Explaining the institutional outcomes of the European financial and sovereign debt crisis.  
The case of Germany

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Introduction

The idea of a political and economic union was set out in the Rome Treaty of 1957. In its preamble, it spoke of an “ever closer union between the European peoples”. This formulation is as vague as possible. It did not spell out a specific institutional design. But it did spell out the idea of continuing processes toward more ‘unity’ between the European peoples. The introduction of the Euro as a common currency for the Euro-zone in 1999 was a new milestone and a turning point for the European Union (EU). The 2008 financial and sovereign debt crisis is the first real economic stress-test faced after a decade of mostly continuous growth. Is this crisis the end of this project of human co-operation? The question is legitimate considering talks of a ‘grexit’ in 2012 (Charlemagne 2012) and since the election of Syriza’s party in early 2015. The continuing crises of unemployment, growth, and public debt (European Commission 2014) are also equally concerning.

Simply put: how can we explain that despite the fact that we are faced with the first real possibility for a reversal of this Europeanization process, the results are still more Europeanization of the institutions? More specifically, how can we explain that at the height of the 2008 European financial and sovereign debt crisis the institutional response was mostly informal and national, and that negotiations were made through state-led channels — in the form of the ‘Merkozy’ couple — and that the results still led to reinforced European institutions — two-pack, six-pack, fiscal compact, European Stability Mechanism (ESM)?

In order to circumscribe such a large object of study, I will focus this paper on the case of Germany and its relationship with European supranational institutions. I chose Germany as my case because it sits in a unique position where its economic and demographic powers are used as tools to exert influence on the supranational processes. It acts first as a member-state, but it also
acted as a partner to European institutions during the crisis. Germany is able to influence the decision-making process as an independent state or actor, not simply as a EU-member. Germany is arguably the dominant negotiator, but clearly the largest creditor in matters regarding the crisis. I will argue that Germany is the critical nod in this complex relationship to explain institutional change since 2008. In order to understand the role of Germany during this process of institutional change spanning the crisis, I will engage in a process tracing of events since the beginning of the 2008 financial and sovereign debt crisis. I will propose theory specific expectations on the eurozone crisis and I will put them to a congruence test with the empirical record and see how they hold on. I will argue that existing theories explaining institutional change are unable to explain completely the unfolding of the 2008 financial and sovereign debt crisis.

**Explaining Institutional Change**

The field of European studies is well-mapped. The geographic location is evident, while the time frame typically start after the end of World War II. In order to demonstrate that contemporary theories of institutional change are unable to explain the unfolding and results of the 2008 financial and sovereign debt crisis, we first need to describe them briefly and propose a series of expectations arising from their internal logic — nine in total numbered from E₁ to E₉. It is only after this brief presentation that it will be possible to trace the events since 2008 with an emphasis on the role of Germany.
Neofunctionalism

Ernst Hass attempt to explain why six different countries came together to create the European Coal and Steel Community (Haas 1968) led to neofunctionalism. Hass addresses three characteristics that are at the center of his explanation. The core feature of neofunctionalism is the spillover effect (Haas 1968, 283). The idea is that by cooperation in one policy area, states would eventually start cooperating in other areas resulting in a spillover effect of cooperation. Changes are incremental and often offer positive-sum games. For this purpose, political integration needs to be understood as an open-ended process (Lindberg 1963, 6). Hass considers that interest groups and political parties would be the main driving force behind more integration. The integration process would be deemed to be another way of solving problems for pressure groups (Haas 1968, 239). Finally, integration would be a top-down process responding to functional and technocratic needs. These needs would be solved by rational actors learning from their experiences. The driving force behind integration would remain in the hands of economic leaders and the political élite (Haas 1968, 526). Finally, the spillover effect remains more likely with high density issues, where interest groups are more likely to perceive supranational decision-making as being beneficial (Schmitter 2005, 258).

In the case of the 2008 crisis, Niemann and Ioannou argue that the crisis provided an opportunity for the “streamlining and tightening of fiscal and economic policy co-ordination” (Niemann and Ioannou 2015, 196). These institutional changes happened because the EMU solved some of the problems that arose from the integrated single market, but it also created new ones. The crisis provided the opportunity to solve some of them, though, it is not said if these changes did not also create problems of their own. According to Niemann and Ioannou, we can distinguish between three types of spillover: functional — when the need to balance dissonances
may foster crises —, political — when élites perceive that problems are better solved at the supranational level —, and cultivated — when the created institutions become agents of integration to increase their powers.

I postulate that the crisis is a good opportunity for neofunctionalist to reveal itself. In order to remain in control, European institutions will provide solutions based on technocratic needs without consulting directly the population. Financial actors and political elites will be at the center of the decision-making process. These solutions will aim to integrate marginal policy areas or competences. In time, these new areas will spillover more complex areas. Because the need to solve the crisis will likely be great and urgent, the cooperation will go in a generally positive direction.

- E1: If the crisis worsen and further integration is the only solution to achieve set goals, then the functional pressure to do so will be strong.
- E2: If the crisis is an opportunity to solve problems in the EA, then Germany will seek to influence the process from ‘within’. If the crisis worsen and supranational collaboration seems the only solution, then political spillover pressures will be strong and the problem is likely to be addressed at a higher than domestic level.

