structural (un)employment. As a rule, German mainstream economists as well as governmental authorities limit Keynesian economic policy foremost to very specific situations: "Government investment for the purpose of stimulating the economy is meaningful only – and on a limited scale – in times of extraordinary crisis" (Deutsche Bundesbank 1999: 15).

From the German perspective, the pathway taken in the eurozone crisis was an attempt to minimise (in a situation of huge uncertainty) the costs for Germany, while simultaneously striking a balance between solidarity – since the alternative of strictly applying the EMU's no-bailout rule was regarded as worse for the countries affected – and putting pressure on the countries in crisis to ensure ongoing reforms at the necessary speed.

## Towards a more stable financial architecture

For Chancellor Merkel and the finance minister in her two coalitions since 2009, Wolfgang Schäuble, all alternatives to the euro have so far appeared to be worse under realistic conditions. Knowing this may explain Merkel's often repeated and sometimes ridiculed verdict on the issue: 'If the euro breaks, European integration will also break' ('Scheitert der Euro, scheitert Europa'; quoted from Marsh 2013: 20). Economic analysis suggests that the acute dimension of the crisis as a self-fulfilling crisis of confidence with highly destructive potential could indeed have resulted in a break or breaks. The largely German-led crisis management, therefore, based as it was on a 'cautious and muddling-through approach towards a permanent solution', may well have been adequate, and was certainly superior to either the quick exclusion of crisis countries from EMU or the introduction of debt mutualisation (Heinemann 2013: 38; on France, Schild 2013).

The recent crisis has made the new German SME into a kind of role model for other countries, at least to some extent (Rees 2011; and see Anderson in this volume). In fact, Germany's leading role in preparing blueprints for structural reforms was based on lessons learned from Germany's own experience of fighting persistently high unemployment and low economic growth in the past. The 'Brussels consensus view' (Hirschel 2013) that has emerged is to a large extent inspired by the pillars of Germany's SME and by Germany's recent experience of a turnaround, within a period of few years, from having a lagging and sick economy to being the country with the best recovery in Europe during a time of deep crisis in the EU. According to Finance Minister Schäuble, flaws in the euro-architecture have been amended since the start of the crisis. With respect to the euro rescue, he noted in an interview published in November 2012 that 'the puzzle is becoming complete' (Schäuble 2012: 17). Decisive steps that would stabilise the eurozone included, according to Schäuble:

- launching the European Stability Mechanism as a protective shield for the euro;
- tightening up the Stability and Growth Pact;
- implementing the Fiscal Compact, including 'debt brakes' based on the German and Swiss model;
- improved governance mechanisms to ensure comprehensive and ongoing reforms as well as successful consolidation measures throughout the member states (European semester, euro-plus pact);
- an effective European banking supervisor;
- the decision of Germany's Federal Constitutional Court in early September 2012 to declare the German government's strategy to rescue the euro in line with the Basic Law;
- a European Central Bank that 'does its job very well – until now inflation in the eurozone has been lower than inflation with the deutschmark' (Schäuble 2012: 19).

(This last statement indicates that the minister, like the chancellor (Schwarzer 2012), does not support the Bundesbank's harsh criticism of unconventional monetary policy even as a short-term emergency measure.)

According to the finance minister, since Lehman Brothers filed for bankruptcy on 15 September 2008, the financial markets have become a safer place due to much regulatory work.



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In an article published in November 2013, Schäuble (2013b) notes: 'By improving supervision and adopting more appropriate capital requirements, we are making the financial system more crisis-resistant. Markets and products have become more transparent.' For Schäuble, the euro rescue is in the best interests of Germany, if it is done properly:

> A collapse of the currency union would be substantially more expensive for German citizens than the obligations that have been made so far in the form of credit guarantees. The loans were only granted under very strict conditions, whose implementation should put the recipients back on their feet economically.
>
> (Schäuble 2012: 19)

An important lesson is that the measures summarised in Table 22.4 that (apart from shorter-term stabilisation mechanisms) address structural issues[6] – the special focus of orthodox ordoliberalism – cannot suffice to stop a self-fulfilling crisis of confidence, as such a crisis 'cannot be contained through an improvement of long-run fundamentals alone' (Heinemann 2013: 39).

This is not to suggest that short-term emergency aid suffices or can substitute for structural measures. Additional sweeping reforms will be necessary despite all the efforts that have been made up till now. However, the speed of those reforms may be better adapted than in the initial phase (Brunetti 2014). Brunetti, a Swiss economist, suggests that in addition to national measures to ensure budget consolidation the continuing design faults of the original EMU system have to be removed. We need an answer to the question how a currency union with sovereign member states can ensure sufficient discipline without in practice abolishing fiscal sovereignty at the national level. In the foreseeable future, steps towards a full fiscal union are regarded as politically unenforceable (not only in Germany), and alternative institutional mechanisms will be needed to overcome the depression-like fall in real incomes in the crisis countries as well as their ongoing solvency problems. The announcement of the so-called outright monetary transactions (OMTs) in July 2012 was an emergency measure that, in retrospect, has helped to prevent a break-up

