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The Euro, The Gold Standard, and German Power: A Cautionary Tale and the Lessons of History

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In a monetary union you can't afford to have large and increasing structural divergences between countries. They tend to become explosive. […] Therefore they are going to threaten the existence of the union, the monetary union.

Mario Draghi, 2015[1]

The parallels between Europe in the 1930s and Europe today are stark, striking, and increasingly frightening. We see unemployment, youth unemployment especially, soaring to unprecedented heights. Financial instability and distress are widespread. There is growing political support for extremist parties of the far left and right.

De Long and Eichengreen, 2013[2]

If you think this [the gold standard system] sounds a lot like the eurozone at the moment, you would not be wrong. Swap "convertibility into gold" with "the integrity of the euro" and it's the same system.

Mark Blyth, 2013[3]

In order for it to be stable, the world economy needs a leading nation, a benign hegemon or 'stabilizer.' I am convinced that this insight can, to a lesser extent, be applied to the European (monetary) union.

Wolfgang Schäuble, 2010[4]

Introduction

Pundits around the world have criticized Germany for either trying to reshape Europe in its image or acting in its own self-interest. Germany has been accused of creating a new "empire," of pursuing a new *Sonderweg*, of "going global alone," of evasiveness, self-imposed isolation, and bullying. The U.S. Treasury and the International Monetary Fund (IMF) have accused Germany of pursuing "beggar-my-neighbor" policies with its trade surpluses that threaten the Eurozone and even the global economy. Germany protests that it did all it could to save the euro and is doing all it can to contribute to European economic health. Indeed, by 2017, the euro had survived. But, it survived at the expense of the societies and the economies of the Europe's periphery and to the benefit of its core. As Mario Draghi's quote above implies, a monetary union between a core and periphery cannot endure. We argue here that it can survive only if a liberal hegemon in Europe uses its resources to underwrite cooperation in the European Union (EU) by transferring resources from the core to stimulate growth in the periphery. That liberal hegemon should be Germany.

We arrive at this conclusion through a set of three interlocking hypotheses: 1) the contradictions between the insecurity of the market and the requirement for political stability raise incentives for defection from a fixed exchange rate regime or a monetary union and can lead to collapse; 2) treaties and institutions are not adequate to assure cooperation in these regimes; 3) the intervention of the most powerful state in the regime is required to provide incentives to those who suffer from market instability to remain in the regime. These incentives can be channeled through institutions like the EU. We believe that Germany must play the role of the liberal hegemon in European Monetary Union (EMU). It is the only state in the EU that has the capability to do so.

To illustrate these hypotheses and our argument, we highlight the importance of an historical perspective for the understanding of present and future trajectories in the Eurozone and for the future of Europe as a whole. We look to the history of the Gold Standard for insight. We are certainly not the first to do so. Wolfgang Schäuble, J. Bradford Delong, Barry Eichengreen, Mark Blyth, and Matthias Matthijs have led the way.[5] Despite dissimilarities in the two historical periods (e.g., the gold standard was not a treaty-based monetary union), the fixed exchange rate system under the Gold Standard of the nineteenth century and early twentieth century and the European Monetary Union have much in common. Both are rigid forms of fixed exchange

among countries, both are characterized by the free flow of capital between participants, and both were thought to be(come) self-stabilizing at their time of inception with the market determining the real currency value in the absence of international coordination. But, here they diverge: the Gold Standard and its successor, the Gold Exchange Standard, functioned as long as great powers provided the means for weaker economies to balance their payments, allowing them to peg their currencies to gold without suffering great economic hardship, thus keeping the free trade system healthy. When Britain and the United States no longer intervened, however, the system collapsed. EMU, on the other hand, was constructed without the provision of support to weaker members that would allow them to flourish within the system. It functioned for a few years until crisis hit. Although no members have yet defected from EMU, deficit countries like Greece continue to suffer.

This historical comparison provides a cautionary tale akin to that of Goethe's "Sorcerer's Apprentice." The tale is an apt metaphor for fixed currency regime like the Gold Standard in the absence of British support or the euro as it stands today. The apprentice magician, tired of his household chores, tests his nascent skills at sorcery by bringing useful household tools to life and making them "self-regulating." He gives them the power to accomplish their tasks on their own without the apprentice having to use them. At first, the plan works well, but eventually the tools become unstable. They take on a life of their own and run amok, leaving chaos in their wake. Like the tools of the sorcerer's apprentice, a free trade area bolstered by a fixed exchange rate regime or a monetary union is inherently unstable and, left to itself, will wreak havoc on the very economies the regime is intended to integrate in order to promote growth in the economies of all its members.

Under what conditions will a monetary union run amok? We draw on theories of cooperation for insight. In a seminal article, Robert Mundell showed that a fixed exchange rate system—and by extension, a monetary union must necessarily be a self-regulating system.[6] He argued that governments can have only two out of three possible options in international macroeconomics: 1) policy autonomy; 2) free capital flows; and, 3) fixed exchange rates. They could not have all three. When participants in the European single market—which required the free movement of capital—chose monetary union with a single currency, they necessarily forfeited their policy autonomy, submitting themselves to a "self-regulating system."[7] That meant that when they experience prolonged hardship, they lose the ability to ease deflationary pressures in their

economies—pressures partly imposed by the fixed exchange rate system and capital mobility itself. Such a system of cooperation is not stable; those experiencing hardship will defect from it. Hegemonic stability theory provides a solution to this problem of cooperation: there must be a power strong enough to provide the resources to aid deficit countries so that they will not defect from cooperation. Contagion from that defection can cause the system to run amok. Hegemonic intervention allows them to avoid painful deflation thereby permitting them to remain in the monetary union and bolster their countries' political stability at the same time.