**Intergovernmentalism**

In its earlier form – inspired by realist IR postulates –, intergovernmentalism is the work of Stanley Hoffmann (Hoffmann 1966). The integration process is not the inevitable result of élites’ convergence, but the result of negotiation based on each state’s diversity. While distinguishing between high and low politics (Hoffmann 1966), Hoffmann proposes that the domain of high politics is too sensible to be negotiated on – foreign policies, atomic policy, etc. On the other hand, the more technocratic low politics – concerned principally with economic interests – can be a good ground for cooperation. In the domain of high politics, the state is not
‘obsolete’, but ‘obstinate’ as he would be known to say (Hoffmann 1995). In its latter form – inspired by liberal IR –, intergovernmentalism put the emphasis on how state preferences are formed within the state. The way negotiations go are based on those preferences and are conducted within a rationalist framework (Moravcsik 1998). States negotiate in order to reduce transaction costs and enhance economic co-operation for their benefit — with the sometimes fortunate outcome of sharing this preference with other states. For Moravcsik, the European integration process is not predetermined. It is even reversible. Depending on the changing formation of state interests, it is possible that states would leave the Union if they felt it was in their interests. Opposing this view during the crisis, Schimmelfennig proposes that “intergovernmental bargaining [was] based on partly converging and partly diverging member state interests and designed to strengthen the credibility of member state commitments to the common currency” (Schimmelfennig 2015, 178). This outcome is the result of “a tripartite explanation of integration — economic interests, relative power, credible commitments” (Schimmelfennig 2015, 178). Because EA members needed to ‘prove’ their commitment to the eurozone, some changes and actions were necessary to palliate some of the enforcement problems in EMU. In this sense, intergovernmentalism is useful to understand the necessity for policy deliberation for successful policy formation (Puetter 2012, 166). Based on this, I postulate two contradictory expectations:

- **E₃**: The level of interdependence between Germany and European institution is too strong and since credibility of EA members is the major issue, actions and institutional change to increase the credibility of the EA will be the main commitment of member-states to each other. If the crisis gets worsen, then commitment gestures will follow and Germany will be forced to commit itself.

- **E₄**: Because Germany relative power and credibility is strong, its economic interests will likely dictate its conduct. If the crisis worsen, then it is likely that Germany will ensure its economic health at whatever price — even the breakdown of the euro if necessary.
Ideological Approach

The ideas-turn picked up at the same time as European integration was picking up again with the fall of the Berlin wall and negotiations toward the Maastricht Treaty. According to Risse (Risse 2005), previous European integration theories lacked a preoccupation with the interaction between agents and structures. The various norms, institutions, and discourses shape social interactions and informally direct the actions that will follow, but contrary to neoinstitutionalists, constructivists emphasize norms over institutions. The way they are internalized determines how agents acquire their identity. This ‘how’ should be the central question under study, rather than the typical ‘why’ (Christiansen, Jorgensen, and Wiener 2001, 537). Understanding this process is the first step to understanding the establishment of norms and their internalization by actors (Risse 2004). Contextualization is the result of the rejection of the view that individuals act solely on a rational cost-benefits analysis. For example, the international context can be a vector for international value-based norms (like democracy and equality) (Schimmelfennig 2000, 110). Agents are embedded within social structures. These structure are important and they frame the behaviour of agents, while being simultaneously constituted by those agents (Ruggie 1988, 33).

In an ideological perspective, the norms internalized by various actors shape the way they will behave during a crisis. This behaviour can go contradictory to rational principles. Ryner, for example, suggests that “the paradox of a monetary union that endures despite its contradictions, social costs and conflicts can be seen as [a German] ordoliberal iron cage” (Ryner 2015, 276). The example of co-constitution of ideas and structure is best seen when considering the crisis-prone regularities constituting the EA. The system of capital accumulation in Europe is not abnormal, it is constitutive of the sort of economic system provided by ordoliberalism. In that
sense, overlooking power relations between labour, capital and markets; and between Europe and the United States to explain the crisis would be a grave mistake (Ryner 2015, 279).

○ E5: Despite sharing many institutions, Germany has its own market rationality. German market rationality will thrive during the crisis to expand. If the crisis worsen, then German fiscal conservativeness will be more likely to be imposed on other EA members.

○ E6: On the other end, a breakup of the EU is very unlikely. If the crisis worsen to a point of non-return, then Germany will come the aid of members in need. The sentiment of ‘togetherness’ of the EU is too strong and institutional change will not by simply dictated by rational-choice principles.

**Neoinstitutionalisms**

For neoinstitutionalists, not all practices are written down and a lot of the actions undertaken have to do with informal regularized practices. Institutions are intervening variables. While they do not determine actors’ behaviour, they certainly influence and shape them through their organizational forms (Saurugger 2014, 80). According to Parsons (Parsons 2003), European institutions are the result of an explainable and rational process. This process is historically contingent. This phenomena of path dependency is hard to overturn. Since its inception, the European Community encountered various critical junctures in time. At those critical junctures, institutional choices were made. The more down the road we get, the more difficult – and costly – it is to switch paths. In order to explain institutions, we need a specific toolkit. Institutions are at the focal point of governance and “institutions play a central role in structuring the governance of the EU […] Institutional analysis is thus the central element of an EU tool-kit” (Bulmer 1993, 378). The domain of economic integration and economic change is a fertile ground for institutional studies across time and across cases (Jackson and Deeg 2012, 1110) (Hall and Soskice 2001).
Verdun offers an explanation of the crisis from an historical institutionalist point-of-view. She studies four different cases with the goal of looking at empirical evidence and testing if institutional structures affect political strategies, outcomes and preferences (Verdun 2015, 221). She comes to the conclusion that the nature of the crisis meant that members offered solutions nationally first — because of the slow decision-making process of European institution — then European institutions offered theirs. The EMU was a critical juncture that constrained the choices during the debt crisis (Verdun 2015, 231).

The high level of institutionalization lead to similar responses from actors sharing similar institutional cultures. This is a very general framework. Considering the neoinstitutionalist understanding of history, there is no reason to believe that the integration process is linear. It is hardly reversible, but it can move in any direction. Typically, neoinstitutionalists avoid prescribing solutions, but I will still propose two likely expectations.

