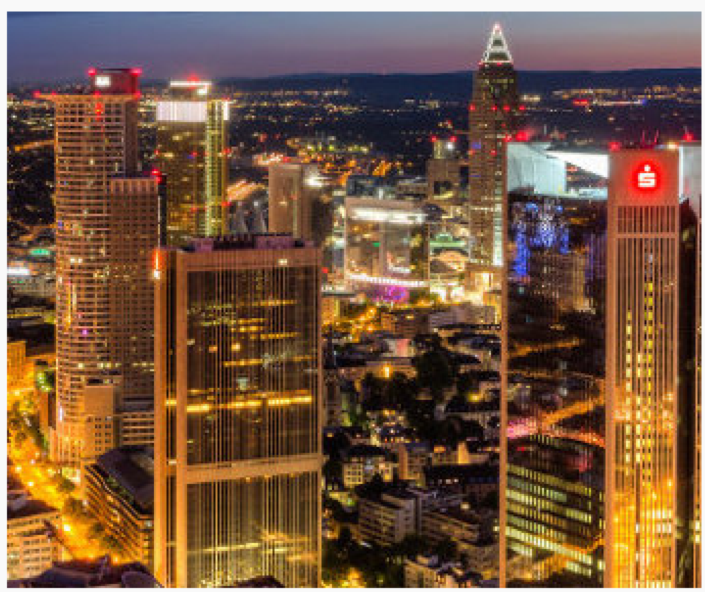
The limits of German power: How ECB decisions have put constraints on Berlin's management of the crisis

The German government has been at the heart of the EU's response to the Eurozone crisis, but key decisions made by the European Central Bank, notably the introduction of a large 'quantitative easing' program, have occurred despite German opposition. **Mattias Vermeiren** *writes that these two developments are intricately linked, with Germany's pursuit of creditors' interests generating unintended 'spillover' effects that have pushed the ECB into particular monetary policy stances. As such, he argues that Germany has been far more constrained in its management of the crisis than is commonly recognised.*

Academic debates on German dominance in the Eurozone crisis seem to be plagued by a paradox. On the one hand, most scholars agree that Germany – supported by the other creditor countries – was able to set the terms of key institutional reforms of the Eurozone. From an intergovernmentalist perspective, Germany's creditor strength was a crucial source of its 'institutional power' to reform the Eurozone in accordance with its 'creditor preferences'.

The institutional reforms of the Eurozone – the restrictive conditionalities of the European Financial Stability Facility and European Stability Mechanism; the asymmetric thresholds in the Macroeconomic Imbalance Procedure; the inadequate fiscal backstop of the banking union – certainly reflect these preferences. On the other hand, the ECB adopted increasingly unconventional policies that reveal a clear shift away from Germany's dearly held conservative monetary principles.

In a recent study, Frederico Steinberg and I draw on the insights of historical institutionalism to show that these two developments are intrinsically connected: the pursuit of creditor interests locked in suboptimal institutional arrangements, generating several unintended negative spillovers that eventually pushed the ECB into an increasingly accommodative monetary policy stance. As such, we believe that Germany has been more constrained in its management of the crisis than is commonly understood.



Frankfurt skyline at night. Credit: Carsten Frenzl / Flickr (CC-BY-SA-3.0)

In order to understand these constraints it is necessary to recall that Germany's creditor preferences reflect four different clusters of domestic interests. The central role played by export-oriented manufacturing firms in the German economy made the government intrinsically wary of adopting reflationary policies to ease the burden of macroeconomic adjustment onto debtor countries, since these policies weaken the cost competitiveness of these firms by reducing the incentives for wage restraint among labour unions.

The government also aimed to preserve the stability of German banks by avoiding as much as possible a substantial restructuring of debtor countries' foreign liabilities. Furthermore, the interests of the German taxpayer had to be protected by guaranteeing that there would be no mutualisation of debt and by making sure that financial assistance would always be tied to strict conditionalities. Finally, the German government promoted 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.

The insistence of the German government to manage the crisis and reform the Eurozone in accordance with these interests produced several unintended negative spillovers that forced the ECB to intervene in increasingly unconventional ways. The escalation of sovereign bond yields of debtor countries between 2010 and 2012 can be connected to the refusal of Germany and the other creditor countries to adopt reflationary measures in order to reduce their current account surpluses. A key reason why these yields escalated during this period was that international financial markets doubted the ability of debtor countries to produce the economic growth necessary to repay loans.

As creditor countries refused to adopt measures to reduce their external surplus, the Eurozone's aggregate current account balance had moved to a significant surplus by 2012. This put upward pressure on the exchange rate of the euro and undermined the attempt of debtor countries to pursue export-led growth. Moreover, weak domestic demand translated into low inflation in the creditor countries, increasing the pressure on debtor countries to improve their competitiveness vis-à-vis the creditor countries by means of outright deflation. This further weakened their debt sustainability by increasing real interest rates and the real value of their liabilities.

