Open access • Journal Article • DOI:10.1111/JCMS.12255

Germany's Institutional Power and the EMU Regime after the Crisis: Towards a Germanized Euro Area?† — Source link

Federico Steinberg, Mattias Vermeiren

Institutions: Ghent University

Published on: 01 Mar 2016 - Journal of Common Market Studies (John Wiley & Sons, Ltd)

Topics: Economic and monetary union, European debt crisis, Debtor, Creditor and Institutionalism

Towards a Germanized Eurozone? Germany's Trilemma and the EMU Regime after the Crisis

Journal:	*JCMS: Journal of Common Market Studies*
Manuscript ID:	JCMS-13-0200.R3
Manuscript Type:	Original Article
Keywords:	Eurozone crisis, Governance reform, Germany, Power, Historical institutionalism

Introduction

The asymmetry of power between 'creditor' and 'debtor' countries in the management of the euro area (EA) crisis and the on-going institutional reform process of the Economic and Monetary Union (EMU) have brought the issue of German dominance in Europe back to the forefront of scholarly debates. Many agree that Germany – supported by the other creditor countries – was able to set the terms of several key reforms of the EMU regime in ways that correspond to its creditor interests (Blyth and Matthijs 2011; Bulmer and Patterson 2013; Thompson 2013; Webber 2013). These scholars rightly note that in an intergovernmentalist setting Germany's creditor strength was a key source of its 'institutional power' to reform the EMU regime in accordance with these interests. German engagement and support is seen to be indispensable to the durability of the euro in ways that allowed the German government to manage the crisis according to its priorities 'as a price for continuing financial support for EA debtor states' (Webber 2011: 20). At the same time, these scholars consider the power of 'hyper-competitive' Germany as central to the problem of intra-regional macroeconomic imbalances, making it impossible to solve the EA crisis in the longer term without a more symmetrical distribution of adjustment costs between creditor and debtor countries. Since the German government aimed 'to restrict the creation and autonomy of supranational organs in favour of more intergovernmental decision-making to preserve a veto over key future decisions' in order 'to maximize the likelihood that the Euro crisis is managed in a way compatible with Germany's preferences' (Webber 2011: 20), these authors note that the survival of the euro cannot be taken for granted. Indeed, as Thompson (2013: 15) maintains, 'German institutional power is entrenched as the condition on which German membership of the [EA] continues.'

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

Germany and the irreversibility of the euro: a historical institutionalist perspective

A central claim of HI is that member states 'may be in a strong initial position, seek to maximize their interests, and nevertheless carry out institutional reforms that fundamentally transform their own positions ... in ways that are unanticipated and/or undesired' (Pierson 1996: 126). As such, HI maintains that 'gaps' in member state control over European integration will appear far more prominent than they do in intergovernmentalist accounts, where creditor governments set the terms of reforms and determine the space for supranational agency. The 'sunk costs' of European integration are a key source of such gaps in member state control over European-level policy processes: 'While sovereign member states engaged in diplomatic bargaining remain free to tear up treaties and walk away at any time, the constantly increasing costs of exit in a densely integrated polity have rendered this option virtually impossible' (Pierson 1996). While other theoretical perspective have also highlighted the importance of exit costs to explain why European leaders preferred to reform the EMU regime rather than leaving the euro (see below), HI goes further by clarifying how barriers to a German exit have *intensified* as a result of societal actors' previous institutional investments in the euro project and the 'increasing returns' associated with these investments. As Pierson (2000) explained, '[i]n an increasing return process the probability of further steps along the same path increases with each move down that path. This is because the *relative* benefits of the current activity compared with other possible options increase over time.' A common manifestation of such a self-reinforcing increasing returns process occurs 'when certain political actors consolidate power during an early formative period and end up promoting institutions and rules that enable them to maintain their authority over time' (Tsai 2006).

From a HI perspective, it can be argued that the establishment of the EMU and its non-accommodating macroeconomic policy regime – featuring restrictive fiscal rules

and an orthodox central bank prohibited from monetary financing of public deficits and a sole mandate to maintain price stability – increased the relative benefits for key actors in Germany. Germany's coordinated wage-setting institutions were highly conducive to maintaining the cost competitiveness of its manufacturing firms and provided them with a key adjustment advantage within EMU's non-accommodating macroeconomic policy regime. The presence of these wage setting institutions, characterized by coordination of wage restraint by trade unions in the exposed export sectors and the extension of wage restraint to the sheltered sectors, proved to be a crucial institutional advantage that differentiated the EA's creditor countries from the debtor countries (Johnston *et al.* 2013). The euro eliminated the possibility of the debtor countries using periodic nominal devaluation as a strategy to regain competitiveness, allowing German export-oriented firms to turn an overvalued real exchange rate to into a substantially undervalued one. As a result, the ability and determination of German export-oriented employer organizations and trade unions to exert wage restraint became even more pronounced after the introduction of the euro.[i] Indeed, as Höpner and Lutter (2014: 7) note, '[i]f trade partners cannot devaluate, it becomes more likely that nominal wage restraint will actually result in the enhancement of price competitiveness not only in the short, but also in the medium run. Accession to a fixed currency regime should, therefore, gradually alter the relative weight of considerations upon which exposed-sector trade unions base their wage demands.'

An unintended consequence of the adoption of wage restraint was that the German economy became increasingly export-led throughout the EMU era and gradually more dependent on a growing intra-EA trade surplus, which was substantially higher than its extra-EA trade surplus. The elimination of exchange rate risk also increased German banks' incentive to earn huge carry trade profits by investing these trade surplus-

es in higher yielding assets issued by debtor countries in the region, leading to a net creditor position of Germany vis-à-vis the rest of the EA of more than 20 percent of GDP (Bibow 2013). The deepening of these trade and financial linkages therefore suggests that German export sectors, financial institutions and taxpayers have much to lose from European monetary disintegration: the euro has shielded German manufacturing firms from the currency appreciation that would normally have resulted from persistent external surpluses, the recycling of which by the German financial system exposed banks (and eventually taxpayers) to massive financial losses that would be associated with a EA break-up (Kirkegaard 2014). Early attempts to quantify the effects of EMU break-up assumed a devaluation of 80 percent for Greece, 50 percent for Spain, Portugal and Ireland, 25 percent for Italy and 15 percent for France against a renewed Deutsche mark (Cliffe *et al.* 2010), suggesting that the profitability of and employment in the German export-oriented sectors would have been fatally undermined. Peterson (2013) calculated that by 2025 the accumulated output loss following a German exit would amount to €1.2 trillion – an estimation that did not even take into account the huge financial losses on German banks' and taxpayers' foreign assets resulting from a Deutschmark appreciation and/or foreign default on these assets.