- **E7**: The debt crisis is a critical juncture. The institutional legacy shaping this juncture is powerful and a breakup of the EA or the EU is unlikely. If the crisis worsen and statu quo is untenable, then members are more likely to provide a solution in line with the existing institutional framework than allow for a breakup.
- **E8**: The future shape of EU institutions is difficult to predict. If the crisis worsen, then Germany will be more likely to get on board institutional changes while being limited in its choices. It is likely that this confrontation will lead to a change in decision-making processes.

**Multi-Level Governance**

According to Multi-Level Governance (MLG) approaches, the process of decision-making is way more diffuse than other theories predict. The emphasis should not be the ‘level’ of institutional change. Emphasis should be on the way that authority is shifted around through time (Hooghe and Marks 2003). As long as a unitary state is out of the question, European policies
will need to transcend national political and legal systems. This is where the need for a “dispersion of governance across multiple jurisdictions” arises to avoid variable geometry policy-making (Hooghe and Marks 2003, 235). There are trans-sectoral issues and policy-specific issues within a distinctive institutional configuration. Decisions are taken at the regional level, at the national level, at the supranational level, and international variables influence all of these. Because of that complexity, a specific tool-kit is needed. The multiple levels are the results of “the search for the optimal scale of government” (Scharpf 1988, 240).

The main issue with this theoretical framework is its problem with prediction. It is clearly a method of analyzing and understanding the way various level of institutions and actors behave. Without providing an active explanatory role, it is still possible to circumscribe MLG to focus on the shifting of decisional power within the Eurozone. This prediction seems appropriate when accepting the likeliness that during the crisis a shift of who is in control should occur. This change will not be uniform through all levels of institutional decision-making. The crisis proved the inherent problems of the EMU. For too long, the EA ignored the necessary legitimacy on both levels (supranational and member-states). The EMU is based on a set of constitutional principles that are binding for the future, without mechanism to ensure that they remain legitimate in the face of their population (Bellamy and Weale 2015, 259). This likely leads to a shift of power over time.

○ E9: The crisis is an opportunity to deepen the interdependence between the different levels of governance. If the crisis worsen, then a new order and a shifting of power between levels of governance will be more likely to occur.
Crisis in Europe

After presenting a gross overview of the crisis, I will discuss the level of congruence between theoretical expectations and reality. I will cover the period between 2008 and 2014. The end-limit is imposed because it can be argued that the crisis was over way before 2014, but if not, the Greek crisis is in the making, so it is not advisable to study it while it is not over yet.

Unfolding of the Crises

The crisis started in America. The EU was left untouched. It took almost a year for the effects to be felt. Then, what started as private debts of overly-high leveraged financial institutions became public debts. I agree with Shambaugh that the European crisis is best understood as three distinct crises: a banking crisis, a debt crisis, and a growth crisis (Shambaugh 2012). In late 2007, some European banks were faced with liquidity problems caused by their investments in American sub-prime investments in the housing market (Constâncio 2014, 253), but the state of the European economy was still considered robust (Drudi, Durré, and Paolo Mongelli 2012, 883). In 2008, German banks got worried about their investments in Eastern Europe. The problem was dealt with quickly, as the German finance minister proposed a 500 billion Euros bailout fund. By the end of 2008, the worst seemed over as German finance Minister Peter Steinbrück said: it was basically an Anglo-Saxon banking-system crisis. After barely 12 months of stimulus, most European countries entered the path of austerity.

A few months later, the crisis proved to take the shape of a ‘W’. In 2009, the markets became wary of lending to GIIPS (Greece, Ireland, Italy, Portugal and Spain) governments (Lapavitsas 2012, 48) and the sovereign debt crises really erupted in 2010. They were caused –
in a large part – by macroeconomic imbalances (Begg 2012, 112), but also by the interlocked nature of the European financial sector. A sovereign debts crash being a problem in itself, it was amplified by the banking sector insolvency caused by their possession of these same debts – largely core banks holding periphery debts (Shambaugh 2012, 159). It did become even more problematic, considering that European firms rely more than their American counterparts on banks for financing – especially the Germans (Hall and Soskice 2001). Policies were put into place, ranging from proposals for financial reforms, to technocratic takeover of Greece and Italy by ‘experts’ to make sure austerity measures go smoothly (Loubert 2012, 442). The banking crisis was deemed to be the most important one and it was dealt with from the beginning. A failure of the banking sector — already fragile — might have meant the end of the EMU (Eichler and Sobanski 2012).

![Graph #1](image)

This is when the crisis on the periphery moved to the next speed, with Greece as the most difficult case. Previously, all GIIPS countries enjoyed a historically low borrowing cost. By
sharing a common currency, the markets stabilized for a rate similar to Germany for almost every one of them (See Graph #1). These lower costs caused the money to be plentiful and stimulated internal consumption. Combined with a historically weak tax-collection system and the fact that in 2009 Greece unveiled a fiscal-deficit-to-GDP not of 6.5% but 13% via shady dealing with Goldman Sachs – passing public debt as derivatives – all hell broke loose on the markets (Lapavitsas 2012, 36). Only at that moment the true scale of Greece fiscal problems were uncovered (Begg 2012, 107). Greece standing was downgraded by rating agencies from A to BBB-. This led to a vicious circle of tightening of the borrowing costs, leading to an economic contraction, leading to an increase of debt-to-GDP ratio, and so forth.

