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Steinberg, Federico

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INTERNATIONAL MONETARY IMPLICATIONS OF A GERMANIZED EUROZONE

*IMPLICACIONES DE UNA EUROZONA ALEMANIZADA PARA EL SISTEMA
MONETARIO INTERNACIONAL*

Federico Steinberg

Real Instituto Elcano y Universidad Autónoma de Madrid
fsteinberg@rielcano.org; federico.steinberg@uam.es

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ABSTRACT

This paper explores the implications of the survival of the euro for the international monetary system (IMS). Since the outset of the euro zone (EZ) crisis, a new Berlin-Frankfurt axis is providing leadership in reforming the EZ's governance. But, in doing so, it is Germanizing EZ peripheral economies. If the process is successfully completed, the EZ would become a more powerful actor in the IMS and the euro would be more attractive for international investors. However, it is unclear if this stronger EZ would be a stabilizing or a destabilizing force for the IMS. On the one hand, a more "German" euro-zone could have a structural current account surplus, and that could be deflationary and problematic. On the other hand, this reborn EZ will be much more inclined to regulate financial markets (following the ordoliberal German tradition) and, to some extent, to manage exchange rates. Finally it is unclear to what extent the EZ would be willing to politically promote the international role of the euro.

Keywords: Monetary Union; Euro; Crisis; Exchange Rates; Reforms.

RESUMEN

Este artículo analiza las implicaciones para el Sistema Monetario Internacional (SMI) de una zona euro (ZE) alemanizada. Desde el principio de la crisis en la ZE, un nuevo eje Berlín-Frankfurt está liderando la reforma de la gobernanza de la ZE. Pero, al hacerlo, está alemanizando las economías de la periferia. Si este proceso se completa con éxito, la ZE se convertirá en un actor mucho más importante en el SMI y el euro será más atractivo para los inversores internacionales. Sin embargo, es incierto si esta ZE reforzada será un factor de estabilidad o de inestabilidad en el SMI. Por una parte, una zona euro alemanizada podría tener un superávit estructural por cuenta corriente, lo que tendría un problemático efecto deflacionario sobre la economía mundial. Por otra parte, esta nueva ZE será más proclive a regular los mercados financieros (siguiendo la tradición ordoliberal alemana) y, en cierta medida, a coordinar los tipos de cambio. Por último, no es posible anticipar en qué medida la ZE estaría dispuesta a promover políticamente el uso internacional del euro.

Palabras clave: Unión Monetaria; Euro; Crisis; Tipos de cambio; Reformas.

JEL Classification: F15, F36, F41, F51, F59.

INTERNATIONAL MONETARY IMPLICATIONS OF A GERMANIZED EUROZONE

1. INTRODUCTION¹

Both the Euro Zone (EZ) and the International Monetary System (IMS) are in transition. The EZ is undergoing a substantial internal reform to ensure its sustainability, a process that started at the beginning of the sovereign debt crisis in Greece in 2010. This reform, which is proceeding gradually, includes the creation of a banking union, a limited fiscal union, a new role for the European Central Bank (ECB), and some form of economic and political union (Pickford *et al.* 2014). The IMS is also facing the need to readjust to ensure that, in an increasingly multi polar world in which the United States (US) and the dollar are loosing economic influence and political legitimacy (Kirshner 2014); the system can function smoothly and facilitate liquidity, confidence and adjustment. This requires revising the functioning of the current unstable and dysfunctional flexible-dollar-standard, discussing the role of reserve assets, liquidity provisions and capital controls; reforming the International Monetary Fund's (IMF) internal governance, and designing new mechanisms to deal with global macroeconomic imbalances in order to ensure monetary stability.

Even though both processes run independently, they are closely interconnected because the EZ is, with the US and China, one of the three most influential actors of the IMS (it is the second largest economic bloc after the US, it issues the second most widely used reserve currency (the euro) and, when its member states coordinate their positions, it has the potential to dominate the decision making process at the IMF and the G20. Historically, however, the EZ has not played a preponderant role in international monetary and financial issues. It has left the leading role to the US. Since the breakdown of the Bretton Woods regime in the early 1970s until the creation of the euro in 1999, European Union (EU) countries felt unable to substantially shape the evolution of the IMS. Once the euro was launched, EZ countries gained autonomy in international monetary affairs, but not necessarily influence. This was due in part to the fact that the IMS was still dominated by the US and by an Anglo-Saxon approach to capitalism that was not dominant in continental Europe, and also to the fact that the EZ chose not to exercise monetary power at the

¹ I would like to thank Miguel Otero-Iglesias, Mattias Vermeiren and two anonymous referees for their comments and suggestions.

international level (in fact, EZ countries never gave the euro a single voice in the international arena (Meuier and McNamara 2003) and they never used the single currency as a geopolitical instrument (Cohen 2010)). Therefore, for decades, EZ countries have been punching below their weight in international monetary affairs. And none of them felt really uncomfortable with the *status quo* because their preferences and interests were, to a certain degree, compatible (albeit not coincident) with those of the US.