These material costs – which are the flipside of the increasing returns of European monetary integration – have made the exit option increasingly unmanageable, pushing the German government to make the EMU sustainable rather than allowing European monetary disintegration. A key insight of HI is that, because of these sunk costs, the preferences of political actors are informed by point-to-point comparisons, whereby evaluations of the costs and benefits of adapting to new circumstances are compared with the costs and benefits of maintaining or losing their investments in past arrangements. Such point-point comparisons – rather than end-point comparisons that seem

to inform preferences and motivate action in rational choice traditions – also point to the importance of timing and sequence of events: '[T]the calculations of political actors (for example, their understanding of their stakes in the current setting), and the nature of the constraints under which they operate (for example, some options may not really exist due to the sequence of prior events) may change significantly over time' (Fioretos 2011: 371; Farrell and Newman 2010; Pierson 1996; Mahoney 2000). By drawing attention to how political calculations and preferences evolve over time and to a significant extent are endogenous to European monetary integration, HI offer tools to explain why the German government responded to the crisis by eventually agreeing on new policies, rules and institutions that were rejected during the original negotiations on EMU and would never have been accepted at initial stages of the crisis. Indeed, as one interlocutor noted, 'the initial starting position of the German establishment is already miles away from where we are now. There is a saying in Berlin that Ms Merkel drew so many lines that we now have a zebra cross. These concessions have moved Germany away of key principles that were held dearly.'[ii]

The observation that gradual adjustments to the EMU regime have significantly digressed from initial German preferences is at odds with liberal governmentalist accounts of the European responses to the crisis. According to Schimmelfennig (2015), asymmetrical interdependence resulted in a burden-sharing and institutional design that predominantly reflected the preferences of Germany and the other creditor countries: 'Whereas the stakes were prohibitively high for all EA countries, the immediate consequences of the crisis were significantly more severe for the highly indebted countries than for the solvent countries … Because they were less immediately and heavily threatened by the crisis and held the key to remedying the situation, the [creditor] countries, and Germany in particular, were in principle in a better position

to realize their preferences on the terms of integration than the southern countries' (2015: 9). Although Schimmelfennig (2015: 2) rightly argues that 'a common preference for the preservation of the euro was accompanied by divergent preferences regarding the distribution of adjustment costs' (2015: 2), his liberal intergovernmentalist analysis that the key institutional reforms of the EMU regime predominantly reflected the creditor interests of Germany neglects the fact that deflecting the burden of adjustment onto debtor countries came at a significant price for Germany: an increasingly expansionary monetary policy by the ECB that clashed with the preferences of the Bundesbank, which 'represents most strongly the rule-based ordoliberal doctrine in the German domestic arena' (Young 2014: 279).

Neofunctionalist accounts of the EMU reforms, on the other hand, tend to ignore how these reforms reflected a struggle over the distribution of adjustment costs between creditor and debtor countries. Niemann and Ioannou (2015: 8) assume that 'a break-up of EMU and/or the exit of a member state would have posed very considerable costs and risks', yet their neofunctionalist analysis overstates the amount of consensus within transnational business groups regarding the distribution of these adjustment costs. Notwithstanding the fact that 'much of the corporate interest representation and articulation has taken place through Brussels-based umbrella organizations and/or in a co-ordinated fashion transnationally during the crisis' (2015: 11), employer organisations in debtor countries tend to favour the adoption of internal revaluation measures in creditor countries to support the exporting capacity of their member corporations – which is a key issue that is considered to be too contentious to be included in joint press statements and reports issued by these transnationally organized umbrella organizations.[iii] Furthermore, their neofunctionalist argument that the ECB's advocacy to adjust and deepen the EMU framework resolved 'functional dissonances between

the different policy domains under EMU that jeopardized the ECB's independence and its ability to shield the euro and deliver price stability' and that its reluctance to buy sovereign debt 'may have itself induced further integrative steps' (2015: 17; for similar arguments, see Yiangou *et al.* 2013 and Henning 2015) disregards the possibility that the ECB was forced to adopt increasingly unconventional policies to deal with the negative side-effects of earlier policy and reform decisions taken by Germany and the other creditor countries.

In order to understand the reasons why the German political establishment was forced to accept a less orthodox central bank, we need to shift our HI analysis from its emphasis on the self-reinforcing increasing returns of European monetary integration towards a focus on 'non-reinforcing event sequences' during the management of the EA crisis. As Pierson (2000: 77) pointed out, events that occur earlier in a particular sequence can have a much greater impact on the final outcome of events than later events, 'not necessarily by inducing further movement in the same direction' but 'precisely because they set the stage for a particular kind of reaction in some other direction.' As the next section will argue, these non-reinforcing event sequences – 'reactive sequences' in which policies and reforms occur in reaction to 'negative feedback loops' emerging from earlier decisions to deflect the burden of adjustment onto debtor countries – explain how early responses to the crisis by Germany have propelled subsequent developments along a trajectory that has increasingly deviated from Germany's initial position with regard to monetary policymaking.

Germany's management of the euro crisis: negative feedback and reactive sequences

Negative feedback and the incongruity of German domestic interests

HI brings attention to how historically contingent socio-economic institutions of national varieties of capitalism have shaped the interests of domestic societal groups and thus the positions governments are likely to adopt in international settings: '[V]ariation in states' preferences across issue areas' ought to be 'consistent with the internal logic of individual market economies' (Fioretos 2001: 215). In this regard, it can be argued that the German government's creditor preferences actually aggregated and reflected four different clusters of domestic societal interests that are supported by the main political parties and are also strongly embedded in its export-led coordinated market economy and its associated institutions (Bonatti and Fracasso 2013; Howarth and Rommerskirchen 2013). The central role played by export-oriented manufacturing firms in the German socio-economic model made the government intrinsically wary of adopting reflationary policies to ease the burden of adjustment onto debtor countries, as these policies weaken the cost competitiveness of these firms by reducing the incentives for wage restraint among labour unions (Carlin and Soskice 2009). The German government also aimed to preserve the stability of the German banking system – particularly the publicly owned state banks (*Landesbanken*) and savings banks (*Sparkassen*) that play a key role in financing the small and medium enterprises (SMEs) – by avoiding as much as possible the prospect of default by debtor countries and a substantial restructuring of their foreign liabilities. In its desire to avoid debt mutualisation, the German government also invoked the 'interests of the German taxpayer' to guarantee that there would be 'neither regular nor permanent transfers', making sure that every debtor state 'must do its homework' and that 'assistance must always be tied to strict conditionalities' (Angela Merkel quoted in Opperman 2012: 511). Finally, the German government defended the interests of the Bundesbank, which prefers the ECB to comply as much as possible to its ordoliberal

principles of 'sound' money, by repeatedly stressing its disapproval of outright purchases of sovereign bonds by the ECB.