We begin with a brief discussion of the Gold Standard of the nineteenth and twentieth centuries and the Gold Exchange Standard of the postwar period of the twentieth century and briefly summarize the argument that cooperation under both flourished under hegemonic leadership of the most powerful state and collapsed without it. We then flesh out the conceptual argument drawn from these historical cases and Charles Kindleberger's theory of hegemonic stability: because of the "sorcerer's apprentice effect of self-regulating systems," free trade regimes, fixed exchange rate systems, and monetary unions require such leadership to ensure the cooperation needed for stability.[8] We then illustrate the conceptual argument with a brief discussion of European monetary cooperation, and an analysis of the Eurozone crisis after 2010, illustrating the "sorcerer's apprentice effect" in the absence of a hegemonic leader. We argue that Germany, although constrained by its embeddedness within the EU and the EMU, has already provided disproportionate resources to help bolster cooperation within the institutions of the European Union and support the euro. Germany has shown that it has the capability to act as Europe's leader if it is willing. But, by 2017, Germany had refused to provide real hegemonic stability to the Eurozone, instead placing the burden of cooperation on weak deficit countries. We predict that if Germany continues to refuse to play the role of the hegemonic leader, the European Monetary Union faces collapse.

The Gold Standard, the Gold Exchange Standard, and the Euro

Like the sorcerer's apprentice, the architects of the Gold Standard, gave it the power to function on its own. Currencies were pegged to a single value (gold), in order to reduce transaction costs of trade; no national policy manipulation of currency values was required or desired; deficit countries could simply deflate their economies or borrow extensively to pay their bills and balance their budgets while leaving the value of the currency intact. But the system would have

collapsed much earlier if it had functioned as it was designed. Instead, the stability of the Gold Standard of the nineteenth and early twentieth centuries was backed by Great Britain and the city of London to provide liquidity which supported deficit countries. Between 1875 and 1913, financial crises were few and far between. When Britain was no longer able to provide resources for that support, the Gold Standard—left to market forces alone—collapsed. Financial crises spread because without the provision of adequate liquidity, countries in deficit were forced to both borrow heavily and deflate their economies to pay for imports. Deflation led to high unemployment, giving birth to social unrest and political instability. Excessive borrowing triggered banking crises; the threat of such a crisis triggered panic and contagion, deepening crisis and fragmenting trade.

Similarly, the Gold Exchange Standard of 1945-1971 was a fixed exchange rate system which was believed to foster international commerce and cooperation after World War II. This time, however, it was not designed to function as a self-regulating system. Its rules and conditions of cooperation were embedded in a newly created institution, the International Monetary Fund.[9] As with the gold standard, all currencies were given fixed rates relative to gold which were permitted to change within a 1 percent margin. Although members entered into similar monetary bondage to fixed exchange rates as that of the Gold Standard, each government held a stock of international reserves--usually gold or dollars (the strongest currency). If market forces changed a currency's value more than 1 percent, its government pledged to draw on its reserves to buy its currency on the international exchange at a price within the 1 percent band. With the knowledge that the absence of liquidity available to deficit countries had destroyed the Gold Standard, the architects of the IMF created a countercyclical lending scheme when a deficit country's reserves were depleted. All members promised to deposit a certain amount of gold with the IMF, in order to give it adequate funds to lend to deficit countries. The IMF would provide the necessary stability. Yet, as members struggled to recover from the ravages of war, IMF resources proved inadequate, and members took back their policy autonomy: currency values fluctuated. It was the outflow of U.S. dollars—pegged to gold—which dampened these fluctuations and halted the tendency to break free of the fixed-exchange straitjacket: the dollar provided the liquidity that greased the wheels of commerce. No other countries actually fixed their currencies to gold until 1959. Because THE U.S. did not change the dollar value, it was as good as gold and became the world's major reserve currency. Financial crises were few and far between. The IMF and the emerging liberal international trading system

required the resources of the United States as dominant power to maintain freedom of trade. But when the U.S. government refused to support the dollar's value with gold, the fixed exchange regime collapsed. The global economy again became crisis prone. Similarly, the Eurozone needs a leader with the resources to intervene on behalf of deficit countries to help them avoid defection from cooperation in the EMU.

Although the gold standard was not a monetary union, the euro is a similar tool, fashioned to "work on its own," without the policy autonomy of its member states. All members of the Eurozone use the same currency with its value set by international financial markets rather than monetary authorities. Members in deficit must deflate their economies or borrow heavily in order to pay their bills; they cannot use monetary policy to adjust, and the currency value remains untouched by economic circumstances, while the economies of the deficit countries suffer in order to protect it at all costs.

Building on Mundell's thesis and the fact that national policy autonomy is absent in the Eurozone, we argue that for a single currency to function properly, some kind of hegemonic intervention is required to maintain exchange rate stability and free capital flows. In the EMU, the "tool" of monetary union worked well in the years following its inception, pushing down interest rates, stimulating free trade and growth. But, as a self-regulating tool, it eventually ran out of control, and deficit economies suffered increasingly high unemployment as they struggled to rein in spending in an effort to balance spending and trade, giving rise to domestic unrest and crisis. The European Central Bank (ECB) took measures to protect the monetary "tool," but not to protect the economies and societies of those using it. As we shall see below, the liquidity it provided was conditioned upon austerity at the insistence of Germany, its dominant contributor, and had perverse consequences for Europe's weaker periphery.

The Problem of Cooperation in the International System: Trade and Money

Stable open trade and monetary systems are dependent upon sustained cooperation among their members to keep their economies open. But achieving cooperation to increase wealth through free trade is difficult because all want its benefits while paying the least possible cost.[10] Or, they decide that although cooperation benefits the group as a whole, it does not promote their individual goals as well as their own unilateral action would. Cooperation is uncertain because

each is worried that others will not cooperate. In an anarchic world of sovereign states, members of a cooperative regime can leave any time for these reasons.[11]

Cooperation to achieve free trade provides a good example of the conundrum of international cooperation. Free trade generates more wealth for all than would be available without trade. Based on the theory of comparative advantage, members of a free trade regime specialize in producing goods which they can make most efficiently instead of focusing on the production of the goods that others can produce more efficiently and cheaply. But production of those goods at home disappears, causing unemployment—at least until the time that the economy adjusts, and it is unclear how long this will be or if the unemployed will find work in the more competitive sectors.