However, with the global financial crisis, the Great Recession and the subsequent EZ sovereign debt crisis, things are rapidly changing in Europe. And these changes might have profound implications for the functioning of the IMS. The EU, and especially the EZ, has embarked itself in a reform process to complete the ill-designed institutional architecture of the Economic and Monetary Union (EMU). A new Berlin-Frankfurt axis is leading the process (Steinberg and Molina 2012) in the creation of a banking union, a limited fiscal union, and some form of economic and political union, all of which are necessary conditions for the survival of the euro (Matthijs and Blyth 2015). However, at the same time, this new hegemonic leadership is forcing a germanization of all EZ peripheral economies (France included) as a prerequisite to granting them financial solidarity (Beck 2013, Marsh 2013). In fact, the EZ has never witnessed a process of coordinated fiscal adjustment and structural reforms as intense as the one that is happening in southern Europe since the beginning of the crisis in 2010. Moreover, the process is likely to continue and deepen as austerity and reforms are the bargaining chip used by Germany to accept some sort of a transfer union. So far, the EU has made substantial progress: it has created a European Monetary Fund (the European Stability Mechanism, ESM); it has reformed EZ fiscal and macroeconomic governance with the Fiscal Compact, the “Six Pack”, the “Two Pack”, and the European Semester; it has set the guidelines to increase competitiveness through the “Euro Plus Pact” and it has created the foundations of a Banking Union, with a single supervisory mechanism and a single resolution fund (Pickford *et al.* 2014). Finally, since September 2012, the ECB has publicly stated that it will act as a lender of last resort when needed to ensure the survival of the euro and to make sure the transmission mechanism of monetary policy functions correctly. Moreover, in early 2015, it launched an open-ended quantitative easing policy to prevent deflation.

The long term vision, as established by the so-called Four Presidents Report in 2012 and updated by the so-called Five Presidents Report² in 2015, presents a specific roadmap that, starting with the single financial supervisory, would end up with an institutional reform that opens the door for po-

² The Four Presidents are those of the European Council, the Commission, the Eurogroup and the ECB. The Fifth is the President of the European Parliament that joined his four colleagues in the 2015 Report. Both Reports are available at: www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134069.pdf and at http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf

litical union under a Treaty Change.³ The final goal of the process is two fold. First, to complete the institutional architecture of EMU, which was designed in Maastricht, in order to make it a viable monetary union despite not being an optimal currency area (OCA). Second, to allow EZ countries to regain part of the economic sovereignty that they lost to financial markets, thus making the European integration process more legitimate. As the ECB president Mario Draghi puts it:

“Countries with high debt and deficits should understand they have lost sovereignty a long time ago over their economic policies in a globalised world. Working together in a stability-oriented union actually means to regain sovereignty at a higher level (...) sharing common rules for them actually means to regain sovereignty in a shared way rather than pretending to have sovereignty they’ve lost a long time ago. That’s the point.” (FT, December 13, 2012)

The task will not be easy. Legitimizing the process of European monetary integration requires presenting European citizens with a credible narrative about why painful reforms are necessary. Moreover, it requires generating economic growth and jobs and reducing inequalities, something that, at the time of writing (July 2015), is far from happening. This paper, however, will not discuss this issue. It will assume, based on a number of qualified opinions (Bergsten 2012, Bergsten and Kirkegaard, INET 2012, Cohen 2012, Pickford *et al.* 2015) that the euro is too big to fail. This means that, difficult as it may seem, the reform process will move forward allowing the euro to survive and, in doing so, the EZ’s fiscal, economic and political institutions will strengthen. This will clearly make the euro more attractive for international investors because it will no longer be perceived as an orphan currency. However, as we will discuss in detail, the stronger and reborn euro will largely reflect German preferences. And this will have profound implications for the IMS.

This is precisely what this paper explores. It argues that, for the first time in the history of European integration, German economic and geopolitical preferences will dominate the EZ’s (and most likely the EU’s) foreign economic policies. And this change will present substantial challenges to the current IMS, which since the late 1970s has been largely dominated by an Anglo-Saxon approach to capitalism which is not fully shared by economic and political elites in continental Europe. While it is unlikely that this new situation will trigger big conflicts in the IMS, tensions are likely to arise in the areas where German (and to a less extent French) ideas differ most from liberal Anglo-Saxon views: exchange rate coordination, macroeconomic adjustment, and financial market regulation. Conversely, a reborn euro might facilitate the governance reform of the IMF because (limited) political union might lead to the consolidation of a single external voice for the euro, which could lead to a single representation for EZ countries at IMF, and also at the G20.