We demonstrate below that the German government's pursuit of these creditor interests during its management of the EA crisis produced unintended 'negative feedback loops', which refer to the 'consequences of policy that tend to undermine rather than reinforce the political, fiscal, or social sustainability of a particular set of policies' (Weaver 2010: 137). As Mahoney (2000) argued, such negative spillovers might generate 'reactive sequences', whereby 'early events trigger subsequent developments not by reproducing a given pattern, but by setting in motion a chain of tightly linked reactions and counterreactions' (Mahoney 2000: 526). The key problem for the German government is that the high issue density of the EMU regime and the deepened trade and financial linkages between its member states have heightened the likelihood of negative feedback loops between those issue-areas that get to the heart of its creditor interests. While the increasing returns and sunk costs of European monetary integration have pushed the German to agree on various reforms that have saved the euro in the short to medium, making the EMU sustainable in the longer term required a combination of policies in the following three issue-areas: (a) a more symmetrical distribution of macroeconomic adjustment costs between debtor and creditor countries, whereby the internal devaluation measures in the former countries would be matched by internal revaluation measures in the latter; (b) some scheme of debt mutualisation involving either a one-time default on/restructuring of debtors countries' foreign liabilities or more permanent fiscal transfers between creditor and debtor countries; (c) a more accommodating monetary policy by the ECB. We aim to show that the German government refused to (a) ease the burden of macroeconomic adjustment onto debtor countries by adopting internal revaluation measures and (b) ac-

cept any significant debt mutualisation only at the cost of generating various negative feedback loops that eventually forced the ECB to adopt increasingly unconventional measures.

The asymmetrical distribution of macroeconomic adjustment costs generated two interrelated negative spillovers. First, the escalation of sovereign debt yields of debtor countries between 2010 and 2012 can be traced back to the refusal of the German government and the other creditor countries to adopt reflationary measures to reduce their current account surpluses. The key reason why these yields increased during this period is that international financial markets doubted the ability of debtor countries to produce the economic growth necessary to repay loans. In a monetary union the adoption of internal devaluation measures is bound to be self-defeating in the absence of compensating internal revaluation policies in the creditor countries. If the creditor countries do not adopt follow strategies to reduce their external surplus in order to assist the debtor countries in their attempt to reduce their external deficit, the EA's aggregate current account balance moves to a surplus and creates upward pressure on the exchange rate of the euro in ways that undermine the latter countries' endeavour to pursue export-led growth. Second, the asymmetric distribution of the burden of macroeconomic adjustment intensified deflationary pressures. Weak domestic aggregate demand translated into low inflation in the creditor countries, thereby increasing the pressure on debtor countries to improve their relative competitiveness vis-à-vis the creditor countries by means of outright deflation: 'when inflation turns low *everywhere* in the EA, each unit of deflation/low inflation endured by indebted countries delivers less price adjustment relative to the surplus countries. Or put another way, each point of relative price adjustment must be bought at the cost of greater debt deflation' (Moghadam *et al.* 2014). Deflation further weakens the debt sustaina-

bility of these countries by increasing real interest rates and the real value of their liabilities as well as by depressing the economic growth necessary to service these liabilities.

In the rest of this section we analyse the reactive sequences through which these two negative spillovers were mitigated, thereby drawing particular attention to the German government's challenges in accommodating the domestic societal interests underlying its creditor preferences. For analytical purposes, we divide the management of the EA crisis in two periods during which solutions were offered to address these spillovers: (1) solutions to redress escalating sovereign bond spreads from 2011 to 2012; (2) solutions to mitigate deflationary pressures between 2013 and 2015. While the increasing returns and sunk costs of European monetary integration induced the German government to prioritize making the euro more sustainable over exiting EMU, we show that these negative spillovers induced it to accept solutions that collide with some of these domestic interests. An additional benefit of HI is that it helps us understand which societal interests will prevail in setting the priorities of the German government with respect to crisis management and EMU reforms: adjustments 'will be less likely to occur … in sectors of activity where the relevant interest groups have managed to embed themselves deeply in the relevant domestic regulatory structures, than in areas where regulators are relatively independent of the interest groups that they regulate' (Farrell and Newman 2010: 620). The lack of embeddedness of German interest groups in the decision-making structures over European monetary policy made it more likely that the German government would accept adjustments in the ECB's monetary policy strategy than in the other two issue-areas, in which the other societal interests are much more strongly vested and the stakes involve more explicit material cost-benefit calculations of well-organized sectoral interests.

Addressing escalating sovereign bond yields during 2011-2012

For the purpose of our argument, it is not necessary to repeat the story of all the events that led to EMU reforms adopted to solve the sovereign debt crisis in 2010 and 2011 – the creation of the EFSF and the ESM to offer financial assistance to EMU member states and the 'six pack' and 'two pack' agreements aiming at reforming economic governance and strengthening the framework for preventing excessive macroeconomic imbalances and fiscal deficits. Intergovernmentalist accounts rightly point out that these reforms predominantly reflected the creditor interests of Germany and the other solvent countries.

From an HI perspective, however, these accounts only offer a 'snapshot view' that neither takes into account 'the lags between decisions and long-term [unintended] consequences' nor the possibility of 'societal adaptations and shifts in policy preferences that occur in the interim' (Pierson 1996: 126). These initial reforms locked in suboptimal institutional arrangements: they were not only ineffective in containing the crisis; they also sew the seeds of a further escalation of sovereign debt spreads between Germany and the debtor countries, whose own growth prospects were undermined in the face of asymmetrical adjustment costs. In the absence of debt mutualisation and/or a more accommodating monetary policy by the ECB, the debt servicing capacity of the debtor countries could only be guaranteed by redressing their competitiveness problem in a manner that would allow decreasing their debt levels based on substantial economic growth. However, estimates by OECD economists suggested that '[f]or Spain and Portugal, the current balance changes required to reduce net external debt to 35% of GDP over 20 years [required] improvements in cost competitiveness against the rest of the EA of about 30%, and by more than double that for Greece' (Guillemette and Turner 2013: 6). Because relying only on this mechanism

was neither realistic nor desirable, at least part of the necessary competitiveness adjustments had to occur in the creditor countries: 'For example, a 23% increase in Germany's unit labour costs relative to the rest of the EA [was] needed to restore German competitiveness to the level prevailing at the creation of the euro' (2013: 6).