The rise in Spanish and Italian sovereign debt yields during 2011 induced the ECB to inject long-term cheap liquidity into the Eurozone banking system via two rounds of unconventional long-term refinancing operations (LTROs). Because banks from distressed countries were no longer able to receive funding from the interbank market, reliance upon these LTROs was very asymmetric: banks from the southern countries absorbed about 70 per cent of the LTROs. These liquidity injections clashed with the orthodox preferences of the Bundesbank, which remained convinced that 'neither providing life support to ailing banks nor propping up the solvency of sovereigns falls under the remit of monetary policy.'

While the LTROs provided a crucial mechanism by which German banks could dispose of assets from the periphery, the repatriation and reallocation of such funds indirectly increased Germany's fiscal exposure to the periphery through the ECB's Target2 payment system – the tool used for the settlement of cross-border transactions in the Eurozone and for the calculation of debt obligations between the region's national central banks: by September 2012 the Bundesbank had accrued a creditor position of €695 billion within this system.

Another problem was that the LTROs encouraged peripheral banks to borrow from the ECB at low interest and invest the funds in higher yielding sovereign debt. This reinforced the vicious 'sovereign-bank loop' by increasing the 'home bias' in peripheral banks' sovereign debt holdings and magnifying their exposure to sovereign default. While in June 2012 European leaders started negotiating on the launch of a banking union in order to break this vicious loop, it was clear from the start that Germany and the other creditor countries would never accept a sizable common fiscal backstop that could be used for bailouts and resolutions of peripheral banks.

In the face of declining prospects of meaningful debt mutualisation, sovereign bond markets could only be stabilised after the summer of 2012 when the ECB pledged to buy an unlimited amount of distressed-country bonds in the secondary market if a government formally applies for a bailout programme. Although its pledge to engage in these 'outright monetary transactions' (OMT) was in clear conflict with the doctrines of the Bundesbank (whose president voted against the decision), the German government had to show more pragmatism and backed the decision on the basis of its conditionality.

While proving critical in stabilising sovereign bond markets, the ECB's announcement failed to address the other negative spillover of Germany's creditor approach: deflation. The adoption of internal devaluation measures in debtor countries without compensating internal revaluation measures in creditor countries contributed to disinflation in the Eurozone, putting pressure on the ECB to adopt additional expansionary measures in order to fulfil its mandate of keeping average inflation in the region below but near 2 per cent.

Deflationary pressures also deepened as a result of specific features of the ECB's previous measures. As the LTROs had a predetermined maturity of 3 years, these liquidity injections were scrolled back automatically as soon as banks returned their borrowed funds. Moreover, the OMT decision offered investors an insurance device against sovereign default and added to these deflationary pressures by contributing to the significant nominal appreciation of the euro between 2012 and 2014. These unintended consequences clarify why by January 2015 the ECB was eventually forced to launch a very large quantitative easing programme, consisting of €60 billion monthly purchases of public and private sector securities and to be carried out at least until the end of September 2016.

How did domestic interests in Germany respond to these increasingly expansionary and unorthodox monetary policies? One implication was that trade unions became more assertive in their wage demands, seemingly clashing with the 'interest-based logic of the German tendency to undervalue, brought about by coordinated wage bargaining'. During the summer of 2014 unions received some unexpected assistance from the Bundesbank's president, who preferred higher wage inflation to the adoption of the quantitative easing programme by the ECB and backed the push for inflation-busting wage settlements.

The Bundesbank's principal concerns, which were shared by the Ministry of Finance, were that sovereign debt purchases would reduce the pressure on debtor governments to implement fiscal and structural reforms and increase the ECB's exposure – and therefore the German taxpayer – to debtor default. In order to avoid debt mutualisation through the back door, Germany insisted that the majority of asset purchases by the ECB and the ensuing default risks would remain on the balance sheets of the national central banks.

Yet, purchases of sovereign bonds by national central banks will intensify their exposure to losses on these bonds, increasing the political incentives to hold these bonds on their balance sheets until maturity. As such, Germany's determination to avoid debt mutualisation only came at the price of additional monetary accommodation.

In sum, the ECB's decision to engage in quantitative easing neatly illustrates the potential contradictions between the domestic interests behind Germany's creditor preferences. Germany's approach of deflecting the burden of adjustment onto debtor countries proved to be self-defeating, preventing it from promoting these domestic interests simultaneously in its management of the crisis.

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Note: For more information on this topic, see the author's recent paper in the Journal of Common Market Studies (co-authored with Frederico Steinberg). The article gives the views of the author, not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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