³ For a debate on the problems of this process, especially with the issue of political union see Dullien and Torreblanca (2012).

In order to understand how this process might have come about, we will first analyze how the crisis has shifted the balance of power in the EZ from debtor to creditor countries, disproportionately increasing Germany's relative influence within Europe. We will argue that Germany has become a regional hegemon, capable of exercising more "structural" power than any other country in the history of the EU (Kundnani 2015). However, Germany does not feel comfortable with this new scenario and it is not willing to provide some of the public goods that the EZ requires (Beck 2013). Second, we will explore what Germany is trying to do with this newly acquired power. In particular, we will analyze how it is taking advantage of its privileged position not only to obtain short-term economic and financial benefits, but also to push for reforms that will incorporate specific features of the German ordoliberal model of capitalism (Bonefeld 2012) in other EZ countries. The core of the paper will be dedicated to speculate about how this new EZ could try to shape the reform of the IMS.

We will argue that if the euro survives its international use will grow, but that Germany (and thus the EZ) will be reluctant to exercise leadership in the IMS or to take full advantage of the monetary power associated to issuing a leading reserve currency. This is due to the fact that a Germanized EZ might adopt a geo-economic and neo-mercantilist economic strategy based primarily on export-led growth, which might not be compatible with the high levels of exchange rate volatility associated with issuing the dominant international reserve currency.

In addition, and connected to the previous point, due to the structural reforms in southern Europe, the EZ could have a structural current account surplus. This would exacerbate the problem of global macroeconomic imbalances and create deflationary pressures in the world economy, thus putting more pressure on the US, which will remain the main consumer of last resort unless China dramatically increases its internal demand. Should this happen, the classical political economy question "who adjusts?" could cause tensions in the IMS.

Finally, the EZ could be much more inclined than in the past to intervene in international foreign exchange and financial markets according to the ordoliberal model of capitalism prevailing in Germany, which exhibits features of a coordinated market economy substantially different from the Anglo-Saxon liberal market economic model (Bonefeld 2012, Duillen and Guerot 2012). This could mean that the EZ could be inclined to manage exchange rates (a goal shared by China and other emerging markets but not by the US or the UK) and to strongly regulate international financial markets, even promoting the establishment of an international financial transaction tax.

In sum, a reborn EZ will have more international monetary power, but it is unclear if it will be a stabilizing or a destabilizing force for the IMS.

2. A NEW UNION OF CREDITORS AND DEBTORS

For half a century, the EU has been a political project underpinned by solidarity and confidence. Rich northern countries were willing to show a remarkable level of solidarity with their less well-off southern neighbors in a combination of perceived self-interest and trust in them. Peripheral countries that had emerged from authoritarian regimes used their EU membership to consolidate their democracies and promote economic growth. This, in turn, gave rise to large and stable markets for the core-countries' exports. It was a win-win situation. Northern solidarity paid off because the countries in the south generally behaved as expected. It was an EU dominated by a balanced Franco-German axis. There was no hegemonic power, but a division of labor in which France's strategic vision and Germany's economic power were compatible and facilitated progress towards deeper integration.

However, the EZ debt crisis has dramatically changed the nature of European integration. The combination of poor financial regulation and an incomplete design of the euro have led EMU to the brink of collapse, forcing the EZ to move forwards decisively in order to avoid catastrophe (Pisani-Ferry 2014). However, the institutional changes that the EZ has been implementing since 2010 to convince the markets that the euro is an irreversible project do not have the same underlying logic as in previous steps towards integration. Northern creditor countries, led by Germany, have increased their bargaining power *vis a vis* southern countries, creating a new decision-making process in Europe in which creditors set the rules and debtors have little option but to follow what the north dictates (Matthijs and Blyth 2015, Thompson 2013, Wolf 2014). They have become 'decision takers'. In fact, the 'community method' has been weakened and a new asymmetric intergovernmentalism has emerged, in which a hegemonic Germany sets the direction, timing, speed and scope of reforms with little or no counterweights (Steinberg and Molina 2012).