Bonatti and Fracasso (2013) correctly argue that reducing the export surplus via such a sizeable internal revaluation would 'hardly be consistent with the distinctive features of the German conservative socio-economic model.' While then French Minister of Finance Christine Lagarde openly questioned the sustainability of Germany's export-led growth model based on wage restraint for the rest of the EA and called for an increase domestic demand already in March 2010, the *Bundesverband der Deutschen Industry* (BDI) was prompt to dismiss her suggestion as 'obsolete in an age of globalisation and open markets', and responded that debtor countries could only 'improve their competitiveness through tough reforms and wage policy founded on productivity.'[iv] From a German policymaking perspective, any strategy 'that deliberately tried to reduce the competitiveness of one of the most successful exporters in world markets' by increasing wages 'would look like a bad joke' (Issing 2010). Even the *Zentralverband des Deutschen Handwerks* – which is the main representative of the predominantly domestic-oriented small and medium enterprises – rejected the notion of increased public spending as 'an approach to do less good in order to make them better.'[v] Moreover, the adoption of a debt brake in the German constitution in the summer of 2009 had introduced legal constraints on fiscal reflation: in 2010 the German government had to introduce a sizeable package of public spending cuts for the following years in order to gradually reduce the structural deficit by 2016 to the target figure of 0.35% of GDP.

Because the initial EMU reforms also had revealed that debt mutualisation was not an option for Germany and the other creditor countries, international financial markets remained in doubt about the debt servicing capacity of the Italian and Spanish government. The continuing rise in Spanish and Italian sovereign debt yields throughout 2011 eventually forced the ECB to adopt unconventional measures aimed at preserving financial stability in the region. The ECB's principle means of intervention was the provision of long-term cheap liquidity to EA banks, which were offered €1,020 billion loans with a maturity of 36 months at a 1% interest rate via two rounds of unconventional long-term refinancing operations (LTROs) in December 2011 and February 2012. These measures should be seen as a reaction to escalating instability in interbank and sovereign bond markets rather than as a compensation for EA governments for reforming the monetary union or implementing structural reforms to improve their competitiveness – as some authors (Yiangou *et al.* 2013; Henning 2015) have argued. The main purpose of the ECB's LTROs was to prevent a collapse of peripheral banking systems. The European System of Central Banks (ESCB) had to replace a dysfunctional interbank market in the EA: because banks from distressed countries were no longer able to receive funding from the EA interbank market, access to the ESCB's refinancing operations was essential to prevent increasing capital flight from leading to banking calamities in these countries. Reliance upon the ECB's LTROs was highly asymmetric across EMU member states: banks from the southern countries accounted for 70 percent of the LTRO, whereas northern banks mainly accounted for the €700 billion parked at the ECB deposit facility (Pisani-Ferry and Wolff 2012). As such, 'in the absence of government action, ECB liquidity provision kept insolvent institutions alive' (Reichlin 2014: 389).

These liquidity programs clashed with the orthodox preferences of the Bundesbank, which remained convinced that '[n]either providing life support to ailing banks nor propping up the solvency of sovereigns falls under the remit of monetary policy' (Weidmann 2012). While Thompson (2013:10-12) might be right in arguing that the LTROs 'provided a crucial mechanism by which German banks … could dispose of periphery assets' (2013: 10), the repatriation and reallocation of private funds from the periphery to Germany indirectly increased the financial exposure of the Bundesbank to the periphery. The ESBC's liquidity facilities offset capital flight by cross-border credits to debtor country central banks, which were extended by creditor country central banks (mainly by the Bundesbank) as part of the ESCB's Target2 payment system – the tool used by the ESCB for the settlement of cross-border transactions in the EA and for the calculation of debt obligations between the region's national central banks. Whereas peripheral central banks accrued massive liabilities, the Bundesbank's creditor position within the Eurosystem increased exponentially from 2010 to 2012, reaching €695 billion in September 2012 (Cechetti *et al.* 2012). The ESCB's liquidity provision therefore indirectly redistributed existing stocks of claims to the periphery from the private sector to the Bundesbank, making the German government more exposed to the risk of redenomination. In this way, widening Target2 imbalances locked Germany into monetary integration by further reducing the attractiveness of the exit option: 'the distribution among former participants [of EMU] of assets and liabilities of the Eurosystem ... and the interlinked issue of Target balances would generate huge difficulties [after the demise of the euro], which could eventually lead to a "reparation" problem as destructive as the one which inflicted Germany in the interwar period' (Papadia 2014: 12).

These unanticipated effects therefore cast strong doubt on the claim that the ECB's liquidity programs merely promoted the interests of the German government by protecting German banks from default. Furthermore, these programs set the stage for the next step in European monetary integration: the creation of a banking union consisting of a single supervisory mechanism (SSM) and a single resolution mechanism (SRM) for EA banks and financial institutions. A key problem was that the LTROs further encouraged these banks to engage in carry trades by borrowing from ESCB at very low interest and investing a significant part of the funds in higher yielding sovereign debt. Acharya and Steffen (2015) found that southern banks (and Italian and Spanish banks, in particular) substantially increased their peripheral sovereign bond holdings during the first half of 2012. As a result, the LTROs reinforced the vicious bank-sovereign loop by increasing the 'home bias' in peripheral banks sovereign debt holdings. Since these banks held a significant amount of bonds issued by their government on their balance sheets, escalating sovereign bond yields generated an inherent risk of mutually reinforcing sovereign debt and banking crises. Although the LTROs temporarily reduced the yields on Spanish and Italian sovereign debt between December 2011 and March 2012, these disruptive dynamics were exposed when these yields started rising again after this period. When on June 9th 2012 the Eurogroup was forced to commit up to €100 billion in EFSF funds to the Spanish government to recapitalize its banks, EA countries' leaders launched on June 28th 2012 negotiations on a European banking union and opened the door to possible direct bank recapitalizations through the ESM in order 'to break the vicious circle between banks and sovereigns' (European Council 2012).