As the election of Donald Trump in the U.S. demonstrates, unemployment in noncompetitive industries can trigger political discontent. Governments often cannot wait for the shift toward competitive industries to materialize and are tempted to leave the international cooperative free trade effort in order to protect domestic jobs. In a world of globalization, in which employment uncertainty reigns, voters—particularly in uncompetitive sectors—seem to prefer this immediate protection to the economic competitiveness and future economic growth that free trade promises. Out of this political necessity, governments erect trade barriers which then reduce their trading partners' exports and weaken their economies as well. Historically, trading partners have retaliated, setting off a cascade of rising trade barriers and even trade wars. All are worse off when each country attempts to protect its (inefficient) industries as a free trade regime disintegrates. They become prisoners of their own defection, captured in a noncooperative equilibrium.

The same tension exists in a fixed exchange rate system or in a monetary union. States that trade with each other prefer stable exchange rates and, better yet, a common currency.[12] Under national currency systems, trade is slowed down because exchange rate stability is not assured. One partner in a business transaction will lose money if the currency of her trading partner depreciates or is devalued. The more a currency's value fluctuates, the more likely that this loss will occur. This instability makes traders more hesitant to conduct business. Recalling Mundell's thesis, exchange rates will fluctuate when governments seek freedom to manipulate their nation's currency value to meet national political goals. For example, states that experience rising unemployment are tempted to pursue policies that devalue their national currency in order to

stimulate exports and create jobs. This tempts trading partners to do the same. Currency devaluations can set off a chain reaction that can destroy trade.

A single currency used by all traders significantly lowers the cost and uncertainty of doing business for all. There are no national currencies to manipulate. The single currency's value is the same for all trading partners, and markets deepen and grow, making all better off in the long run. In the short run, however, a system of free trade bolstered by monetary union still creates winners and losers even as it creates aggregate growth. Members would still be tempted to leave the union to protect their own economies if they perceive that protecting the value of the common currency endangers political stability.

Ultimately the problem of cooperation to achieve free trade and exchange rate stability through fixed exchange rates or monetary union is this: there will always be a temporal contradiction between the requirements of a liberal trade and exchange rate regime and the requirements for national autonomy to pursue policies that shore up political stability. In the market, individuals and firms are free to fail, and the inefficient must fail for the sake of growth and prosperity for all. The basic anarchy of the market mechanism acting on its own—like the tools of the Sorcerer's Apprentice—produces instabilities in the lives of individuals and whole societies.[13] Governments topple when society is unstable; they therefore act to protect their societies from economic threats by withdrawing from a self-regulating free trade or exchange rate regime.

Achieving and Maintaining Stability: Institutions and Liberal Hegemony

If institutions are inadequate, how can states cooperate to maintain stable trade and monetary systems in which defection is minimized? Multilateral institutions such as the EU and the EMU were fashioned to do just that. Members make promises via a treaty (the EU) and, in protocols annexed to the treaty and promises to meet the criteria for convergence (EMU). Cooperation would be ensured by treaty and coordinated by an institutional structure. Indeed, creating and maintaining cooperation within a free trade regime is the EU's primary raison d'être. Most of its budget is devoted to shoring up and administering the free trade regime. From the outset, the European Communities built a regulatory structure to reduce transaction costs in a single market; members agreed to submit to those regulations to bring about the benefits of free trade. But, aware of the contradiction between a free trade system and domestic political stability in member states, leaders of European integration also provided incentives for cooperation to keep trade

open when members might be tempted to defect and close off their economies. The EU created "cohesion" funds to subsidize and thus protect less competitive sectors and stimulate poorer regional economies. The composite effect of these expenditures was to create a regime within which both equal standards and subsidies to prevent defection would allow for a cooperative free trade regime.

The question of whether a single market needs a monetary union remains unsettled in the literature. Free trade areas and customs unions can survive without a single currency (until now NAFTA functions in an area with three currencies), but there is general agreement that a single market provides a strong incentive for a monetary union.[14] To accomplish this, EMU members promised to give up monetary and fiscal policy autonomy, keep their inflation rates low, and keep budget deficits and debt within strict limits. The entrenched belief was that if all members would "self-regulate," a self-regulating monetary union would emerge. Extending Mundell's thesis, EMU required participants to give up policy autonomy for the sake of a single currency and free capital flows. Unlike with the subsidy provisions the EU provided to bolster competitiveness in weak countries, however, there were no provisions to offer weak members financial stimulus to make their goods more competitive. If unemployment rose because of flagging exports, the weak would be forced to deflate their economies and reduce public spending in the hope of distant economic growth. EMU required weaker members of the periphery to pursue the same fiscal policies as stronger members of the core and made no provisions to provide countercyclical lending. If any member did not stay within the strict limits on inflation, debt, and deficits, it would be punished. The ECB would not be a lender of last resort. EMU made no provisions for stronger members to take in the weaker countries' distress goods to stimulate their exports. But, as the cases of the Gold Standard and Bretton Woods strongly suggest, intervention to aid weaker currencies was required to prevent their defection. The EMU, as it was originally conceived, provided for no such mechanisms for intervention on behalf of Europe's weaker countries. At Germany's insistence, members that face trade and budget deficits are forced to take "austerity measures," e.g., deflate their economies, lay off workers, and reduce pensions and incomes in order to rein in inflation and imports. This hurts all trading partners. A treaty commitment to remain in the union is simply not enough to prevent defection. Austerity measures which put the burden of cooperation on weaker deficit countries tempt those countries to leave the union.