Greece was the exception, as the others ‘IIPS’ cases were different. Their financial crises were more similar to the one in the USA. A property bubble emphasized by over-leveraged banks led to a too big to bail system. Ireland had to bail-out a banking system 400% the size of its GDP in 2007-08 (Blyth 2013, 67). In Spain, the local banks, worth 50% of the banking sector, were under-capitalized and held over-evaluated assets in their hands – much like the US in 2007 – making up over 200% of Spain GDP. The cases of Portugal and Italy are even less dramatic. They are similar in that they have low growth, old age, low productivity, and institutional sclerosis (Blyth 2013, 68). Prior to the crisis, their economies were not preoccupying anybody. The fundamentals of their economies did not changed during the crisis. It is important to recall that most GIIPS members respected the Stability and Growth Pact, unlike Germany and France in the early 2000s. There are no correlation, even less causality, between the yields demanded by the market and whether a member respected the pact (Constâncio 2014, 251). It was mainly a change in perception on the markets that could explains the tanking of their economies caused by a harsh increase in borrowing costs on the markets. Because of the
measures enacted to bail-out and protect their banks, the sustainability of GIIPS public finances were severely questioned by the markets (Drudi, Durré, and Paolo Mongelli 2012, 887).

As for Germany, their insularity might be the reason they were able to get out of the crisis pretty much economically unscathed (Young and Semmler 2011, 9). If all the other countries had adopted a model similar to Germany, maybe the Eurozone would not be on the verge of deflation (Bonatti and Fracasso 2013) and the members would have had stronger growth. German leadership has clearly been an issue. Hoped for by some, feared by others, it has been largely limited to the narrow economic sphere while international legitimacy and domestic approval are not high enough for bolder steps (Bulmer and Paterson 2013). But the question remains: why did some countries entered into crisis overnight, while some remained stable? Prior to the crisis, Greece was not on the brink of collapse. Why was its debt fine previously, but the next day it threatened the Eurozone with meltdown? A similar story can be told about Italy, Portugal and Spain. The three of them were believed to have manageable debts and unemployment levels — according to their government bonds’ yields (Lapavitsas 2012).

**Effects of the Crises on European Institutions**

The institutional response up until that time was mostly an answer to the banking crisis. Lapavitsas argues that this response was made at the expense of the growth crisis (Lapavitsas 2012). The debt crisis, it can be argued, is intertwined with the banking crisis as the role of financialization grew with the Eurozone and international trade prior to the emergence of the crisis — some might even argue that it is part of its cause (see (Duménil and Lévy 2011) for example). If this is not the case, the remaining option is that individual member states’ debts are
the results of their own carelessness (Zahariadis 2012) and they must be dealt with through economic shock and enhanced responsibility (Schwarzer 2013).

In May 2010, a first package of 110 billion euros was promised to Greece. A 750 billion euro loans guaranty package a week later for the European markets as a whole. It also saw the creation of a 60 billion euros European Stabilization mechanism, financed through emission of European Commission Debt, not needing national approval. This small amount would be completed, eventually, by a 440 billion euros European Financial Stabilization Facility (EFSF). The IMF also promised a 250 billion euros for members in needs, but at the condition of economic and fiscal adjustments. It is important to note, that all these packages were aimed at the stabilization of the various banks’ balance sheets, not for the peripheral states struggling with austerity. The package promised to Greece in exchange for economic and fiscal adjustments was the result of co-operation from individual Eurozone members, the European Commission, and the IMF; while the larger fund was financed by bonds guaranteed by individual Eurozone members. The EFSF was meant to be only temporary and it was created in order to protect the investment of various actors in the banks under pressure from international markets. In fact, many German and French banks were highly involved in GIIPS countries (Hardie and Howarth 2009). The failure of one of them could have led to a complete meltdown of the European banking system (Blyth 2013).

Fiscally speaking, the European answer came later than its American counterpart, but also later than its own member-states. The first ECB move waited late-2008. Unluckily enough, the ECB even raised its interest rate just before the Lehman Brothers’ collapse and it expanded shyly its balance sheet, topping 39%, while the American Federal reserve was busting 210% early on. Despite these moves, the banking crisis slowed-down, but was not settled (Shambaugh
In 2009 and 2010, the European Commission unveiled a 200 billion euros recovery package. This plan only amounts to 1.5% of EA-GDP. On the other hand, most European countries already have a strong safety net that acts as an automatic stabilizer in the case of a crisis. This net helps stabilizing the economy by maintaining internal demand. But, on the other hand, it increases the debt-to-GDP ratio accordingly. As the crisis continued to deepen by the end of 2010 and early 2011, it became clear that the EMU lack of a unitary fiscal policy was a grave mistake. To alleviate the pressures, the ECB adopted ‘unconventional measures’ that were able to palliate in large part to the worst. But it did risk the integrity and independence of the ECB’s mandate (Begg 2012, 115).

In 2011, during the first half of the year, several concrete measures were taken. The six-pack was put into place. Its goal was to strengthen the Stability and Growth Pact. Then the Europlus pact was adopted. Its goal was to foster stronger economic policy coordination. Eventually in July 2012, a permanent mechanism was created: the European Stability Mechanism (ESM) with 80 billion euros in funds and a guarantee of 750 more. It can be used as a bailout fund conditional on members’ implementing and restoring their financial and fiscal situation (read implementing austerity in one form or another). The entity charged with overseeing this process is the ‘Troika’ — the European Commission, the European Central Bank (ECB), and the IMF (Leska 2013). From that moment on, the ECB gained a lot of importance in macroeconomic decisions over the whole Eurozone. The ECB was part of the Troika deciding on the assignment of bailout funds and the ‘correctness’ of fiscal reform; but it also promised it would start a program of de facto quantitative easing (QE) by buying individual members’ bonds on the secondary market — at their request — with the condition of their application to the ESM starting in August of 2012. It can be argued that the ECB acted as a lender of last resort in fact, if
not on paper (Buiter and Rahbari 2012) and solved the problems of intergovernmental decision-making (Fabbrini 2013).