*Table 22.4* Important elements of a firewall against financial crises in the European Union

*Unified and effective banking supervision and single resolution mechanism*
- to be implemented via a banking union that had been agreed at the end of 2013 (supervisory mechanism and complex resolution regime) and further implemented in the medium term

*Mandatory introduction of debt brakes and stricter handling of public deficits*
- introduced by Fiscal Compact for improved budgetary discipline of 25 EU member states

*Implementation of European stabilisation mechanisms, initially temporarily and then permanently*
- establishes jointly guaranteed stability mechanisms; loans in return for consolidation measures and structural reforms; aims at achieving short-term financial stabilisation of entire countries and banks in emergencies

*Precautionary measures against macroeconomic imbalances*
- particularly to fight lasting high current account deficits as well as ongoing very high current account surpluses

*Early coordination of budget and economic policies among member states by European Commission*
- introduced via the European semester

*More effective control of public budgets*
- by making the Stability and Growth Pact stricter and simultaneously more effective

Source: based on Europäische Kommission 2012: 5

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of the eurozone so far. But no more can be achieved by such a rescue measure. Despite the Bundesbank's (and, in February 2014, the German Constitutional Court's) rejection of the OMTs (Sinn 2014; Weidmann 2014), a good number – though most likely not the majority – of German economists regard them as an appropriate emergency measure. The promise of the ECB's president Mario Draghi to do 'whatever it takes' to rescue the euro will not deal with the huge remaining solvency problems, as the ECB can only resolve uncertainties with respect to liquidity; in practice, it will act as a lender of last resort for sovereign debt, something many economists (especially outside Germany) regard as a suitable mode of rescue for financial institutions that can be regarded as solvent but have liquidity problems in panic situations, when investors suddenly remove money from financial institutions. According to Brunetti (2014):

> The liquidity risk was eliminated with OMT considerably; and one has to hope that the Court of European Justice will acknowledge the applicability of this central instrument. The problem remains, however, that this measure can help only in the case of illiquidity of states that are still solvent. If a country is not solvent anymore, however, the ECB's hands are bound by its constitution.

The original 'no bailout' clause has already been replaced, in effect, with a limited joint bailout fund, following the implementation of the European Stability Mechanism and the fiscal pact to improve the enforcement of fiscal goals compared with the original SGP and its successor. Further measures will nevertheless be needed, as prior to the crisis fiscal policy in many member states was structurally deficient. Banking union appears to be indispensable in order to get rid of the link between banking crisis and sovereign debt crisis in the eurozone, which essentially means breaking the 'doom loop' of weak banks and weak governments lending to each other. Apart from the measures already taken in 2013, it will be essential to implement a credibly financed joint single resolution mechanism (SRM) for de facto bankrupt large banks (Brunetti 2014).

## Conclusions

The financial crises since 2008 have had only a transitory impact on most important economic indicators in Germany, with the exception of real investment, which has still not entirely recovered. Despite severe fluctuations in real GDP and other values, such as exports, real wages and consumption remained roughly constant even in 2009 (the year of deep crisis) and increased slightly in succeeding years (Funk 2013).

All in all, Germany seems to have benefited from the euro largely in terms of export gains, especially after the abolition of the exchange rate risk that existed prior to the euro. The country was ranked fourth of the relative winners from the adoption of the euro, according to a very rough ranking by Raiffeisen Research in 2012 (see Table 22.5). The ranking assumes an improvement due to the euro if one of the six chosen macroeconomic indicators improved in the period 1999–2011 compared with 1986–98. While this is a broad-brush analysis that neglects other factors (for example, the specific effects of German unification or key reforms potentially independent of the euro), it is of some interest.

How does Germany's performance match up against that of other countries if we compare the periods 1999–2011 and 1986–98? West German exports were at the heart of the Federal Republic's postwar economic success (Funk 2012: 1–2); and this has been true again since the adoption of the euro. Germany is the only country among the initial euro member states plus Greece that was able to increase its real exports between 1999 and 2011, compared with the

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*Table 22.5* Relative success since the adoption of the euro

| Rank/country | | *Real GDP* | *Employ-ment* | *Unem-ploy-ment* | *Inflation* | *GDP per head in ppp** | *Share of exports* | *Average score* |
|---|---|---|---|---|---|---|---|---|
| 1 | Finland | 1 | 1 | 5 | 5 | 2 | 7 | 3.6 |
| 2 | Greece | 2 | 8 | 12 | 1 | 1 | 11 | 5.0 |
| 3 | Austria | 5 | 3 | 8 | 8 | 4 | 3 | 5.1 |
| 4 | Germany | 7 | 7 | 9 | 7 | 3 | 4 | 5.8 |
| 5 | Belgium | 3 | 5 | 6 | 10 | 5 | 6 | 5.9 |
| 6 | Spain | 6 | 9 | 2 | 4 | 8 | 8 | 6.3 |
| 7 | France | 4 | 6 | 7 | 6 | 6 | 10 | 6.5 |
| 8 | Italy | 8 | 2 | 4 | 3 | 11 | 9 | 6.8 |
| 9 | Ireland | 10 | 11 | 1 | 9 | 10 | 2 | 7.4 |
| 10 | Netherlands | 8 | 12 | 3 | 11 | 6 | 5 | 7.5 |
| 11 | Luxembourg | 10 | 4 | 10 | 12 | 8 | 1 | 7.6 |
| 12 | Portugal | 12 | 10 | 11 | 2 | 12 | 12 | 9.7 |