Germany and France's breaches of the EMU's Stability and Growth Pact in 2003, the rejection of an EU Constitution in 2005, the Euro Crisis of 2010, the de facto rejection of a common refugee resettlement policy in 2015, and Brexit in 2016 illustrate that these incentives and treaty promises are not enough to sustain cooperation. The EU is not a sovereign authority over its members. Rebates, subsidies, promises, and punishments are not always adequate instruments prevent defection. Defection is costly, but members can leave. While the EU represents a multilevel system of governance in which members have ceded aspects of sovereignty to Brussels, member governments have ultimate authority over their economies, and they are free to take their sovereignty back—most often by simply cheating and ignoring EU Directives.[15] It is common for cheaters and delinquents to be fined and just as common for them to ignore the fines. The EU does not represent the aggregate will of a European people or majority.[16] Although it is attempting to build a common cultural foundation for its authority,[17] as yet it has no shared language, no shared traditions and symbols, no shared religion, no shared sense of political identity and culture upon which a federal or confederal system of unified governance can be built.[18] As Robert Schütze, aptly notes, whenever "the sovereignty question is posed, European statist tradition returns from the depths of a subconscious past."[19] Even though the literature on this topic is vast and debate continues to rage,[20] we base our argument here on the assumption that the EU is ultimately an "association of compound states."[21] All members indeed contribute, but it needs a hegemonic leader to back up its programs to assist less competitive members with disproportionate resources. Of course, Germany has made disproportionate contributions but they have not always been sufficient, and Germany, like others, has "cheated" on the rules.

If treaties and multilateral institutions are inadequate, how does an "association of compound states" achieve stable cooperation? Mancur Olson—looking at labor unions—argued that it could only be achieved if a cooperative system had a hegemonic leader. Applying his argument to international relations, hegemonic stability theory argues that these leaders possess the requisite economic size and political power to soften the contradictions that liberal markets and fixed exchange rate regimes impose. More generally, a hegemonic leader can alleviate tensions of cooperation by providing the bulk of a collective good, i.e., liquidity and/or a large, open domestic market, thereby increasing the incentive of those who share in the consumption of that good to cooperate. The inductive theory of hegemonic stability please delete this footnote was constructed from the observation that when there is a dominant state in an open international

economy—Britain in the late nineteenth century and the United States in the middle of the twentieth—there was a high degree of cooperation to achieve openness in trade and foreign exchange policies.[22] In both cases, the absence of hegemonic intervention was devastating: the breakdown of the Gold Standard led to trade wars and the breakdown of the Gold Exchange Standard precipitated frequent banking crises.[23]

Our definition of a hegemonic leader is the standard one first introduced by Charles Kindleberger, and elaborated by Robert Gilpin, Robert Keohane, Barry Eichengreen, and others in Kindleberger's tradition (i.e., Stephen Krasner and Duncan Snidal): a hegemonic leader is the state powerful enough to pay the costs required for cooperation and the state most instrumental in shaping the roles of cooperative institutions that can prevent defection from cooperation.[24] Kindleberger claimed that in order to remove the temptation to defect from a free trade regime, the hegemonic leader must provide five incentives: 1) a stable exchange rate (to provide certainty in cross-border trade); 2) a market for distress goods (goods that cannot find a buyer, thereby stimulating the potential defector's economy and creating employment); 3) countercyclical long-term lending (to balance deficits and possibly create jobs); 4) macroeconomic policy coordination (to maintain sustainable government debt and build institutional arrangements that allow the correction of emerging imbalances), and; 5) real lending of last resort during financial crises. The hegemon might need to run a trade deficit with the crisis country to stimulate its exports; it would need extensive capital for countercyclical and last-resort lending. Finally, it would need to provide these incentives in order to gain agreement from other members of the union for the creation of stable institutions for policy coordination. In a monetary union, a hegemon will underwrite cooperation in the ways outlined above because the stable currency that cooperation offers will work to its benefit, promoting exports, creating certainty in good times and preventing competitive devaluations in bad ones.

Although Kindleberger insisted that a single hegemonic power was necessary for cooperation in an open international economy, it is now commonplace to note that the hegemon in a cooperative regime does not lead alone. Indeed, leaders have never had such a preponderance of power that they could provide the all resources needed for stability.[25] Furthermore, they can lead within multilateral institutions by providing them with adequate disproportionate resources. In fact, it would not be a good idea to provide all of the necessary resources. Kindleberger also suggests that shared leadership adds legitimacy and reduces the danger that leadership will be

regarded as a cloak for domination.[26] Shared leadership reduces the liberal hegemon's temptation of to bully. Certainly, cooperation among liberal democratic states requires leadership within institutions in which all members have a say. In a regional discriminatory regime, like the European Union, it would be politically impossible for a single state to play the role of the hegemon. A state with a disproportionate share of power must necessarily be "embedded" within a thick institutional framework that would provide for shared leadership and a cover for hegemony.

Not altruism, but rather the provision of an adequate disproportionate share of resources to underwrite cooperation characterizes hegemonic leadership. Like other members of cooperative arrangements, hegemons gain the intangible benefits of stability, while also garnering reputational benefits and influence as a result of taking on the largest burden. But, they also gain tangible benefits. In a free trade regime, for example, although in theory open markets benefit all, they benefit the strongest economy the most; its exports are the most competitive and it provides the most lucrative employment market.

As an institution, the EU currently lacks the ability to provide these resources to the monetary union,[27] and the ECB is currently unable to be a "lender of last resort." National governments in the Eurozone issue debt in a currency that they do not control, different government bonds in member countries have different risks, returns, and degrees of liquidity, and there is as yet no guarantee that there will always be enough cash available to pay out the bondholders. Sovereign bond markets in the EMU are therefore susceptible to contagion which can snowball into a liquidity crisis.[28] More importantly, EMU members are still separate states with their own interests and have evidenced little solidarity. They are not willing to create Eurobonds; nor are they willing to become a viable transfer union.[29] Without a liberal hegemon, EMU will always be susceptible to the "Sorcerer's Apprentice effect."

