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SNAPSHOT

# The World Waits For Germany

Berlin Is Moving to Solve Europe's Crisis, But Not Fast Enough

Mark Blyth and Matthias Matthijs
*MARK BLYTH is Professor of International Political Economy at Brown University. MATTHIAS MATTHIJS is Assistant Professor of International Political Economy at the Johns Hopkins School of Advanced International Studies.*

The nineteenth-century French diplomat Charles Maurice de Talleyrand-Périgord, better known simply as Talleyrand, claimed that the Bourbon kings who were exiled during the French revolution had "learned nothing and forgotten nothing." By hanging on to their old-fashioned beliefs about France, they were blind to the changing times and missed the popular uprising and political earthquake that were transforming Europe. Until about a month ago, Talleyrand's contemporaries at the Quai d'Orsay, home of the French Foreign Ministry, could have claimed the same about the modern-day Germans, who have let the euro crisis, and contemporary monetary history, pass them by.

Two years, three sovereign bailouts, more than a trillion euros in cheap ECB loans, and dozens of summits later, the latest developments in Europe suggest that Berlin might be capable of learning after all. Chancellor Angela Merkel's government has begun shifting away from its long-standing mantra of "austerity plus more rules" to something somewhere between a pan-European deposit insurance scheme and a full-fledged fiscal union. In short, the threat of a Spanish bank run sparking Europe's financial collapse has focused the German mind. Although eurobonds -- whose proponents include Mario Draghi, president of the European Central Bank; David Cameron; and Barack Obama -- remain taboo in Berlin, other policy proposals are finally receiving a better hearing among policymakers in Europe's largest economy.

According to Quentin Peel in the *Financial Times*, behind closed doors Merkel's government is even more open toward unorthodox policy proposals. Merkel holds her tongue because of upcoming Greek and French parliamentary elections, domestic opposition (particularly over extending bank insurance schemes beyond the national level), and fear of sending the wrong signal to financial markets. And despite Berlin's declared opposition to eurobonds, its dismissal is not as clear-cut as it seems. Berlin would back a eurobond, but only after a full fiscal union has been constructed to avoid future moral hazards.

Also consider that the Bundesbank has softened its stance on inflation, a historically unprecedented shift. It now takes the view that allowing German inflation to go higher than two percent could be combined with lower than two percent inflation on Europe's periphery, so the eurozone average would stay "close to but lower than two percent," keeping with the official ECB mandate. Lastly, since the election of François Hollande in France, the German policy elite are increasingly willing to discuss growth measures, even if their emphasis remains on long-term structural reforms. In other words, rather than discussing short-term fiscal stimulus and fresh borrowing, Berlin prefers to focus on labor market and pension reform, which would actually lower growth in the short term. After all, if you make it easier for firms to hire and fire during a recession, they are more likely to fire than hire.

The current situation is reminiscent of the late 1990s, when a newly elected French socialist prime minister, Lionel Jospin, and his finance minister, Dominique Strauss-Kahn, insisted on adding the word "growth" to the German-inspired Stability Pact for the eurozone. Despite the French modification of the pact's title, the emphasis then, as now, remained on sticking to the rules, and not on growth, solidarity, or much else. Then, as now, policy change required real leadership and a willingness to contemplate alternatives. This time around, that leadership has been lacking. As we argued in Foreign Affairs last November, until Germany embraces its hegemonic role, which was first identified by the economist Charles Kindleberger as being critical for monetary stability, Europe will not be able to surmount this crisis. And no development in the last seven months alters that diagnosis.

According to Kindleberger, one state has to provide a market for goods that cannot find a buyer, stable exchange rates, full lender of last resort functions, countercyclical long-term lending, and macroeconomic policy coordination. A hegemonic state does this not out of altruism but because it garners the lion's share of the benefits from the existing order. Late last year, Germany was failing on each of those five indicators, seemingly unable or unwilling to lead Europe out of the crisis. Since then, there has been progress in some areas and significant regress in others. But what matters most -- with Greece about to run out of cash, Spain's banking system teetering, and fresh concerns about the stability of Italy's unelected technocratic government -- is that the balance sheet of Berlin's accomplishments remains in the red.