The launch of these negotiations disclosed several tensions between the interests of German banks and taxpayers. The German banking system had a high exposure to

debtor countries' sovereign-bank loops, which was unevenly distributed among different types of financial institutions: whereas its *Sparkassen* remained domestically oriented, the balance sheets of its large commercial banks and some of its *Landesbanken* were loaded with debt from southern governments and banks. At the early stages of the crisis, the German government therefore had to protect these financial institutions from major losses by tactically ensuring financing for banking bailouts in peripheral countries (as well as to delay sovereign debt restructurings) until they had either taken these assets off their balance sheets or created sufficient capital buffers. Between the first quarter of 2008 and the fourth quarter of 2012 German banks reduced their cross-border holdings – in terms of counterparty GDP – by 1.8 percent in France, 5.2 percent in Italy, 10.3 percent in Spain, 8.2 percent in Portugal, 43.2 percent in Ireland and 10.6 percent in Greece (IMF 2013). But by the end of 2012, after six months of intergovernmental negotiations on the banking union, the German banking system still had about €1,342 billion EA assets on its balance sheet.[vi] Yet, in order to break the sovereign-bank loop, the banking union needed to have an SRM with a credible fiscal backstop that to a significant extent had to be funded collectively by European taxpayers (Pisani-Ferry and Wolff 2012a). Therefore, apart from shielding its banks from an escalating sovereign debt crisis, the German government also had to protect its taxpayers from the creation of an implicit transfer union. After mobilizing against offering direct financial support to Spanish banks through the ESM, the German association of taxpayers indeed strongly criticized the notion of an SRM based upon a European-level backstop funded by taxpayers for unduly 'punishing responsible banks and governments' (Bund der Steuerzahler Deutschland 2012).

However, the real game changer to address the problem of rising yields on Spanish and Italian sovereign bonds was not European leapers' commitment to the banking

union, the features of which would still be subject to a process of intergovernmental bargaining; it was Mario Draghi's speech 'to do whatever it takes' to save the euro' on July 26th 2012 and his pledge on September 6th 2012 to engage in outright monetary transactions (OMT), whereby the ECB would buy an unlimited amount of distressed-country bonds in the secondary market once a government has formally applied for a bailout program at the ESM. The OMT pledge was deemed necessary to address the risk of redomination, which had fragmented European financial markets and obstructed the proper transmission of its monetary policy. While being in clear conflict with the doctrines of the Bundesbank – whose president voted against the decision with the argument that such sovereign bond purchases would be 'tantamount to financing governments by printing banknotes' with 'the additional danger that the central bank may ultimately redistribute considerable risks among various countries' taxpayers' (Jens Weidmann quoted in Steen 2012), – the German government backed the OMT decision on the basis of its conditionality. This reflected a cautious move towards increased pragmatism with respect to monetary policy making, which confirms the HI claim that powerful member state governments, while seeking to rein in supranational institutions, also 'recognize that these crucial collective organizations cannot function without significant power and that the authority required will grow as the tasks addressed at the European level expand and become more complex' (Pierson 1996: 132-133).

Several authors have argued – from a more or less explicitly neofunctionalist perspective – that the ECB's OMT pledge was a *quid pro quo* for EA leaders' commitment to banking union (Henning 2015; Niemann and Iannou 2015; Veron 2014). It is doubtful, however, that the ECB decided to engage in OMT only because EA leaders agreed to start negotiating on the banking union. Rather, its decision reflected its am-

bition to guarantee 'what may be termed its foremost objective: the sustainability of EMU as such' (Torres 2013: 297). Indeed, arguments connecting OMT to banking union cannot easily explain why the ECB did not wait to see the actual content of the intergovernmental banking union agreement, which – as it turned out – fell short of expectations (see below). Already in mid-September 2012 the finance ministers of Finland, Germany, and the Netherlands issued a joint statement opposing any direct bank recapitalization by the new ESM to bridge 'legacy' capital gaps – that is, losses on investments made by banks before the banking union, – thereby reversing the prior agreement by those same countries' at the June 2012 summit that the ESM would directly recapitalize Spanish banks, as well as raising doubts about the creditor countries' commitment to the banking union project (Posen and Veron 2014). Our counterfactual hypothesis that the ECB would have intervened even without the commitment to banking union is supported by the fact that it felt forced to move further along an increasingly heterodox trajectory *despite* the disappointment of the intergovernmental banking union agreement in December 2013 and the lack of additional commitment to integration and/or structural reforms in the EA countries.

Mitigating deflationary pressures 2013-2015

While proving critical in stabilizing sovereign bond markets, the ECB's unconventional measures failed to address the other negative spillover of the asymmetric distribution of adjustment costs: deflation. The main problem was that the focus on generating internal devaluation in debtor countries via reduction in prices and wages without compensating internal revaluation measures in creditor countries contributed to *disinflation* in the region, putting pressure on the ECB to adopt additional expansionary measures to fulfil its mandate. By December 2013 the annual inflation rate averaged 0.9 percent as inflation had already dropped to 0.6 percent in debtor countries

and 1.5 percent in creditor countries (Ubide 2014). Between 2010 and 2013 the southern EA countries had made substantial efforts in realigning their real effective exchange rates by means of deflationary declines in unit labour costs vis-à-vis creditor countries, resulting in a substantial improvement of their trade balance. However, the restoration of Germany's trade surplus over the same period moved the EA's aggregate current account towards a surplus of €221.3 euro (2.3 percent of GDP), further intensifying deflationary pressures by pushing up the euro's exchange rate. Such a high euro was much more problematic for manufacturing firms in the southern countries – which tend to make price-sensitive standardized goods with low-to-medium added value – than for those in Germany – which tend to be specialized in quality differentiated, high value-added goods (Vermeiren 2014). Given that these debtor countries already had made substantial efforts in realigning their real effective exchange rates by means of declining unit labour costs vis-à-vis creditor countries, a nominal depreciation of the euro was urgently needed to promote extra-regional rebalancing (Darvas 2012; Chen *et al.* 2013; Benassey-Quéré *et al.* 2014).

Deflationary pressures were also bound to intensify as a result of the disappointing banking union agreement in December 2013. In response to the explicit demand by the German association of savings banks that 'purely national or regional financial institutions' would 'remain exclusively under the supervision of national supervisors' (Deutscher Sparkassen- und Giroverband 2012), the German government insisted on transferring supervisory powers to the ECB and applying the SRM only to systematically important credit institutions. Apart from the fact that the ECB would directly supervise only the approximately 130 most significant banks in the region, an even larger problem of the intergovernmental agreement was that the SRM's common backstop would merely have €55 billion at its disposal (initially structured into na-

tional compartments and to be slowly filled up and mutualised over a period of 10 years) and would not be applied to legacy assets (European Council 2013).[vii] The lack of debt mutualisation has the unintended effect of constraining the process of macroeconomic adjustment between creditor and debtor countries. The fact that the common fiscal backstop is insufficient and does not apply to legacy assets reduces the level-playing-field within the European banking system: banks that are backed by solvent governments are considered as safer as those that are not. As a result, 'German banks have a lower cost of funding and – all else being equal – higher profitability. To the extent that some of the lower cost is rebated to their clients, even industrial firms in Germany enjoy a lower cost of capital, giving them an unfair advantage vis-à-vis their European competitors' (Zingales 2013). Moreover, the lack of a solution for legacy assets risked inducing governments and regulators in debtor countries to postpone the recapitalisation of their distressed banks, which would have detrimental effects on the domestic supply of credit and could push these economies into a prolonged deflationary spiral (Valiante 2014).