This can be seen in the negotiations on the Germany-sponsored Fiscal Compact (which constitutionalizes the German debt brake and reduces the scope for fiscal discretion), the banking union (in which a limited common fiscal backstop will only be implemented after 2020 and in which there is no common insurance deposit guarantee system (Howarth and Quaglia 2013), essentially reflecting German interests), the ESFS/ESM (which is arguably too small and too inflexible, again reflecting Germany's goal of providing only the minimum level of solidarity required to avoid a EZ collapse) and the "Six pack" and "Two pack" negotiations, in which, for instance, Germany has dictated that the macroeconomic imbalances procedure will not be symmetric (i.e., large current account deficits are considered to be 'more dangerous' than large current account surpluses (Moschella 2014)).

Similarly, Germany has so far kept out of the negotiating agenda proposals which would have satisfied the preferences of the Mediterranean countries (France included), such as a partial mutualization of debt (in the form of Eurobonds or a Redemption Fund), a EZ fiscal capacity to deal with asymmetric

shocks or a strategy to smoothly absorb with legacy assets in the financial system (only in 2015, when the Juncker Commission took office, it did accept the launch of a limited pan-European Investment Plan, the so-called Juncker Plan).

Finally, the ECB's reluctance to intervene on a continuous basis in the debt markets to reduce financing costs for the EZ's periphery (at least until September 2012 when it launched its OMT programme) has forced these countries to adopt austerity measures and implement structural reforms in order to be able to raise money in the international markets (De Grauwe 2011). In fact, the EZ has never witnessed a process of coordinated fiscal adjustment and structural reforms as intense as the one that is currently taking place in southern Europe since the beginning of the crisis in 2010. And the process is likely to continue and deepen as austerity and reforms are the bargaining chip used by Germany to accept some sort of a transfer union in the long run.

In sum, the old Franco-German axis has been replaced by a Berlin-Frankfurt axis, which is Germanizing the south's economies through austerity and structural reforms and, at the same time, is creating a new governance framework for the EZ, which is essentially an extension of the German view of capitalism (Wolf 2014). This is not the first time that Germany has tried this. As Marsh (2009) or Pisani Ferry (2014) show, the creation of the euro itself had as one of its indirect goals to promote supply-side structural reforms in southern Europe. By eliminating the possibility of devaluing their currencies to solve competitiveness and growth problems, countries will have more incentives to reform their labor and products markets and to improve their education systems. Unfortunately, as Fernández-Villaverde, Garicano, and Santos (2013) demonstrate, the opposite occurred. Peripheral countries experienced an investment boom that created exactly the wrong incentives for reforms.

To underpin, justify and legitimize its actions, Germany has created a narrative of the crisis according to which the EZ's problems are mainly the result of profligacy and competitiveness losses in the south, not of an ill-designed EZ or the global financial crisis. According to this diagnosis, the solution to the crisis, given that it is too risky for the EU to break the euro and too costly for Germany to exit, is to force southern European economies to adopt certain features of the German socio-economic model (Bonatti and Fracasso, 2013) (and to provide them with limited assistance in cases of market turmoil). In particular, Germany's own reforms in the 2000s, which made its economy more flexible and competitive, appear, combined with austerity, as the blue print for the reforms in the south (Wolf 2014).

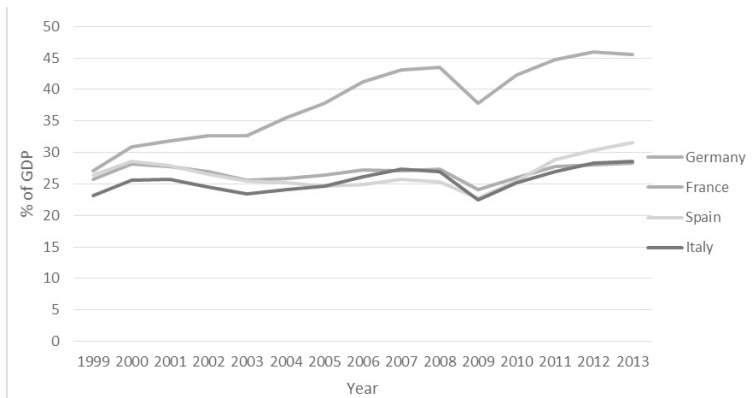
Therefore, not only is Germany more powerful in relational terms than any other country has been in Europe since World War II, it is also acquiring structural power, as defined by Strange (1988), by diffusing its own ideas about what is the best strategy to exit the crisis.⁴ So far, it has not completely suc-

⁴ "Structural power in short confers the power to decide how things shall be done, the power to shape frameworks within which states relate to each other, relate to people, or relate to corporate enterprises" (Strange 1988).

ceeded. Alternative narratives of the crisis still exist (European Commission 2012, INET 2012, Moravcsik 2012, Wolf 2014, De Grauwe 2011). However, once Germany has realized that it is trapped in the euro (which has also benefited its export-oriented sector enormously), it has been trying to use the crisis as an opportunity to radically transform the economic structure of southern EZ members by forcing the adoption of rules that will reduce the policy space for implementing policies that are divergent from the Coordinated Market Economy/Ordoliberal model predominant in Germany.⁵ Therefore, austerity, limited solidarity, reluctance to accept higher levels of inflation, or labor market reforms are instruments to attain its goals and consolidate its incipient structural power.