This program was launched despite its questionable legality. The consent resulted from the absence of formal complaint from most members (Begg 2012). Only Germany seemed opposed on legal principles to bond-buying as a form of QE (Wolff 2013). Also, — less known to the public — it seems that the ECB started to adjust its EONIA (Euro OverNight Index Average) a lot more to periphery needs, rather than those of core countries — and this despite the fact that the ECB is supposed to have the whole EA’s interests at heart (Bouvet and King 2013). It is interesting to note that similarly to the USA, the ECB has dominated the response to the crisis and it has taken a larger role in economic and fiscal policy. This growing unconventional role seems to have been caused by political blockages (from Congress on one side, and from the individual European members on the other).

In March 2013, the European Council endorsed German priorities for ensuring financial stability, fiscal consolidation and economic growth (European Commission 2013). Deficits were falling in most Eurozone countries, but the consolidated public-debt was still rising (Ewing 2013). In the summer 2013, the effects of austerity were felt strongly in periphery countries. Unemployment was still soaring, technocratic governments have not been able to reverse the situation economically, even less democratically speaking (Leska 2013, 434). Europeans had to wait until November 2013 for the ECB to adopt its historical lowest rate at 0.25% in the hope of facilitating business borrowing and job creation. Things seems to fare better, but there is still place for improvement. As Barroso said in his State of the Union Speech in September 2013: “For Europe, recovery is within sight [...] Let us not overestimate, but let’s also not underestimate what has been done [...] We owe it to our 26 million unemployed” (Barroso 2013,
4). At that time, most of the financial crisis is considered to be over. The remaining crises are the employment and growth crises. The underlying fear is an EA stagflation spiral. In order to avoid it, the ECB slashed its interest rate to 0.05% in September 2014 (News 2014) and finally, in the beginning of 2015, the ECB finally decided to start buying bonds directly on the markets (60 billion a month) in order to relieve some pressure and to incite private investors to invest in the real economy (Cox 2015).

**The Crisis Through the Eyes of Germany**

The thesis underlying this section is that we can account for the German response by emphasizing two different aspects: its predominance as a state in the European framework and its overwhelming influence within the European institutions.

**Germany's Response to the Crisis**

At the beginning of the crisis in Europe, in late 2008, Germany was more or less willing to intervene. At that point, the crisis was still financial and was yet to inflict real damage to the EA economy. German economic actors were more concerned with the probable downturn and the effects on Germany export-led model. In the beginning of 2009, negative growth in Germany – and most EA members – called for government intervention (see graph #2). The debate was intense between German national parties. While some stimulus was warranted, the CDU-CSU and SPD coalition was shared the economic tradition of ordoliberal supply-side economics
rationale (Hübner 2012, 162). It took a full year before Merkel was able to come up with a stimulus package, only after the September 2009 elections.

Graph #2

In February 2010, the European Council promised to help member states with their sovereign debts\(^1\), but Germany was dragging its feet (Schwarzer 2013, 64). Germany did not want to provide too quick a loan, so it could continue to exert more pressure on the Greek government to adopt more drastic fiscal reforms (Schwarzer 2013, 64). There was also the pressure of the constitutional court, which gave more bargaining power to Chancellor Merkel. But, the more Germany waited to agree to the package, the higher its cost became. Uncertainty on the markets drove CDS and Greece government debts yield skyward (Young and Semmler 2011, 8). In May 2010, while the crisis escalated, Merkel supported the creation of a new rescue fund: the EFSF and EFSM on May 10th\(^2\). It was not so much justified to help Greek to get out of its debt, but to make sure the Euro would not implode – national interest over solidarity.

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(Schwarzer 2013, 65). The idea was to use the crisis as a moment to push for reforms in the Eurozone. On May 21st 2010, German finance minister\(^3\) said he wanted stricter rules, automatic sanctions, withdrawal of voting rights, and interference with national budget in the case of non-respect of the Stability and Growth pact. This agenda was finally pushed through the European Council in December 2011. The fiscal compact included automatic punishments for ‘sinners’. A QMV is possible to withdraw sanctions, but it clearly made their imposition easier.

During this period, the German public seemed to be clearly behind their political leaders. Considering the efforts made during the 1998-2005 period, they felt that it was unfair for them to bail-out fiscally-lax governments while they tightened their belts since reunification (Young and Semmler 2011, 8). Eventually this led to January 30\(^{th}\) 2012 adoption of the fiscal compact, signed by 25 members of the European Union. The Fiscal Compact\(^4\) has the goal to push every members in the direction of more competitiveness. Making every members, a bit more like the Germans. This institutional change can easily be assimilated to a change in economic rationale. Was this ‘Germanization’ of Europe willfully done? It is another question that can be debated.

In July 2011, the volume of EFSF was enlarged to cover the possibility of an Italian or Spanish default, even though Germany and the Commission were opposed to Eurobonds. But the situation called for a reinforcement anyway\(^5\) to counter the promises of a self-fulfilling prophecy. By the beginning of 2012, the austerity measures were being felt and the crisis was deepening. At that moment, discussion regarding a deepening of EU integration were advanced. The idea was to reduce the fiscal imbalance built-in the Eurozone. Up to that point, Merkel was still a