Finally, deflationary pressures in the EA deepened as a result of the specific features of the ECB's previous unconventional monetary measures. The LTROs led to a significant expansion of the ECB's balance sheet to a level that could be compared with the Federal Reserve's balance sheet expansion as a percentage of GDP. However, a crucial difference between the ECB's liquidity programs and the Federal Reserve's QE measures was the insertion of an automatic exit mechanism: 'With a predetermined maturity for bank-based liquidity injections, [the ECB's] balance sheet [would] adjust automatically for all counterparties when banks return the borrowed liquidity and [the ECB] the collateral pledged' (Gabor 2012: 12). Between March 2011 and January 2014 ECB's balance sheet had shrunk by about 35%, mostly because of the

reimbursement of LTRO funds by banks. Moreover, the ECB's OMT pledge indirectly contributed to these deflationary pressures: while not leading to any purchases of sovereign bonds, the OMT decision provided global investors with an insurance devise against EA break-up and almost certainly contributed to the euro's significant nominal appreciation between the third quarter of 2012 and the second quarter of 2014. The president of the ECB regularly expressed his concern about euro appreciation, which 'affect[ed] external demand and reduce[d] the competitiveness gains of price and cost adjustment in some EA countries' (Draghi 2014).

A notable institutional response to the problem of macroeconomic adjustment and decreasing inflation has been the supranational entrepreneurship of the Commission, which became increasingly critical towards Germany's persistently high current account surplus. In its 2013 Alert Mechanism Report the Commission openly acknowledged that excessive surpluses can have negative implications for debtor countries through the common exchange rate: 'Unless the real effective exchange rate appreciates in the surplus countries due to relatively stronger increases in wage and price levels, the nominal exchange rate of the euro will tend to appreciate' which 'may have competitiveness and deflationary effects on ... countries whose exports are more price-sensitive' (European Commission 2013: 15). It therefore maintained that '[a]n increase in demand in the EA surplus economies would improve the trade balance of the EA peripheral economies', particularly 'if such an increase in demand (and reduction in the trade balance) of the surplus countries took place in parallel with a weakening of the euro exchange rate' (2013: 16). Increasingly concerned about the problems potentially caused by Germany's persistently high surplus, the Commission even conducted a first in-depth review in 2014 in which it reiterated that 'spillovers from higher domestic demand in Germany could support overall aggregate demand in the EA'

(European Commission 2014: 95). The Commission´s increased activism reflected a move from being an 'agent representing the interests of the creditor countries' (De Grauwe 2013) towards becoming a more balanced player in its approach of macroeconomic imbalances, revealing some unanticipated consequences associated with the translation of the intergovernmental agreement on the Macroeconomic Imbalance Procedure into subsequent institutional procedures.[viii]

However, since the Commission does not have the legal instruments to impose internal revaluation measures onto Germany, the ECB remained the only supranational institution that could fight deflation. The fall of the EA inflation to 0.5 percent in June 2014 prompted the ECB to implement a new arsenal of unconventional monetary measures. It was the first mayor central bank to adopt a negative deposit rate of -0.1% and launched a new 'targeted' €400 billion LTRO programme. Apart from further lowering its deposit rate towards -0.2%, the ECB announced in September 2014 that it would purchase a broad portfolio of asset-backed securities (ABSs) and euro-denominated covered bonds in order to steer its balance sheet back to the level its had at the beginning of 2012. However, taking the limited capacity of the European market for high-quality ABSs and covered bonds into consideration, it was clear from the beginning that it would be highly difficult to accomplish such a balance sheet expansion only by purchasing these private assets. When in December 2013 Mario Draghi defined the ECB's 2012 balance sheet as an explicit target, even Bundesbank officials had to admit that 'buying sovereign bonds would be the only solution to reaching that target.'[ix] One month later, in January 2015, the ECB announced the launch of its widely expected QE program, consisting of combined monthly purchases of public and private sector securities amounting to €60 billion – intended to be carried out until end-September 2016. Remarkably, the program would be *open-ended* and 'be con-

ducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term' (Draghi 2015).

How did domestic interests in Germany respond to these supranational responses to the problem of deflation? There continues to be widespread consensus among German government officials, employer organisations and monetary policymakers about the unacceptability of internal revaluation measures in order to assist the rebalancing efforts of debtor countries and avert deflationary pressures in the region. The Commission's calls for more symmetrical adjustment generated a backlash by industrial federations and drew cross-party criticism for aiming to undermine Germany's export strength.[x] German policymakers believe that the external surplus 'is the result of millions savings and investment positions' on which economic policy should not – and could not – have any impact: 'competitiveness is an issue for firms and the only role for economic policy is to offer a framework in which firms can use their competitive advantages'.[xi] The BDI also criticized the Commission's in-depth review by stressing that 'the export surplus is not the result of political intervention in the market, but of a competitiveness that the German companies work on every day'. Nevertheless, Germany's stellar labour market performance during the EA induced trade unions to become more assertive in their wage demands, leading key trade unions such as IG Metall to increasingly link their wage target ambitions to developments in the rest of the EA.[xii] During the summer of 2014 German trade unions received some unexpected assistance from the Bundesbank's president, who backed the push for inflation-busting wage settlements by arguing in favour of wage increases of at least 3%. Bundesbank economists were also reported to have visited the Confederation of German Trade Unions (DGB) in order to encourage their members to base their wage targets

on the ECB's 2% inflation target instead of the actual level of low inflation.[xiii] These unprecedented attempts to interfere in the wage bargaining process suggest that the Bundesbank preferred higher wage inflation to the adoption of QE measures by the ECB, revealing the potential contradictions between German domestic interests during this episode of the EA crisis.