German Leadership in Europe? The Case of European Monetary Cooperation

If, first, the contradictions between the insecurity of the market and the requirement for political stability raise the incentives for defection of weak countries from a fixed exchange rate regime or a monetary union; if, second, treaties and institutions are not adequate to assure cooperation in those regimes, and; if, third, the intervention of the most powerful state in the regime is required to provide incentives to those who suffer from market instability to remain in the regime, then

we believe that Germany must play the role of the liberal hegemon in the EMU. It is the only state in the EMU that has the capability and the potential will to do so because Germany is the preponderant economic power in Europe. We do not wish to argue that its regional power resources are commensurate with those of Britain in the nineteenth or the United States in the twentieth centuries. Our argument concerns regional—not global—cooperation: Germany is Europe's largest and the world's fourth largest economy. Its reserves are enormous. Its disproportionate resources allow it to play the role that Kindleberger ascribed to an economic hegemon in a fixed exchange rate regime. They also allow it to play that role in EMU if it is willing to provide the kind of leadership required by Kindleberger's analysis. Historically, however, the force of its ideology of price stability[30] and its unwillingness to provide a market for "distress goods" because of its own domestic austerity policies has reduced its willingness to fully play this role.

By dint of its disproportionate economic strength and growing political power since unification, Germany's actual or potential "hegemonic" role in Europe and in monetary cooperation has been addressed and debated by a number of scholars.[31] We suggest here that Germany has the capability but not the willingness to play Kindleberger's role of a responsible hegemonic leader. We could describe Germany's positive role as one of "soft leadership" in that it is deeply embedded in the institutions of the EU, it is shared, and, in many cases, Germany leads by example, often making domestic sacrifices to ease the burden of cooperation on others.

German "Soft Leadership" in Europe

A few examples illustrate Germany's "soft leadership" in the EU. In contrast to all other member states, it is the largest both absolute and net contributor to the EU budget, consistently paying in more than twice as much as it receives.[32] In order to stem the tide of weapons proliferation Germany contributes disproportionately to the EU's nonproliferation export control efforts, imposing more stringent restrictions on its own high technology exporters than other members.[33] Being by far the largest of the environmentally progressive countries in the EU, it is the most important of the three leaders in EU environmental policymaking, leading by example by imposing at the outset more stringent regulations on its own industry than other EU members were required to do.[34] When the EU imposed sanctions on Russia in 2014 as a response to the Ukraine crisis, Germany once again led its European partners by example, Defying powerful

domestic exporters, Merkel put up the highest stakes when she crafted the EU sanctions regime. Because Germany's trade with Russia was the largest in the EU, German business had the most to lose if Russia retaliated.[35] EU members agreed to cooperate. When the influx of refugees became a "crisis" for Europe in 2015-2016, Germany took in the majority of refugees that fled to Europe from the Middle East. On this issue, however, Germany failed to persuade all EU members to cooperate in refugee resettlement.

Domestic politics and ideology have long prevented Germany from fully taking on the mantle of a liberal hegemon in the European economy. Its ideology of ordoliberalism is the ideology of wage suppression and austerity.[36] By virtue of its power position, Germany has forced that ideology onto the periphery of the Eurozone and its domestic policies contributed to the crisis in the first place. It is to this story that we now turn.

German Leadership (and Lack Thereof) in European Monetary Cooperation

The history of monetary union in Europe provides a good case study of Germany's role and the role that cooperative institutions (the role of burden sharing and institutional provision of incentives for cooperation) played in in creating stable cooperation. It also underlines the requirement for Germany to expend more resources to aid cooperation. Our assessment of Germany's role is organized according to Kindleberger's five criteria for stability discussed above. Using these indicators, we examine why the European Monetary System (EMS) was not deemed adequate to provide stability and why it was scrapped.[37] We then turn to EMU to assess the causes of instability and whether future stability can be assured.

The Snake

The blueprint for European Monetary Union was a 1969 agreement (the "Werner Plan") that was shelved at the outset because of disagreements over how the burden of cooperation should be shared—whether surplus (France's position) or deficit (Germany's position) countries should bear the lion's share of the burden.[38] A stalemate between the two countries led Germany to introduce a substitute, called the "snake," which was intended to provide exchange rate stability by lining up European currencies in "bands" allowing for upper and lower limits of currency value. In the postwar years, a recovering Germany was not able to play the role of an importer of "distress goods," but it imported roughly as much as it exported with no

significant surplus. It also was both unwilling and unable to meet Kindleberger's additional criteria for leadership. Snake members agreed to joint intervention in exchange rate markets to keep member currencies within the band, buying up currencies that were dropping in value, and selling those that were appreciating. The burden was to be equally shared among all of those who participated in the "snake."

In actuality, they did not have the resources to do so. The snake was launched during the first oil crisis, the breakdown of the Gold Exchange Standard, and a period of high global inflation. Currency values were falling, liquidity was in short supply, and interventions were few. Germany's Bundesbank alone intervened to stabilize the exchange rates of weaker currencies, but those interventions as well were insufficient to prevent defection from cooperation.[39] This meant that deficit countries would have to deflate their economies—Germany's preference—and/or leave the band altogether. Of course, they left rather than deflate. By 1974, the "snake" had failed, but Germany's de facto dominance was unmasked: Denmark, the Benelux countries, France, Austria, Norway, and Sweden pegged the value of their currencies to the deutschmark, creating a zone of exchange-rate stability. They purchased their own and each other's' currencies to stabilize them. Nevertheless, the peg to the deutschmark also meant that in order to maintain the value of their currency, members would have to adhere to German preferences for the coordination of macroeconomic policies through belt tightening if necessary in order to maintain price stability.