\(^3\)www.bundesfinanzministerium.de/nn_53836/DE/Wirtschaft__und__Verwaltung/EuropaDer_Euro/20100520-Task-Force.html?__nnn=true


proponent of the ‘Union’ or intergovernmental method, instead of the community or supranational method (Schwarzer 2013, 69). But the limit of democratic legitimacy were starting to be felt. The negotiations were caricatured as being ‘more’ Europe, but it needs to be a ‘German’ Europe. By the end of 2012, Germany gradually abandoned its punitive measures adopted against Greece. They changed from the stick to the carrot, by approving various assistance programmes (Bonatti and Fracasso 2013, 1033-1034). But, there is still a limit to what Germany is ready to do. There is no systemic system of fiscal redistribution or debt mutualization. By doing so, Germany still has its power of providing – or not – assistance to members in need by asking them to comply with fiscal responsibility reform. Élite support is not has unified as it was before. After the 2013 German elections, the leader of the SPD asked Merkel to take the social hardships of GIIPS countries more seriously⁶. Even Mario Draghi started to consider the low-inflation rate to be problematic in the long-term, as unemployment stays at record highs⁷, hence creating the probability of a Japanese-style stagflation. In the beginning of 2014 the German Constitutional Court finally rejected lawsuits seeking to block German participation in the ESM (Matussek and Buergin, 2014) and they also cleared the German participation in the Fiscal Compact. In the meantime, GIIPS members were able to finance themselves directly on the markets (notably Portugal and Spain) as the government bonds yields are starting to come down⁸. By the end of 2014 and the beginning of 2015, the EA is still facing the risk of stagflation. The ECB started buying members bonds at the height of 60

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⁶ (Der Spiegel, Sept. 24, 2013)


billions euro a month, in order to stimulate the economy. Germany is still opposed on principle to this process, but they are letting it go. It must be said that the current state of the euro is providing a competitive advantage for German exports worldwide — the euro being weak against the dollar, for example, since June 2014.

Prior to the crisis, Germany undertook steps that led to the consolidation of the fiscal imbalance. While periphery countries had no incentive to reduce their borrowing at lower-than-expected costs, Germany was transforming its social model to become ever more competitive to counter the cost of reunification. The lowering of unit labour cost is staggering in the German case (see graph #3).

![Unit-Labour Cost for GIIPS, Germany and France 1999-2014; source ECB](image)

Graph #3

German dependence on exports led to Germany not being the ‘consumer of last resort’ – like the US – but became the ‘main continental factory’ – much like China. In order to penetrate
emerging markets, Germany had to increase its competitiveness even more (Bonatti and Fracasso 2013, 1031-1032).

Was Germany in control the whole crisis? Germany lacked leadership. According to the late Tony Judt (2010), Germany is living a symptom of insularity. Most of the political debate in Germany is revolving around domestic issues (Young and Semmler 2011, 9), even though Germany has an immense influence on European politics. Chancellor Merkel is prisoner of the Constitution. It asks for a lot of involvement from the Bundestag to give the Chancellor a mandate to act (Schwarzer 2013, 71). Merkel had to move forth slowly to avoid a Constitutional overturn. But, in the end, is it simply a question of normative underpinnings? It can be ordoliberalism: central banks acting as stabilizers and nothing else. Government are to set the framework of the market, with an approach closer to supply-side economics, contrary to most demand-side economies in EU (Schwarzer 2013, 70). Or was there a rational-choice to impose the model on the rest of Europe. The question is open.

**Balanced response?**

I argue that the crisis has been dominated by the German decision-making process. Germany was exercising a powerful influence on the outcome, but it still lacked the ability to provide public good and underwrite the free rider problems. The Euro can be said to have been advantageous to the Germans, but they are still too much concerned with their internal problems to exert completely their influence on the rest of the EU. Germany was not willing – and maybe not able – to act positively in the crisis prior to the danger brought directly upon them with the sovereign debt crisis – hence endangering the existence of the currency. The way that Germany
was able to enforce its political and economic agenda was posing as a model for economic growth and fiscal conservativeness in the EA. Because of its economic firepower, Germany was able to impose its model (Hübner 2012, 165), but it was not able to take completely the driver’s seat for itself. It is difficult to assess if the reason for this was Germany’s unwillingness to do so, the institutional arrangement, or even the historical contingency.

As soon as December 2009, EU Monetary Affairs Commissioner declared that “The problems of Greece are the problems of the Euro area” (Zahariadis 2012, 106). The risk of contagion was not necessarily high at that time, but it was already a possibility. The temptation for decentralization of the problem was also high. It was considered that each country was responsible for its own public finance problems. But, on March 25, 2010, bilateral Eurozone members and IMF loans were provided to Greece, even with the German regional elections looming in May 2010. They were able to post-pone the decision for a couple of months, but not forever (Zahariadis 2012, 106). By the end of April 2010, Greek bonds were reduced to junk status. Following that failure to finance itself directly on the markets, Greece asked for the Memorandum of Understanding (MoU). It included 110 billion euros, 80 in bilateral loans and 30 from the IMF. The MoU came with harsh austerity conditions (VAT tax hikes, salary cuts, pension cuts, etc.). At the onset, Germany wanted the loans to be at market rate, but they were eventually maxed at about 5%. While EU leaders favored a Europe-only solution, in Germany the debate was getting out of control as near-racist analysis of the Greek case was taking place in the tabloids. It forced Merkel to maintain the hard line (Hübner 2012, 166). Germany was able to get its way by including the IMF in the mix and not taking the responsibility alone. This approach led to incremental changes in the Eurozone, but not to any wide-ranging reform.
The next year, in July 2011, after failure from the Greek government to reach its part of the deal, they were forced to accept to the MTFS. This new package included 109 billion euros in new loans and private holders of Greek debts would take a 20% haircut. In October 2011, an EU rescue plan was basically designed by Germans, with inputs from the French. This second plan increased the might of the EFSF to almost a trillion euros. In exchange, higher tier-one capital ratio was a condition. Once again, Germany was able extract a plan where public and semipublic joined forces (Hübner 2012, 172), but also where the support is not ‘unlimited’, but is predetermined. There is no way of knowing if even one trillion is enough in the case of a Portugal, Italy and Spain collapse. Finally, the actual vehicle is important. Promising funds for the EFSF is not the same thing as actually stimulating the economy. This is a loan-guarantee, and in the eyes of Germany, it will never be used. But, the conditions asked for Germany to agree to this ‘guarantee’ are enforced anyway. In the end, the ECB is still not a lender of last-resort, like central banks in other countries. Its main focus remains price stability (Butti and Carnot 2012, 900). Austerity was institutionalized, but deeper European integration is still uncertain.