In fact, as Vermeiren (2012) shows, the original design of EMU allowed Germany to increase its monetary power because of the nature of its coordinated market economy even before the EZ crisis started. In particular, Germany's flexible labor market and export-oriented economy (with a comparative advantage in goods and services that do not compete primarily in price (Bonatti and Fracasso 2013)), allowed Berlin to reap more gains from EMU than southern European countries. As graph 1 shows, German exports (as a percentage of GDP) grew dramatically with the introduction of the euro (rising from 27,1% in 1999 to 43,5% in 2008), while Spanish, French, and Italian exports remained stable or even fall during the same period.

GRAPH 1: EXPORT AS A % OF GDP (EZ'S LARGEST COUNTRIES)

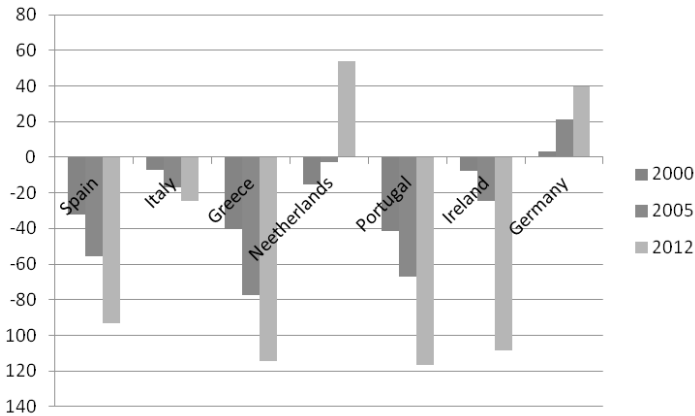


Source: World Bank

⁵ For a discussion of the different models of capitalism see Hall and Soskice (2001) and Hanke *et al.* (2007). See Vermeiren (2012) for an application of this literature to the distribution of power within Europe after the creation of the euro. For an updated version of the peculiarities of the German-Ordoliberal model of capitalism and its implications for the EZ crisis see Bonefeld (2012) and Duillen and Guerot (2012).

This, in turn, generated large intra EZ macroeconomic imbalances, with Germany emerging as the main creditor country and Spain, Greece, Ireland, and Portugal as debtors (graph 2). When the debt crisis started, southern European countries realized that they were in a weak bargaining position and Germany was able to increase its influence.

GRAPH 2: NET INTERNATIONAL INVESTMENT POSITION AS A % OF GDP



Source: Eurostat

In addition, besides this long-term strategy, Germany has tactically used the economic problems of the periphery to obtain short-term advantages and to preserve its financial interests. Firstly, financial instability in southern Europe has reduced Germany's own financing costs because of capital flight from the periphery to the core (Merler and Pisani-Ferry 2012). In fact, Germany, just like the US, is now enjoying the "exorbitant privilege" of issuing the safest debt of the EZ, but unlike the US, it is not willing to provide sufficient public goods for the EU. Secondly, Germany, as the largest creditor country, has consistently refused to accept inflation to facilitate deleveraging and has set the timing and the conditions of the Greek debt restructuring, thus preserving its financial interests. Finally, and related to the previous point, it has not tried to reverse the appreciation of the euro despite the damage that the strong currency has done to southern European countries' exports (especially Italy, Portugal and France), because an appreciated euro does not damage so much the competitiveness of German exports due to the high value added nature of the goods and services it sells outside the EZ. Only once the EZ has entered deflation, has the Bundesbank (reluctantly) accepted that the ECB adopted a more expansionary monetary policy to depreciate the euro (Vermeiren and Steinberg 2015).

3. HOW WOULD A GERMANIZED EUROPE AFFECT THE IMS?

Although every EZ country will maintain its idiosyncratic characteristics, if the structural reforms across Europe continue (particularly in labor markets, products markets, financial markets, taxation and pensions) and if the EZ manages to increase its level of financial, fiscal, economic, and political integration, there would be important implications for the IMS. We will dedicate the rest of the paper to discuss them.