First, in terms of providing a market for distress goods, Germany has recently seen its imports surge, and trade imbalances within the eurozone have begun to narrow. Even so, that turnaround is not enough to right the massive structural imbalances at the heart of the eurozone. Second, the value of the euro compared to other currencies has begun to decline, which gives eurozone countries a badly needed competitiveness boost. However, the biggest beneficiary of a weaker euro may well be Germany itself, given that it represents almost a third of all eurozone exports to the rest of the world. Third, the ECB has provided ample lending of last resort since late 2011. But the trillion quasi-free euros it has disbursed so far have not been enough to calm the markets. (That is likely because the markets know all too well that liquidity instruments cannot solve the solvency problems of the Greek state and Spanish banks.)

Continuing down the list, the problems mount. The pro-cyclical low-rate lending and the core banks' orgy of periphery bond buying in the buildup to the crisis have been replaced by a slow-motion bank run in Greece and Spain. This necessitates matching transfers among eurozone central banks through the so-called Target 2 payments system. Therefore, as well as German banks being on the hook for periphery debt in the event of a default, the German central bank may now be on the hook for hundreds of billions of euros in the event of an actual breakup of the eurozone, which would be hard to handle, even for Germany.

The last of Kindleberger's categories is macroeconomic policy coordination -- and this is the area where there has arguably been the most positive change across the eurozone in recent months. But even if Berlin continues to move toward a rules-based fiscal union and common bank deposit insurance scheme, would it be enough to save the euro? The answer depends on the timing of politics, the politics of timing, evolving economic realities, and the power of key European institutions.

Despite the conventional narrative in the financial press, Germany's shift is not simply driven by electoral politics. There's no doubt that the French and Greek elections have turned up the heat on pro-austerity governments, but the results in each case were neither overwhelming (France) nor conclusive (Greece). Irish voters did not throw austerity overboard in the recent referendum on the fiscal pact. Meanwhile, polls consistently show that the majority of Greeks wish to keep the euro. Although the election of Hollande in France has put pressure on Germany to alter its course, Hollande has neither been able to get the Germans to abandon generalized austerity nor to convince Merkel to fully embrace eurobonds.

The fact that Europe's debt zombies keep coming back to life in scarier forms has arguably done more to focus the minds of German policymakers. Greece was bailed out, and then ring-fenced, and then firewalled, but none of that contained its problems for long. Greece is really only important as the trigger of a bank run that would upend the European bond market, and most core banks have managed to rid themselves of their Greek exposure. However, those same banks cannot rid themselves of Spanish or Italian debt so easily. This is where the ECB's role as a surrogate lender of last resort comes into play. Its activities on that front go a long way in explaining why Germany is tacking now.

Late last year, the ECB began offering LTROs (Long Term Refinancing Operations, or, in other words, very cheap loans) that were supposed to give Europe some breathing space by funding European banks for three years with quasi-free money. The disappointing reality was that nearly all the banks that borrowed returned 75 percent of the cash directly to the ECB (instead of lending it domestically) where it sat as insurance. The banks then used the remaining quarter to buy short-term government debt. While this initially reduced their national bond yields, it had the side effect of increasing the correlation between the sovereign and the banking system. As a result, if the sovereign fails, its national banking system fails, and vice versa. Unsurprisingly, the markets began to price in this correlation risk and bond yields once again shot up.

The fact that three years of cheap money bought three months of time was surely noticed in Berlin, which is where the timing comes in. The threat of crisis spread to Italy and Spain in the spring of 2012 as the LTRO's temporary benefits wore off. By March it seemed that Italy was going to be the region's new problem child, but then, in April and May, the scale of losses at Spanish savings and loan banks, the *cajas*, came to light. Germany is worried because Spain is basically Ireland writ very large. Housing construction generated 14 percent of employment and 16 percent of Spanish GDP prior to 2007, and housing loans went from 28 percent to 103 percent of GDP over the same period.