Within the EA, questions are asked about the level of German influence. Populist talks of a ‘Fourth Reich’ while Germany is almost in complete control of the European agenda (Schwarzer 2013, 62). This view is a contestation of the sheer power of Germany, but also the use it is making of it. German Chancellor Merkel is strongly supported by her population in refusing the ‘deadly embrace’ of the periphery (Bonatti and Fracasso 2013, 1024). The EU is at a historical crossroads. Eurosceptics believe that the EU went too far in integration with the Lisbon Treaty. On the other side, optimists believe that the integration process is not moving fast enough (Leska 2013, 431) and should consider a banking union, a common financial and fiscal framework (Tombasos 2011), or even completely federalizing Europe in a Alexander Hamilton’s
moment (Loubert 2012). But there is still ‘in between’ positions, where the EMU should only be reinforced with better governance mechanisms (Butti and Carnot 2012, 900).

A strengthening of the EA – which has become necessary because of the crisis – might cause a problem with the larger 28 members EU. The deepening of this economic core would lead to a threat of the integrity of the larger group. Germany was the largest contributor to the new rescue mechanism (27%). It was this strong impact in European negotiations and bilateral interaction that provoked the debate on the new German hegemony (Schwarzer 2013, 76). But underlying all this debate, is the question of the current account deficits between Germany and periphery countries. It so happened that the promised convergence from the creation of the EMU never materialized in terms of economic growth and current account deficits (Bonatti and Fracasso 2013, 1025) (see graph #4). The built-in asymmetry between core and periphery countries was only reinforced to collapse as a sovereign debt crisis after financial markets loss confidence. As extreme the crisis was, it was also predictable in a sense. According to the data compiled by Reinhart and Rogoff (2011), almost 80% of the time, a financial crisis is followed
by a sovereign debt or public debt crisis. With the extent of this crisis, this should have been
foreseen – or at least seriously considered – by political and economic actors. But, even then,
there was no mechanism to deal with such a crisis included in the EMU.

Why is Germany losing some control of the agenda since the height of the crisis? The
Franco-German couple is weaker with Sarkozy gone. Hollande seems less inclined to cede
ground on austerity than his predecessor. Germany stronger allies are: either, not part of the Euro
like Poland and the UK, or growing weaker with the popular pressure coming from rescue
packages – countries like Austria, Finland, the Netherlands. Finally, it might also be conjectural.
Since the ECB decided to buy government-bonds, German help is less essential. Or, maybe,
because the crisis is wearing out, we witness a return to intergovernmental practices because the
economy is returning to a low-politic governance.

**Conclusion: Germany, a reluctant hegemon?**

Are theories of institutional change able to explain the various institutional outcomes of
the 2008 financial and sovereign debt crisis? In this last section, I will review the congruence
with the postulated expectations. German response to the crisis and its institutional undertaking
is different from the one done by the Eurozone as a whole. This is where is becomes difficult to
reconcile European integration theories. If some theories can explain how the Eurozone
responded as a whole, the same cannot explain how Germany responded to the crises.
Were Theories' Expectations Congruent with Reality?

The neofunctionalists were debunked pretty early in the crisis (Leska 2013, 436). The spillover effect did not take place as expected, and the newer Lisbon institutions created were completely useless. Barosso could only bow to the Merkozy leadership. The Commission was powerless. The logical next-step initiative of the introduction of Eurobonds never materialized and seems even farther away than ever before. As for E₁, the crisis felt more like a confrontation of two conception of a top-down Eurozone, spearheaded by France and Germany and other members taking side, not marching ‘hand in hand’. Despite more power to certain European institutions (fiscal compact, six-pack, ESM, etc.), these were incremental steps of the type of ‘minimum-winning coalitions’. The European commission was sidelined for the longest part of the process. As for E₂, Germany did achieve its goal of having its voice heard. Many reforms enacted can arguably be described as being based on the German model of fiscal conservativeness.

On the intergovernmental side, expectations were mostly verified at some point during the crisis. According to Moravcsik tripartite nexus, Germany was left with no choice but to show its commitment to the EA in the end. At first, temporary mechanisms were created — like EFSF — but when that proved to be insufficient, a more permanent mechanism was put into place — the ESM. The process by which it happened is similar to intergovernmental expectations. Germany negotiated to achieve most of its interests, but in the face of a complete breakdown of the Union, it finally ceded some grounds and accepted the necessary institutional changes. It is interesting to point out to the response of Germany at the beginning of the crisis, contrasted with its interventions later on. In 2008, respecting liberal intergovernmentalism prediction, the state interests were constructed internally by various actors, then they were defended on the
international stage by the head of state. The real tension is the co-existence with the troika. It is constituted by the ECB, the IMF, but Germany plays a strong role as the largest creditor. “Although the member states play an important role in overcoming the crisis, the activities of transnational EU institutions cannot be ignored” (Leska 2013, 439). Explaining why Germany decided — or was forced — to give in on helping Greece is ambiguous. Did its economic interests have allowed at some point its own exit or the breakdown of the EA? Did Germany act based on rational-choice theory or did Germany act based on some other rationale? The question is still open.