3.1 A STRONG AND MORE ATTRACTIVE EURO, BUT NOT A RESERVE CURRENCY

So far, the euro has been no rival for the dollar. Despite having emerged as the second most used international currency worldwide, it has a number of structural limitations: economic factors such as insufficient financial integration and lack of liquidity in its debt markets, political shortcomings related to having a monetary union without a fiscal and political union, and limited European military ambitions (Cohen 2010, Eichengreen 2011, Otero-Iglesias and Steinberg 2012). Even though the global financial crisis started in the US, market participants and official reserve holders have regarded the dollar as a safe haven throughout the crisis, and the dollar's structural position has even strengthened since 2008 (Helleiner 2015).

The "military" factor is unlikely to change in the foreseeable future in the EZ. Budget cuts in Europe are undermining military spending and the EU still relies in the US and NATO for its basic security. However, as mentioned above, the EZ debt crisis has triggered a radical transformation in the governance institutions that underpin the euro. It has also opened the door for the creation of some sort of Eurobonds/euro bills, which could eventually make European financial markets deeper, wider, and more liquid.⁶ In fact, as Otero-Iglesias and Steinberg (2012) show, financial elites in key dollar-holding countries would be willing to buy large quantities of euro-denominated assets to diversify away from the dollar if the EZ were to issue a debt instrument comparable to the US 10-year T-bill and if the euro had a fiscal and economic union to ensure its long term sustainability.

Therefore, it could be argued that, from a purely economic perspective, the euro could increase its role as a reserve currency if it consolidates its banking and fiscal union and ends up issuing some sort of common debt instrument. And it will most likely do so, as these reforms are deemed necessary for its long run survival (Blyth and Mattijs 2015).

The question, however, is, to what extent European authorities would be willing to politically promote the international role of the euro. This is relevant because a currency can only become the top international currency if there is

⁶ Debt issued by the ESM can be considered as a pseudo Eurobonds. However, so far the ESM has issued relatively small quantities of assets and some doubts about ESM governance and guarantees preclude it from becoming a liquid and well-understood instrument.

an active political commitment by the issuing authorities (Eichengreen 2011). And, so far, only the US in the XXth Century and the UK (in the previous century) had been willing to do so. Using Cohen's (2006) definition of monetary power, it is clear that the consolidation of the euro has (and will) give the EZ more autonomy in international monetary affairs. But, will it give it more influence? That largely depends on the balance of power within the EZ, thus on German political preferences.

Issuing an international reserve currency has both costs and benefits (Cohen 2010). Benefits include flexibility in macroeconomic policy, increased revenues from seigniorage, and greater political influence on the international arena. Costs, however, are related to the fact that the issuer of an international currency faces the risks of imported inflation and competitiveness losses due to currency revaluation. This means that countries may choose not to promote the internationalization of their monies. This was the case with the Deutschmark (Marsh 1992) and the Japanese Yen (Grimes 2003), and, to a certain extent, is also the case with the euro today. The ECB remains officially agnostic on the internationalization of the euro and different European leaders have traditionally had different views. French officials have often expressed their interest in consolidating the euro as a serious rival to the dollar, while Germany has tended to have a lower profile, rarely including geopolitical considerations in their currency discourse, which stresses above all macroeconomic stability and low inflation.⁷

Therefore, if a stronger Berlin allows the German positions to prevail, it is unlikely that the EZ engages in a strategy to politically promote the internationalization of the euro. Market forces may well increase the appeal of the European currency, especially if the ECB maintains its anti-inflationary stance and if Eurobonds markets are created. However, without German willingness to exercise monetary power internationally, the euro will, most likely, remain a secondary international currency, probably competing with the RMB in the medium term.

3.2. THE EZ IN STRUCTURAL CURRENT ACCOUNT SURPLUS

Global macroeconomic imbalances have been a persistent problem of the IMS in the last decade. Excess savings in China, Japan, Germany, oil-exporting countries and some other emerging powers in Asia and excess spending in the US, the UK and the peripheral EZ countries were, together with financial deregulation, key causes of the global financial crisis (Wolf 2014, Rajan 2010).⁸

The Great Recession helped to correct global imbalances mainly by reducing imports in deficit countries. However, since 2011, these imbalances have

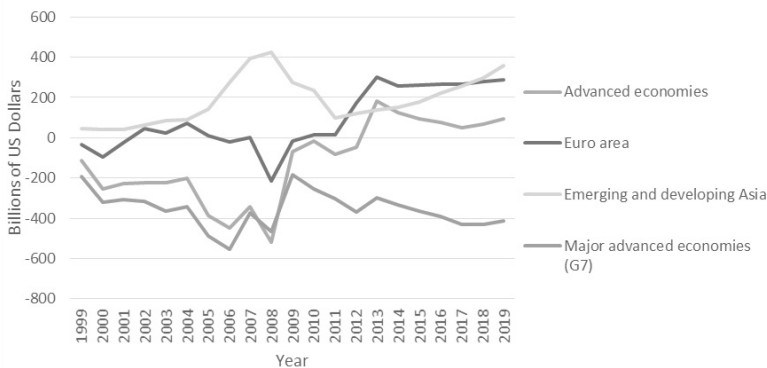
⁷ There is also an ongoing debate regarding the value of the Exchange rate of the euro, in which France (and Italy) tends to complain about the strength of the euro in the context of current currency wars, while Germany maintains silence and tries to protect the independence of the ECB.