In line with our HI arguments, the Bundesbank seemed to anticipate the reactive sequence through which the ECB would be forced to tackle the deflationary effects of the asymmetrical distribution of macroeconomic adjustment costs between debtor and creditor countries through the adoption of QE. One Bundesbank official acknowledged that 'there is a clear interaction between the readjustment process and the ECB's monetary policy' as 'the process of regaining competitiveness affects inflation in debtor countries and inflation in the Eurozone in a way that has repercussions on monetary policy.'[xiv] The Bundesbank main concerns, which were shared by the German Ministry of Finance, were that sovereign debt purchases would reduce the pressure on debtor governments to implement fiscal and structural reforms and increased the ESCB's exposure – and therefore the German taxpayer – to debtor default.[xv] These concerns gained widespread traction within German society, leading several politicians to submit a motion with the Federal Constitutional Court (FCC) to investigate the legality of the ECB's OMT. In February 2014 the FCC reinforced these apprehensions by claiming that the ECB's OMT is contrary to European law, deferring a definite ruling on the legality of OMT to the European Court of Justice (ECJ). Finally, the ECB's decision to lower the deposit rate below zero also attracted general condemnation from German media for penalising German savers and was criticised by the *Deutschen Sparkassen- und Giroverbands* for reducing the amount of money deposit-

ed at German savings banks, which fund most of their lending activities through deposits, as well as for undercutting their net interest margins.[xvi]

Hence, the ECB's monetary policy adjustments again revealed the constraints on the capacity of the German government to accommodate the domestic societal interests underpinning its creditor preferences. The interim ruling of one of the ECJ's advocate-general that the ECB's OMT 'in principle' adhere to EU law – on the condition that it refrains from any direct involvement in the ESM programme – was widely considered to have cleared the final legal hurdle to engage in an ambitious QE program. While its specific features – whereby 80% of the asset purchases and the ensuing default risks would remain on the balance sheets of the national central banks – reflected a bow to to the pressure of Germany and the other creditor countries to minimalize the mutualisation of risk, it also demonstrated the inconsistency between the Germany's veto on debt mutualisation and its preference for an orthodox monetary policy that does not engage in sovereign debt purchases. In this regard, Germany has been forced to approach European monetary policy with increased pragmatism. German policymakers accepted the ECJ's confirmation of the legality of OMT without further contestation, possibly because the OMT pledge had 'reduced the budgetary risk for Germany' by helping the ECB 'to reduce its current role as a financial intermediary between banks in the fragmented financial system' (Wolff 2013: 30). Taking into account the uncertain fiscal capacity of the southern government to recapitalise their national central banks in the face of losses, the informal consensus about the necessity of such a recapitalisation also reduced the prospects of default at the same time as it increased the political incentives to roll-over and hold the sovereign debt on their national central banks' balance sheets until maturity.[xvii] Therefore, the ECB's latest monetary decision again demonstrated that Germany's desire to minimise debt mutu-

alisation only came at the price of additional unconventional monetary accommodation.

Conclusion

In this article we made use of the HI literature to show how the issue-density and interdependencies created by the EMU made the German government's approach of deflecting the burden of adjustment onto the debtor countries self-defeating, preventing it from reforming EMU in ways that simultaneously advanced all the domestic societal interests underpinning its creditor preferences. The unwillingness of Germany and the other creditor countries to adopt reflationary policies to ease the burden of adjustment onto the debtor countries made growth in the Eurozone increasingly dependent on the attainment of an extra-regional trade surplus, which weakened the competiveness of debtor countries by putting upward pressure on the exchange rate of the euro. It also encouraged deflationary pressures, which further weakened their debt servicing capacity. While these negative feedback loops put pressure on creditor states to accept some mutualisation of debt in a banking union, the German government could only minimize the exposure of the German taxpayer by allowing the ECB to adopt increasingly unconventional expansionary measures to stabilise sovereign bond markets and reduce deflationary pressures. Accordingly, our HI analysis of Germany's influence over the policy process highlights the importance of the temporality by showing how the sequence of political and economic events during the crisis had a path-dependent causal effect for later developments. More specifically, we showed that key mechanisms for sequencing in European monetary integration after the crisis are negative feedback and reactive sequences rather than positive feedback and self-reinforcement (cf. Howlett 2009).

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

References

Acharya, V. and S. Steffen (2013) 'The "Greatest" Carry Trade Ever? Understanding Eurozone Bank Risks'. NBER Working Paper No. 19039.

Benassy-Quéré, A., P. Gourinchas, P. Martin and G. Plantin (2014) 'The Euro in the "Currency War"', CEPR Policy Insight No. 70.

Bibow, J. (2013) 'Germany and the Euroland Crisis: The Making of a Vulnerable Haven'. Levy Economics Institute Working Paper No. 767.

Bonatti, L. and A. Fracasso (2013) 'The German Model and the European Crisis'. *JCMS,* Vol. 51, No. 6, pp. 1023-139.

Bulmer, S. and W.E. Paterson (2013) 'Germany as the EU's Reluctant Hegemon? Of Economic Strength and Political Constraints'. *JEPP*, Vol. 20, No. 10, pp. 1387-1405.

Cechetti, S., R. McCauley and P. McGuire (2012) 'Interpreting TARGET2 balances'. BIS Working Paper No. 393.

Chen, R., Milesi-Ferretti, G.M. and T. Tressel (2013) 'External Imbalances in the Eurozone'. *Economic Policy*, Vol. 28, Issue 73, pp. 101-142.

Cliffe, Mark, et al. 2010. *EMU Break-up: Quantifying the Unthinkable*. ING, Global Economics, July 7.

Darvas, Z. (2012), 'Intra-Euro Rebalancing Is Inevitable, But Insufficient'. Bruegel Policy Contribution No. 2012/15.

Draghi (2015) 'Introductory Statement to the Press Conference (Q&A)', January 22 2015.

Ecofin (2013) 'Council conclusions on the Annual Growth Survey 2013'. February 12.

European Commission (2013) 'Alert Mechanism Report 2014'. Report from the EC to the European Parliament, the Council, the ECB and European Economic and Social Committee, November 13.

European Commission (2014) 'Macroeconomic Imbalances Germany 2014'. European Economy Occasional Papers No. 174.

Deutscher Sparkassen- und Giroverband (2012)

Farrell, H. and A.L. Newman (2010) 'Making Global Markets: Historical Institutionalism in International Political Economy'. *RIPE*, Vol.17, No. 4, pp. 609-638.

Fioretos, O. (2001), 'The Domestic Sources of Multilateral Preferences: Varieties of Capitalism in the European Community', in P.A Hall and D. Soskice (2001) *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, New York: Oxford University Press, pp. 213-244

Fioretos, O. (2010) 'Historical Institutionalism in International Relations'. *IO*, Vol. 65, pp. 367-399.

Henning, R. (2015) 'The ECB as a Strategic Actor: Central Banking in a Politically Fragmented Monetary Union', in Caporaso A. and M. Rhodes (eds.) *Europe's Crises: Economic and Political Challenges of the Monetary Union*, New York: Oxford University Press.

Höpner, M. and M. Lutter (2014) 'One Currency and Many Modes of Wage Formation: Why the Eurozone Is Too Heterogeneous for the Euro'. MPIfG Discussion Paper 14/14.

Howarth, D. and C. Rommerskirchen (2013) 'A Panacea for all Times? The German Stability Culture as Strategic Political Resource'. *WEP*, Vol. 36, No. 4, pp. 750-770.