*ppp = purchasing power parity

Source: Raiffeisen Research (Angelé 2012)

13 years prior to the existence of the euro (in 1986–98 Germany lagged behind all other countries in the sample, apart from Austria, in terms of export growth). According to Angelé (2012), this

> clearly hints at the actual advantage which the euro meant for Germany: the risk of exchange rate shocks was excluded. Sudden exchange rate appreciations (with negative consequences for price-competitiveness and thus for German exports) as during the crisis of the EMS in 1992/93 are no threat for the German economy any more.

In other words, the euro can help maintain German export competitiveness within the European monetary union and against the rest of the world because the damaging appreciations that affected Germany prior to the euro (when the country pursued stricter policies to fight inflation) are avoided.

The euro also helps explain why Germany was able rather easily to recoup a considerable temporary fall in real exports by roughly 14 per cent in 2009, compared with 2008, during the financial crisis (Funk 2013: 205): 'Without the euro and with the Deutsch-Mark, the economic effects of the so-called "Great Recession" would have been arguably considerably more serious. The flipside of this is, however, the sovereign debt crisis in the euro zone' (Angelé 2012). That flipside means massive savings packages as well as interventions from the ECB to keep the currency union and the euro alive. It is still too early to know how costly this will be for Germany.

Table 22.5 suggests that simply creating a common currency union cannot guarantee further convergence. If that were so, we would expect to see Portugal, Greece, and Spain in the role of 'catch-up'-countries, while Luxembourg, the Netherlands, and Austria would be at the bottom of the ranking. Both predictions are partly contradicted by the facts. This indicates, as Angelé (2012) has suggested, that 'in many member states the economic and fiscal policy remained suboptimal and had considerable influence on the highly divergent economic development in the single states of the euro zone'. In that light, the focus of the German government – inspired by ordoliberal ideas – as well as of international institutions such as the OECD, the World Bank, and the IMF on the need for meaningful structural reforms seems justified. That does not mean

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that further German support for the countries in crisis should be resisted (Funk 2013), but simplistic Keynesian recommendations leave unanswered the key question how the troubled countries' structural problems can be resolved; the evidence also suggests that structural reform efforts at home tend to decrease as soon as more foreign aid is made available. It must not be forgotten that the debt crisis has also left the German economy vulnerable (Das 2013; see also Gros 2013).[7] Germany's government could pursue efficiency-enhancing structural economic policies that would serve both Germany and the common good, while also supporting the troubled nations' economies to some extent. This might reduce the kinds of criticisms of Germany that this chapter has highlighted; and such reforms might also address foreseeable future problems for Germany.

## Notes

1 I am grateful to the editor for her patience and support during the completion of this chapter.
2 Cited in Morisse-Schilbach (2011): 26. The article is available online at www.theguardian.com/books/2010/may/15/hans-magnus-enzensberger-interview (accessed 13 October 2014).
3 'Denn die Deutschen haben begriffen, dass wir – um mit Fritz Stern zu sprechen – unsere zweite Chance durch die Integration in Europa haben. Eine Zukunft haben wir nur in dem Maße, wie Europa gelingt. Auch Deutschland wird es nur dann gut gehen, wenn es Europa gut geht'. Unless otherwise stated, all translations from the German are the author's.
4 On this issue, see Leonhard and Funk (2002).
5 Please note that – in contrast to Koo on the previous page – Conradt and Langenbacher regard the monetary policy at that time as still too contractive from the point of view of the weak, ailing German economy in the early 2000s. Gradually, however, the German export sector helped to get a struggling Germany running again.
6 Particularly inspired by the German ordoliberal discourse is the German finance minister's insistence on 'a high priority on ensuring that shareholders and creditors bear the main responsibility for the costs incurred in winding up troubled banks' (Schäuble 2013b); that is, the importance of manageable and predictable 'bail-ins' for all partners involved.
7 Das (2013) notes: 'Germany's economic power and financial strength is overstated. Germany remains dependent on its neighbours, with 69 per cent of total exports going to European countries, including 57 per cent to the member states of the European Union.' Das adds with respect to the eurozone countries in crisis: 'Continued weakness in these troubled countries will affect German economic prospects. [. . .] Peripheral countries will be forced to rely on the European Stability Mechanism and European Central Bank to provide financing directly or indirectly via cheap funds to banks to purchase government bonds which will be used as collateral for the central bank loans. National central banks will also use the "Target 2" payment system to settle cross border funds flows between eurozone countries financing peripheral countries without access to money markets to fund trade deficits and capital flight. Over time, financing will become concentrated in official agencies, the ECB and national governments or central banks. Risk will shift from the peripheral countries to the core of the eurozone, especially Germany and France.' Given the current weakness of France, the pressure on Germany is likely to grow.

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