⁸ Low interest rates in the US and excess savings in emerging countries gave rise to a glut of liquidity that ended up generating a bubble in asset markets, which was also fed by financial deregulation and the creation of new financial instruments.

reappeared (see graph 3). Although China is rapidly reducing its current account surplus and the Great Recession in the US contributed to reduce its current account deficit, structural changes in the EZ, aimed at increasing exports, have become a new source of global macroeconomic imbalances.

In the past decade, the US and China have been the most vocal powers in criticising the *status quo*, sometimes called Bretton Woods II, but for different reasons. The US complained about China's exchange rate policy and China claimed that irresponsible expansionary monetary and fiscal US policies represent a risk to global stability and to their dollar-denominated assets (Steinberg 2013). Nevertheless, both countries seem to be comfortable with the current situation and have not taken rhetorical confrontation further (the US has not introduced unilateral protectionist measures and China has not sold its dollar-denominated assets).

GRAPH 3. GLOBAL MACROECONOMIC IMBALANCES – COUNTRY GROUPINGS



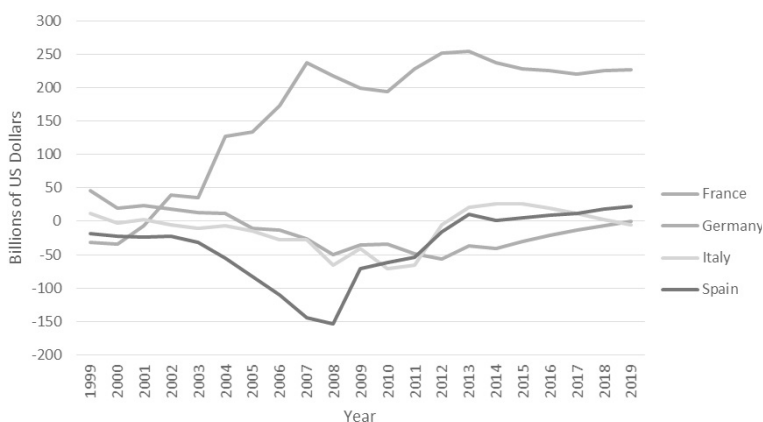
Source: IMF, World Economic Outlook, 2014

So far, the EZ has not participated in this debate. At the G-20 meetings, it has insisted that China should revalue the RMB, but with much less emphasis than the US. Since its creation, the EZ has had a balanced current account because the external surplus of “northern” countries was compensated by the external financing needs of the countries in the periphery (in fact, Germany is the only large country in the world that has not contributed to global rebalancing). EZ countries have always resisted a discussion in the G-20 about intra EZ macroeconomic imbalances because they consider this issue as internal (just like health care reform in the US) and have defended that the EZ has not contributed to global imbalances. This, however, is rapidly changing. While Germany and its northern neighbours are expected to maintain large surpluses,

structural reforms in southern countries are likely to generate external surpluses in these traditionally deficit countries as well.

For instance, Spain, which ran a current account deficit of over 10% of GDP in 2007, moved to surplus in 2014 due to the internal devaluation and austerity policies that depressed domestic demand and boosted exports. This contributed to an overall current account surplus of the whole EZ of 262 billion euros in 2014, a surplus larger than that of China. As graph 3 illustrates, the IMF projects that by 2019, the EZ will have a current account surplus of almost 300 billion euros (2% of its GDP). Even though Germany would be the largest source of that surplus, no large EZ country is expected to have a significant current account deficit (see graph 4).

GRAPH 4. CURRENT ACCOUNT IMBALANCES IN THE EURO AREA



Source: IMF, World Economic Outlook 2014.