On the ideational side, did the change in socialization brought forward by the European integration process really led to a change in attitude of the ECB, European Court of Justice, European Parliament and the Commission? The ideology of German political and economic actors was a powerful determinant in their blindness to the scale of the crisis in 2008 and 2009 – even at the beginning of 2010. The scale was underestimated and the response was weak, at best, according to Hübner (Hübner 2012, 170). These two elements being largely influenced by their ordoliberal conception of the economy: either by the supply-side intervention model, or by the relative withdrawal of the political as a possible remedy. But, it is important to note that the way the crisis was handled, the language used, the discourse production had a strong impact on how the markets reacted. It became clear, according to Vivien Schmidt (2014) that the political elite was addressing itself to the markets during the crisis, and not to the population. It is reflected in the complexity of producing discourse capable or persuading the markets, the people, while being able to convince the medias and the other European members (Schmidt 2014, 206). Such a clash of diverging ideas can be at the root why it was so difficult for German Chancellor Angela Merkel to coordinate and intervene fully on the European scene, while still having public support
and a positive media image. In the end, the patchy political elite discourses became a self-fulfilling prophecy on the markets. In the case of E5, it does seem that German market rationality triumphed over alternatives. As the crisis worsened, the ‘German ideology’ was implemented even more deeply. In the case of E6, it is difficult to speak of any real sense of community. Germany did finally come to the aid of other members, but the explanations seems more rational than ideational. It was in order to ensure the survival of the EA, rather than the sharing of a community. This is even more clear when we look at how negotiations between Germany, the EU and Greece’s Syriza party went down.

In the neoinstitutionalist perspective, it is not clear that the incentive influence really worked in the case of the crisis. The Economic and Financial Affairs Council still adopted key decisions throughout the crisis. Were they acting on everybody’s interests or were they heavily influenced by the Germans? It is difficult to say. A lot of their policies were oriented for the wellbeing of EU as a whole. Even contrary to its original directives, the ECB went on with non-traditional measures, including bond-buying and indirect intergovernmental bail-outs (Butti and Carnot 2012, 900). Regarding E7, some of the created institutions can be seen as ‘copies’ from existing ones. But on the other hand, the ECB really went out of its way to ensure stability — secondary market bonds-buying, actual lending of last-resort, etc. — on the markets. This role was truly novel and problems went out of the typical ‘paths of integration’. Germany was unable to efficiently and rapidly safeguard its core interests of stabilizing the EA and to limit its financial commitment (Hennessy 2013, 432). The incentive structure in Germany emphasizes crisis-response – not preparedness. Also, they could not agree internally on which steps to take (Hennessy 2013, 436, 439). Considering the status of Germany, its economic might and its role of ‘creditor-in-chief’, it is surprising — or disappointing — that it failed fully to take the driving
seat and reign back the markets when needed. In the case of E8, there was some change in the decision-making process. A new relational institution emerged, the relationship between countries is now based on creditor/debtor status. Countries’ decisions were more likely to be aligned on this spectrum than on any else. But, when push comes to shove, Germany had no apparent choice and it had to intervene to ‘save the day’.

The MLG approach can be useful to provide some insight post-crisis, but it is not useful in explaining expectations. The lot of political cleavage brought forward by the crisis is impressive in the German case. German political parties could not agree completely with the path to follow. The CSU was at odds with Merkel’s CDU on demand and supply side perspective – and we are not even speaking about Der Linke or the Green party. The German coalition was at odds with the ECB and its unorthodox market interventions, but also with their own representatives. Axel Weber declined to succeed to Jean-Claude Trichet as the head of the ECB. Also, ECB chief economist Jürgen Stark was a shy representative that did not make full use of his tenure (Hübner 2012, 167). With the coming of Hollande, the Franco-German alliance of the Sarkozy-era caught a cold. The European Commission had a divergent opinion in helping Greece directly, while the German Supreme Court struck down a large part of what was multilaterally agreed on. The MLG approach can be useful in emphasizing the fact that the reality is way more complex than it seems, but it is not a useful predictor of actual outcomes. The basis of multi-level conflicts and cooperation is interesting and enlightening, but academically useless. Somehow, Giddens framing of the EU in two different groups E1 and E2 – the former being the supranational institutions and the latter being intergovernmental governance – is still an attractive path to follow. Lacking clear leadership, the EU is swinging back and forth between these two various governance methods (Giddens 2014, 6-8). This framing is useful to understand
the underlying way the EU is working, but as the rest of the MLG approaches, it does not provide clear insight on how things could actually unfold before-hand. As for ES, as it is not a clear prediction per se, it is difficult to assess its results. Some powers was indeed shifted around. ‘Merkozy’ took control at the beginning of the crisis, more fiscal and macroeconomic powers are centralized. In that sense, it was ‘right’.

A Possible Alternative?

It appears that no theory of institutional change can account for the whole crisis. Neofunctionalism helps describe the results, but falls short to explain the process that led to them. Intergovernmentalism is of some use to explain how Germany acted during the crisis, but its explanatory power is not as good when explaining why other members followed suit. On the side of alternative theories, ideational and MLG approaches are having problem with coming up with verifiable expectations in the first place. They are useful to help understand how some of the processes unfolded, but they are not as useful to explain why a certain event went into a certain direction instead of another. Finally, as for the neoinstitutional approach, it is probably the framework that provided the best predictions. The question of whether this crisis is a critical juncture for the EU is still open for debate, but based on the fact that it could be it opens the way for a change in the alignment of members. The fading out of left-right debate during the crisis for an alignment based on the member status as a creditor or a debtor is an interesting avenue to explore further (Hall 2012). Members holding more ‘power’ over others are now defined by that status, as the growing power of Germany as a member and a partner in its own name proved.
This paper raised new questionings about the validity of existing integration theories. Are they enough to answer pressing concerns? The problem with most of them is their close-mindedness to external factors. Existing theories try to explain the European Union as a closed-system, mostly closed from the rest of the world. As the 2008 crisis proved, this is very problematic. The consequences of this crisis on the integration projects need to be understood within a framework that consider the international context and the importance of historical legacy at the same time. If existing theories are unable to explain the institutional evolutions based solely on internal politics and policy-making, we need to look elsewhere for answers.
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