The *cajas* matter, because the other side of their balance sheets is made up of Spanish private sector debt, which now stands at more than 200 percent of GDP. One in four Spaniards -- the population that holds the debt -- is unemployed. Spain's banking losses are currently put at around $220 billion, which, if past experience is any guide, is almost certainly an underestimate. In all likelihood, Spain will have to ask Europe for a limited bank bailout. Spain as a whole -- unlike Greece, Ireland, or Portugal -- is "too big to bail," which is why it cannot be allowed to fail, which in turn explains why the Germans are changing their tune.

Spain's precarious position on the brink highlights the fact that European banks are the real generators of the crisis. The German narrative of profligate states that spent too much is no longer credible for the simple reason that it is not true anywhere besides Greece. In 2007, Ireland's net debt-to-GDP ratio was 11 percent and Spain's was 27 percent. The periphery's current mess comes from the bursting of housing bubbles financed by the private sector and from northern European banks' reckless bond buying. German banks' exposure to Spanish debt is such that a generalized bank run could destroy them. When you consider that Deutsche Bank's asset exposure is 80 percent of German GDP, and it is levered at around 44:1, Germany's new policy direction begins to make more sense.

In sum, events since March have revealed to Germany that no amount of austerity can solve a banking crisis. Brussels can push Greek public spending down to Neolithic levels, but that would do nothing to improve, for example, Commerzbank's balance sheet. So, assuming that the Germans have gotten the message, and that they really do intend to back the proposals for a banking union and a fiscal union that Herman Van Rompuy, the president of the European Council, will make at the Council's next meeting in late June, will the euro be saved? There is reason to doubt that it will, and it all goes back to Kindleberger's idea of leadership.

A fully worked-out plan for fiscal union is expected no earlier than December, with Germany hinting that the European Council could sign off on the plans by the spring of next year. That would simply be too little, too late. It is not just the financier George Soros who believes that Europe has only three months left. The markets agree with him; spreads on credit default swaps (which measure the risk of insuring against loan default) and deposit transfers inside the eurozone illustrate the broader fear. If the EU policy elites do not want to be crushed by a slow-moving bank run, EU institutions need to act much more quickly and decisively. But as the economist Mancur Olson taught us, and as Kindleberger generalized, at the heart of the EU is the problem of collective action. The structure -- twenty-seven radically different member states and no leader -- remains the main obstacle. Germany is the de facto leader, but just as Kindleberger said about the United States in the 1930s, "she could have led, but didn't," which leaves the ECB to play the role of Great Britain, who "wanted to lead, but couldn't."

Given the history of the twentieth century, it is not surprising that Germany has a hard time leading Europe. Yet there is no real substitute for its direction. The world faced a similar problem in 1944 at Bretton Woods. Back then, the United States took up Kindleberger's leadership role and agreed to provide the global public goods that the system needed to survive. It was only in the early 1970s, when the United States -- then a surplus country -- refused to adjust to global imbalances and a chronically weak dollar, and wanted to put the whole burden of adjustment on deficit countries, that the system collapsed.

Ironically, this is exactly where Europe finds itself today. Germany runs the surplus, pushes adjustment wholly onto eurozone deficit countries, and then blames them for being in debt. This misses the point, as Martin Wolf, the *Financial Times* columnist, has stressed repeatedly, that Modell Deutschland can only exist because of the

Club Méditerrannée. That is, surplus countries need deficit countries because, in a relatively closed economy like the eurozone, savings equals investment. The notion that we can all become more German and all run a surplus is nonsense. Given this, the idea of "fiscal union now" and "eurobonds later," as Germany prefers, strongly suggests that the country's idea of a solution to the crisis remains a system in which Berlin gets de facto and de jure veto power over national budgets in return for eurobonds. But such a setup would rather spectacularly miss the point: the crisis is not fiscal but financial. It began and will end with the banks of the eurozone.

So Germany has shifted, but not enough to make any real difference to the outcome. Germany is both devoutly anti-reflationary and leadership averse, which is the worst possible combination at the worst possible moment. It would be nice, to use an American expression, for Germany to step up to the plate and put its full economic weight behind a fiscal and a banking union, including euro-denominated sovereign debt. But for reasons of history and ideology, as well as political and economic context, Europe may well be about to re-run Kindleberger's 1930s, with the ECB in the role of the British and the Germans playing the Americans. And should the global economy go down that route, there is a lot more at stake than the existence of a fiat currency.



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