Germany's ordoliberal ideology of keeping inflation down through belt tightening prevailed, because the deutschmark was the strongest currency in Europe and Germany's economy was rapidly becoming the strongest. Kathleen McNamara argues that Germany's preference was clearly influential during this period, but contends that a general preference for price stability was part of a neoliberal consensus that was beginning to emerge at that time.[40] The evidence suggests, however, that Germany forced its ordoliberal preference on others: it was the German Bundesbank and the strength of the deutschmark that constrained the preferences of its European partners; in negotiations over the creation of the EMS, the Bundesbank even issued threats to those who did not meet its demands for belt-tightening.[41]

The European Monetary System (EMS)

Negotiations to create EMS began when German Chancellor Helmut Schmidt launched a multilateral initiative in 1978 to create a new set of common "bands," and a new set of rules that would be embedded in a new EMS institution. Like the rules of the deutschmark zone, the rules of the EMS conformed to German ordoliberal preferences: exchange rate stability would be backed by increased macroeconomic policy harmonization according to the Bundesbank's anti-inflationary standards.[42] But, the EMS was also backed by two "safety nets" for those with weakening currencies: liquidity and intervention. Though the EMS was supposed to provide those safety nets, analogous to the postwar IMF, they proved to be inadequate. Liquidity instead was provided by the German Bundesbank. After 1987, the Bundesbank agreed to intervene in defense of stable exchange rates to the extent that the defense did not endanger price stability.

Over the 1980s, German exports grew to exceed imports and domestic investment began to decline. Germany thus became the major net creditor to Europe and a major creditor to the rest of the world,[43] paving the way for the deutschmark to provide a central source of liquidity for the EMS system. Throughout the decade, the Bundesbank bought falling currencies and lowered the discount rate to provide countercyclical lending. With Germany providing the resources, coordinating decisions on adjustment, providing liquidity, and intervening in crisis, the EMS proved to be remarkably successful in stabilizing exchange rates. With its success, German monetary hegemony grew and stable exchange rates benefitted German exporters in turn. At the same time, however, Germany ran a current account surplus, a de facto blocking of imports from less competitive countries.

The single market could not ensure continued economic growth, particularly because the dollar devaluation after 1985 made European exports to the world relatively more expensive. Despite the liquidity that Germany provided, and the currency interventions and discounts that did occur, they proved to be inadequate, especially because deficit countries began to import more German products and began to borrow from Germany to pay for them. European exports slowed, unemployment in deficit countries grew, and economic growth was reduced to a snail's pace. As the situation in the deficit countries worsened, Germany proved unwilling to take in their distress goods or provide them with adequate loans. German officials believed that increasing liquidity in a recessionary period would put inflationary pressure on the system. The dire situation was exacerbated because the currencies of EMS deficit and surplus countries were

interlocked; economic fluctuations between them were reflected directly in rising unemployment and cuts in the deficit members' spending rather than in depreciation in value of their currencies. Many analysts attributed the worsening situation to the deflationary bias of the German-dominated EMS. Although participants benefitted from the credibility that the DM "anchor" had given their currencies, deflationary pressures and the pressure on exports rendered adherence to EMS rules increasingly painful for deficit countries, while Germany continued to accumulate a surplus in intraregional trade. As Kindleberger's argument would predict, without adequate liquidity and a willingness to import distress goods, cracks began appearing in EMS cohesion, as members were tempted to set their own economic policies to alleviate the budget stresses of trade deficits. The EMS as an institution made no provision for deficit countries to tighten their belts in order to bring trade into balance. Although Germany took on the task of providing stable exchange rates, it was unwilling to undertake the task of stabilizing the system through providing deficit countries with adequate liquidity. German leaders began therefore to prefer a tighter monetary union that would require deficit countries to deflate their economies if they participated in the union.

European Monetary Union (EMU)

For their part, deficit countries were demanding more "voice" in decisions on monetary cooperation in Europe. Certainly, not wanting to engage in deflationary policies, most EMS members believed correctly that monetary union would reduce interest rates—achieved by collectivizing risk—making it cheaper for them to borrow in order to fund national budgets that fell into deficit and prime the employment market lost through the failure of uncompetitive businesses. The loss of national monetary policy and debt and inflation limits required by the union became secondary concerns compared to these benefits, so agreement among both surplus and deficit countries on the benefits set the stage for monetary union.

In 1988, France and Italy took the initiative that led to EMU and the creation of a European Central Bank. This bank would allow the deficit countries to have a voice in the development of EU exchange rate policy. Indeed, Germany quickly came on board in order to shape the new system, demanding an independent central bank dedicated to price stability, constraints on members' deficits and inflation, and tight sanctions on "defectors." In the end, deficit countries may have achieved a voice, but it was a weak one, and EMU constrained their behavior. EMU's

core rules were not subject to a vote, and those rules were constructed according to German policy preferences. Gone were the "safety nets" of the EMS. Germany required a deliberate process of economic convergence among EMU members according to specified "convergence criteria." Indeed, Germany would not agree to a date for the final stage of monetary union until others agreed that those criteria must be met before a potential entrant could join the Eurozone.[44]

The "convergence criteria" for EMU membership represented a German effort to achieve a common fiscal policy that enshrined price stability, wresting some control over national budgets from member governments in order to achieve "burden-sharing" on the part of deficit countries. The criteria established common rules to ensure that members who made painful economic reforms would not face higher interest rates caused by countries that did not make the same reforms. The rules defined 3 percent of GDP as the upper limit for public deficits and 60 percent of GDP as the upper limit for public debts. Members also promised to maintain an inflation rate not more than 1.5 percent above the rate of the three members with the lowest inflation rates. In 1996, the convergence criteria were strengthened when Germany insisted on a Stability and Growth Pact (SGP) that created sanctions for defection. Any country breaching criteria for three consecutive years was subject to fines that could run to billions of euros. And of course, the European Central Bank as the guardian of price stability was not permitted to provide countercyclical loans or be a lender of last resort for members breaching the criteria.

Without loans and currency interventions, countries and regions feeling recessionary pressures had a smaller toolkit for reviving their economies than they had under EMS. National control of interest rates had come to an end. Hamstrung by wage and labor inflexibility, European governments would normally use fiscal policy to carry much of the load of cushioning recessions, but fiscal policy had become severely circumscribed. Despite the arguments of many economists that it made no sense to force countries in recession to cut public spending, Eurozone members were not allowed to expand budget deficits beyond the 3 percent of GDP required by the convergence criteria.