Howlett, M. (2009) 'Process Sequencing Policy Dynamics: Beyond Homeostasis and Path Dependency'. *JPP*, Vol. 29, No. 3, pp. 241-262.

IMF (2013) 'Article IV Consultations: Eurozone Macroeconomic Policies'. Washington D.C.

Johnston, A. and B. Hancké (2009) 'Wage Inflation and Labour Unions in EMU'. *JEPP*. Vol. 16, No. 4, pp. 601-622.

Kirkegaard, J. (2014) 'What Should Surplus Germany Do'. Peterson Institute for Economics Policy Brief No. 14-4.

Mahoney, J. (2000) 'Path Dependence in Historical Sociology'. T*heory and Society*, Vol. 29, No.4, pp. 507-548.

Moghadam, R., R.Teja and P. Berkmen (2014) 'Euro Area – "Deflation" versus "Lowflation', iMFdirect – The IMF's Global Economic Forum, March 4.

Opperman, K. (2012) 'National Role Conceptions, Domestic Constraints and the New 'Normalcy' in German Foreign Policy: the Eurozone Crisis, Libya and Beyond'. *German Politics*, Vol. 21, No. 4, 502-519.

Niemann, A. and D. Ioannou (2015) 'European Economic Integration in Times of Crisis: A Case of Neofunctionalism?'. *JEPP*, forthcoming.

Papadia, F. (2014) 'Operational Aspects of a Hypothetical Demise of the Euro'. *JCMS*, Forthcoming.

Peterson, T. (2013) 'How Germany Benefits from the Euro in Economic Terms', Bertelsmann Stiftung Policy Brief.

Pierson, P. (1996) 'The Path to European Integration: A Historical Institutionalist Analysis'. *Comparative Political Studies*, Vol. 29, No. 2, pp.123-163.

Pierson, P. (2000) 'Increasing Returns, Path Dependency and the Study of Politics'. *APSR*, Vol. 94, No. 2, pp. 251-267.

Pisani-Ferry, J. and G.B. Wolff (2012), 'Propping Up Europe?'. Bruegel Policy Contribution, Issue 12/07.

Schimmelfennig, F. (2015) 'Liberal Governmentalism and the Euro Area Crisis'. JEPP, forthcoming.

Thompson, H. (2013) 'The Crisis of the Euro: The Problem of German Power Revisited'. SPERI Paper No. 8.

Torres, F.S. (2013) 'The EMU's Legitimacy and the ECB as a Strategic Political Player in the Crisis Context'. *JEI*, 35(3), pp. 287-300.

Ubide, A. (2014) 'Is the European Central Bank Failing Its Price Stability Mandate?'. Peterson Institute for Economics Policy Brief No. 14-5.

Vermeiren, M. (2014) *Power and Imbalances in the Global Monetary System: A Comparative Capitalism Perspective*. Basingston: Palgrave Macmillan.

Veron, N. and A. Posen (2014) 'Europe's Half a Banking Union'. *Europe's World*. June 15 2014.

Weaver, K. (2010) 'Paths and Forks or Chutes and Ladders? Negative Feedbacks and Policy Regime Change'. *Journal of Public Policy*, Vol. 30, No. 2, pp. 137-162.

Webber, D. (2011) 'How Likely Is It That The European Union Will Disintegrate? A Critical Analysis of Competing Theoretical Perspectives'. *ANU Centre for European Studies Briefing Paper Series*, Vol. 2, No. 3.

Weidmann, J. (2012) 'Containing the Sovereign Debt Crisis – Germany's Role and Contribution'. Mexico City, February 24th, BIS Central Bankers' Speeches.

Wolff, G. (2013) 'The ECB's OMT Programme and German Constitutional Concerns'. *Think Tank 20: The G-20 and Central Banks in the New World of Unconventional Monetary Policy*, pp. 26-31.

Yiangou, J., M. O'Keefe, and G. Glöckler (2013) '"Tough Love": How the ECB's Monetary Financing Prohibition Pushes Deeper Euro Area Integration'. *JEI*, Vol. 35, No. 3, pp. 223-237.

Zingales, L. (2013) 'German Banks on Top'. *Project Syndicate*, July 18.

Endnotes

[i] Interview with representative of German employer organisation, January 2015.
[ii] Interview with German ECB official, December 2014 in Frankfurt.
[iii] Interview with representatives of Spanish employer organisation (member of BUSINESSEUROPE) and Spanish ministry of finance, October 2014 in Madrid.
[iv] *Financial Times*, March 15 2010.
[v] Interview with representatives of ZDH, January 2015 in Berlin.
[vi] Data from the Bundesbank.
[vii] In March 2014 the European Parliament marginally adjusted the December 2013 deal by reducing the build-up period to 8 years and accelerating the mutualisation process. The resolution of banks will still be decided by a plethora of institutions, with the European Council retaining a veto power over decisions on debt mutualisation.
[viii] The €315 billion investment plan by the new Commission president Jean-Claude Juncker also aimed to stem deflation and promote growth in the region.
[ix] Interview with Budnesbank official and economists, December 2014 in Frankfurt.
[x] *Financial Times*, November 3 2013.
[xi] Quotes from interviews with German ECB official and Bundesbank official, December 2014 in Frankfurt. These views were confirmed in interviews with representatives of the German Federal Ministry of Finance and Federal Ministry of the Economy and Energy, January 2015 in Berlin.
[xii] Interviews with representatives of German trade unions, December 2014 in Frankfurt and January 2015 in Berlin.
[xiii] Interview with representative of German employer organisation, January 2015 in Berlin.
[xiv] Interview with Bundesbank official and economists, December 2014 in Frankfurt.
[xv] Interviews with Bundesbank officials and representative of the Federal Ministry of Finance, December 2014 in Frankfurt and January 2015 in Berlin. It is interesting to note that within the Federal Ministry of the Economy and Energy there is more pragmatism about these issues and scepticism about the allegedly negative effects of QE on debtor countries' incentives to adopt structural reforms (interview with representative of the Federal Ministry of the Economy and Energy, January 2015 in Berlin).
[xvi] *Financial Times*, June 4 2014.
[xvii] Even though the ECB argued in its 2010 convergence report that 'any situation should be avoided whereby for a prolonged period of time [a national central bank's] net equity is below the level of its statutory capital or is even negative', it should be noted that there are no legal recapitalization resquirements. While there is currently an informal consensus of the necessity of such a recapitalisation, the German government will most likely approach the issue in a pragmatic way (interview with representative of the Federal Ministry of the Economy and Energy, January 2015 in Berlin).