Germany's insistence on these measures was its way of diffusing the burden of adhering to a currency union. In doing so, however, Germany relinquished a key function of "soft" hegemonic leadership that it had provided under the "snake" and the EMS; neither Germany nor the ECB would provide loans or intervene in any other way to reduce recessionary pressures on members'

economies. The strong German economy did provide one important component of Kindleberger's requirement for hegemonic stability: a stable currency.

But something was about to shift. Beginning in 1996, Germany fell into a sustained period of low growth and mounting fiscal burdens as unemployment skyrocketed, the population aged, and healthcare obligations mounted. In order to ease the fiscal burden, the German government could have borrowed from within the EU capital market, (to which they were the largest contributor), but borrowing would have raised interest rates across the EMU region, further contributing to deflationary pressures. Until 2000, Germany had experienced a trade deficit and because of a building boom in its new eastern states, it provided a market for its trading partners' goods. Germany attempted to adhere to the SGP, cutting government spending to meet the requirements, and shoving the economy into deeper economic crisis. By 2003, it had violated the pact and refused to pay the fine for doing so, following Portugal and paving the way for France to break the pact as well. Germany flouted the SGP for four years, and in doing so, weakened the very regime that it had created. It would now be difficult to ask other Eurozone members with chronic deficits to curb their borrowing and spending.

Germany's domestic policies, grounded in its longstanding ordoliberal ideology, helped to turn this situation around but also helped to contribute to the impending crisis.[45] In 2003, the Harz IV reforms begin restrain wage growth and household consumption as a share of GDP, which increased the savings rate and the export of credit (surplus savings). While domestic investment stagnated, surplus savings were exported as loans to Europe's periphery, which used them to import German goods, leading to lower unemployment in Germany and a growing current account surplus. With excess savings, low wages, and stagnant domestic investment, German banks expanded their procyclical lending. During the economic boom of 2003-2008, Germany extended credit on a massive scale to the Eurozone's Mediterranean countries.[46] With that credit, they imported German products while Germany bought little from them. Between 2000 and 2007, Greece's annual trade deficit with Germany grew from 3 billion euros to 5.5 billion, Italy's doubled, Spain's almost tripled, and Portugal's quadrupled. In Germany, consumption of imports dropped, and the savings rate increased.[47] But, as the financial crisis escalated in 2009, lending abruptly stopped, and Germany had thus failed two tests of a hegemonic leader: providing countercyclical lending and providing a market for distress goods.[48]

As Europe's main exporter Germany was the chief beneficiary of the lower transaction costs that the euro introduced. Because the value of the euro was far below what the value of the deutschmark would have been, exported products benefit from competitive advantages. In 2014, for example, the IMF estimated that Germany's inflation-adjusted exchange rate was undervalued by 5-15 percent.[49] So, rather than providing a market for their trading partners' goods, Germany began to accumulate a huge trade surplus with the rest of the EU. Indeed, German exports increased four-fold from 2002 to 2010. In 2012, its share of the wealth created by the euro was almost half the EU total.[50] This contributed to German dominance and its insistence of policies based on its ordoliberal ideology. It did nothing, however, to spur Germany into taking on the role of a liberal hegemon.

The European Financial Crisis: The Need for Hegemonic Leadership

Kindleberger's argument was that cooperation for exchange rate stability—and by extension, monetary union—will disintegrate without hegemonic leadership in the form of a market for distress goods and adequate aid to deficit countries. While Germany's large financial reserves and lending ability gave it considerable political clout in the Eurozone, Germany had no intention of providing a market for the distress goods of the periphery. Private banks were the lenders, and the EMU initially had no provisions to aid deficit countries. Between 2003 and 2009, it appeared that the Sorcerer's Apprentice had created a mechanism for stability that would work on its own, and aid was not needed. As expected, the pooling of risk in the Eurozone kept interest rates low, and along with Germany's liberal financing, allowed the countries of the periphery to expand trade deficits to buy German exports.

But, low interest rates were a temporary privilege, given the growing imbalances between the Eurozone core and periphery. In 2009, five members of the Eurozone periphery– Greece, Portugal, Ireland, Italy, and Spain—had failed to generate enough economic growth to pay back their debts. Investors were exposed and the threat of bank failures loomed. When the 2008 U.S. financial crisis hit Europe, a lender of last resort was nowhere to be found.

European leaders held a series of panicky meetings in spring 2010 to find such a lender. German Finance Minister Wolfgang Schäuble had apparently read his Kindleberger, and declared that the hegemonic stability thesis was more relevant than ever in Europe's current

situation. He suggested that Germany and France should revive their old alliance and together become the liberal hegemon of Europe—the hegemon that was missing in the 1930s.[51]

Yet, for the next three years, this was not to be. Briefly it appeared that Germany would back the ECB with funding as a lender of last resort, but its loans were inadequate to alleviate the crisis. Members pooled their resources to raise euro 500 billion in conditional loans, and for the first time, the ECB intervened in markets to buy debt. But, it was not enough, and the loans had the perverse effect of reducing bank exposure, and increasing the exposure of Greece's sovereign debt.[52] Because it provided the largest contribution (30 percent to France's 20 percent and Italy's 17 percent), German voters threatened a backlash. Chancellor Merkel insisted on a euro 250 billion IMF load to ensure that Europeans would not bail out Greece alone.

Soaring interest rates and slowing growth in Spain, Italy, Portugal, Ireland, and France triggered more concerted action within the Eurozone to create a lender of last resort. In late 2012, EMU members created the European Stability Mechanism (ESM), a treaty-based organization capitalized at euro 700 billion with a lending capacity of euro 500 billion. Because Germany's funds were indispensable in providing the bulk of ESM's capital, it retained veto power over its decisions. Fearing the potential moral hazard that would come with such lending,[53] Germany required borrowers to implement belt-tightening measures and join the "Fiscal Compact," a stricter replacement of the SGP. Financial markets deemed that none of these measures were sufficient, and so the crisis was only reigned in once the ECB president pledged to do "whatever it takes" to save the euro. (He did not pledge to save the economies of countries in distress.) Ultimately, this meant agreeing to purchase bonds and accepting them as underlying support for commercial banks from countries in distress that promised to meet Germany's conditions.

Germany's dominance and the dominance of its long-held ordoliberal convictions meant that austerity in the periphery became the condition for the core to provide bailout funds intended to save the euro. For the deficit countries, however, this meant deflation. So, without fulfilling the other criteria for leadership, namely stimulus from creditor countries to spur growth in weaker economies, Germany's insistence on austerity meant that the odds of weaker countries' defection from cooperation would increase.

Since 2011, the ECB has extended its authority to purchase sovereign debt, and to become a lender of last resort through the ESM, and to provide liquidity through its quantitative easing program beginning in 2015. The European Financial Stability Facility now joins the ESM as a

bail-out mechanism, and the ECB has begun to provide long-term loans to prevent private banks from collapse. By 2017, the ECB had added U.S. $2.3 trillion to its balance sheet.[54] The Fiscal Compact provided ECB oversight of individual country budgets and strengthened budget rules. With Germany's hesitant approval, the ECB created a "banking union" with plans for a common fund to aid failing banks and the transfer of bank supervision to the ECB. But it did not create a transfer union, i.e. a mechanism for transferring resources from rich to poor countries in crisis. Surplus countries were not required to make adjustments to reach macroeconomic equilibrium.

These new and expanded institutions still cannot respond adequately to economic downturns resulting from deflationary pressures. President Emmanuel Macron of France has argued that the monetary union needs to expand its budget to do so. That budget expansion, however, largely depends on Germany's willingness to provide the bulk of the required resources. But, Germany seems unwilling to bend—in fact, saving the currency union as a self-regulating edifice appears to be more important than helping struggling European economies in the periphery to create the economic conditions necessary for cooperation within that union.

Greece provides a potent example of how Germany and the EMU protected the currency at the expense of the periphery's economy and the welfare of its society in the absence of hegemonic intervention. Greece received three "bailouts" during the crisis, calming threats of defection ("Grexit") from the Eurozone. While Greece clung to the euro, unemployment increased to 28 percent and between 2008 and 2013, the Greek economy contracted by a quarter of its pre-crisis level. Despite optimistic reports from the government to the contrary, the Greek economy remained stagnant through 2016;[55] the debt-to-GDP ratio rose from 128 percent in 2010 to over 175 percent in mid 2017[56] with no debt relief in sight. In the first half of 2017, Greek household consumption continued to decline, and Eurostat reported in 2016 that 22 percent of Greece's population was "severely materially deprived." Forty percent of Greek children live below the poverty line.[57]

But, because the euro remains intact, optimism has shaped the official narrative of Eurozone recovery in 2017. According to the EMU framework, Greek debt is considered sustainable as long as the total cost of servicing it does not exceed 15 percent of annual GDP. Nonetheless, for Greek society, the burden of remaining in the Eurozone is dangerously high. The same is true for other European periphery countries; borrowing costs have fallen and growth has recovered, but unemployment and debt burdens remain high, and the banking system remains fragile.[58] The

stability of the currency continues to be preferred over the health of members' society and economy.

Conclusion: What Needs to be Done

Growing economic power has permitted various German governments to shape the terms of cooperation in the European Union. The cautionary tale told here suggests that cooperation among sovereign states in a monetary union can spiral out of control, like the broom in Goethe's "Sorcerer's Apprentice." By putting harsh burdens on the backs of weak countries that could not carry them, the 1919-1939 interwar period cruelly and painfully taught the world many lessons about how not to solve problems in periods of crisis. At least three of these lessons are important for our discussion of the role of hegemonic power in stabilizing the Eurozone. First, in order for all members of a free trade and fixed exchange rate regime to be prosperous, adjustment to macroeconomic disequilibrium needs to be undertaken by both "surplus" and "deficit" economies—not by "deficit" economies alone. Second, in order for crises to be successfully managed, the lender of last resort must truly be a lender of last resort: it must create whatever asset the market thinks is the safest in troubled economies, and must be able to do so in whatever quantity the market demands. Finally, in order for any monetary union or fixed exchange rate system to survive, it must be willing to undertake large-scale fiscal transfers to compensate for the absence of exchange rate movements. All three of these measures require liberal hegemonic leadership.

These measures rub against Germany's entrenched ordoliberal ideology, but Germany may play a more constructive hegemonic role in the future. In recent years, both German GDP and productivity growth has slowed, and the IMF predicts that by 2020 it will fall below the Eurozone average.[59] Germany's aging population means a shrinking labor pool, which suggests that in the absence of new immigrant labor, the economy will remain sluggish. It may also suggest that Germany will reduce its surpluses; it has already introduced a minimum wage, and its aging population should soon begin to draw down their savings. Surpluses have already fallen from a peak of 8.6 percent of economic output in 2015 and are expected to fall to 7.6 per cent of GDP in 2018.[60] This is good news for the weak economies of the Eurozone, but Germany will need to take further steps to lower its savings rate and increase its imports in order to help stimulate the economies of the periphery.

Germany's slow growth further suggests that German dominance over Eurozone rules may wane; a strong Germany is needed to enforce austerity as a condition for economic stimulus in the periphery; low interest rates in Europe mean less dependence on Germany, and Germany's slow growth can lead to a less "Germanic" policy ideology and continued ECB stimulus in the Eurozone as a whole.[61]

Germany still remains Europe's economic powerhouse with the potential to provide hegemonic leadership. The saga of Germany's role in European Monetary Union, however, is still unfolding. Ordoliberalism is an entrenched ideology, but economic conditions may push Germany to play the more constructive role of a liberal hegemon. We have argued here that leadership means not only shaping the terms of cooperation, but also using resources to stabilize the weakest members of the regime. Will Germany hear our cautionary tale, heed the lessons of history, and become the kind of leader that the EMU requires?

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