The implications of the EZ in a structural external surplus for the IMS would be remarkable. Should that happen, and if China and Japan do not begin to run current account deficits (something that is not likely to happen soon), the global economy will have all of its major economic blocs except the US trying to lend to the rest of the world. So the question will inevitable become, who is the buyer? Either the US consumer reemerges once again as the world's consumer of last resort, or the world economy would have to accept slower economic growth and deflationary tensions, as argued by the proponents of the "Secular Stagnation" hypothesis (Teulings and Baldwin 2014). But, as the Great Depression of the 1930s and the long deflation in Japan in the 1990s show,

declining prices in an environment of high debt could increase the problems of the financial sector in advanced countries and drag economic growth even more. In that scenario geopolitical tensions are likely to increase, with currency wars, rising protectionism, and redistributive conflicts between debtor and creditor countries becoming more acute. In particular, there could be growing tensions between the US and the EZ, which have traditionally cooperated in international monetary issues. Finally, an EZ behaving more “like China” could open the door to more exchange rate and regulatory cooperation between the EZ, China and the other BRICS countries. We explore these issues in the next section.

3.3 A MORE INTERVENTIONIST EZ IN THE IMS?

One of the key philosophical difference between the Anglo-Saxon model of capitalism and that prevalent in continental Europe is its trust in markets. Both views agree that the free market economy is the best way to generate innovation and growth. However, for liberal Anglo-Saxons, markets tend to be self-stabilizing and relatively well self-regulated, requiring only small doses of government intervention (domestically, these views correspond to the liberal market economies of the varieties of capitalism literature (Hall and Soskice 2001)). Contrarily, continental Europeans tend to believe that markets should be more heavily regulated in order to generate adequate (and legitimate) outcomes. Specifically, in the German ordoliberal tradition, the free market economy requires the existence of a “strong state – a state that restrains competition and secures the social and ideological preconditions of economic liberty” (Bonefeld 2012:1). Thus, there is an emphasis in the need for rules and coordination to avoid adverse market outcomes that could eventually delegitimize the system, which correspond to the Coordinated Market Economies within the varieties of capitalism literature. This view, to a certain extent, is shared by other continental European countries (especially France) and with a number of varieties of so called State Capitalism that prevail in some emerging powers.

Before the global financial crisis, the Anglo-Saxon view of capitalism was dominant, especially in the western world. However, the severity of the crisis and of the Great Recession (2008-2010) has triggered an ideological shift in favor of more regulated markets (Rodrik 2011). As a result, the international community has been trying to establish new rules and enhanced coordination mechanisms to improve the functioning of international markets, especially in the areas of money and finance. Besides the financial reform implemented in the US and the EU (which aims at improved and extend regulation), the IMF has accepted the use of some forms of capital controls, the EU has established an international financial transactions tax and has banned short-selling temporarily, and the Basel III accord has increased capital requirements for banks. In emerging markets, neo-mercantilist strategies are becoming more common and they even seem to have gained legitimacy because their capacity to generate relatively successful economic outcomes. It is still early to know

to what extent these new forms of regulation are moving the world economy towards deglobalization. What is clear, however, is that, in the realm of ideas, the German view of Capitalism is gaining influence *vis à vis* the Anglo-Saxon, and this could have important implications for the IMS in the coming decades (Kirshner 2014).⁹

First, in the area of exchange rate coordination, the world economy could witness a higher degree of collaboration to manage exchange rates. There have been numerous recent proposals to introduce some level of exchange rate coordination (Mundell 2005, Padoa-Schioppa 2010, Camdessus *et al.* 2011, United Nations 2009). However, they have usually been rejected by the US, who is comfortable with the current regime, in which the status of the dollar and the flexibility of exchange rates allow it to use its monetary power. Emerging markets, on the other hand, from China to Brazil, have repeatedly called for more coordination to avoid the adverse externalities of American macroeconomic policies (Zhou 2009). In Europe (and especially in France), there has been remarkable sympathy for the idea of coordinating exchange rates (Otero-Iglesias and Zhang 2014), a view not always shared by Germany, who considers that coordination should not undermine the independence of the ECB. However, as discussed earlier, the EZ has never had a strong position towards this issue, in part due to the institutional weaknesses of the EZ. Should this change in the future, the EZ could come closer to the position of emerging markets, thus leaving the US with limited allies (only the UK) to resist changes in the IMS that include more monetary cooperation. And even if the EZ does not align itself with emerging markets in this issue, the eventual creation of an EZ chair at the IMF (something that could well happen in the foreseeable future should the EZ moves towards some form of political union), could greatly increase European influence in shaping the future IMS.

Second, in the area of financial regulation, EZ countries have repeatedly showed their intention to curtail markets. In fact, after failing to convince the other members of the G-20 to pass an international financial transactions tax, they decided to implement it in the European Continent in 2012. And in the broader area of financial regulation, EZ collaboration with some emerging markets that also seem to distrust the risks involved in sophisticated financial derivatives or excessively lax forms of control for portfolio investments, could improve. This could also trigger confrontation with the US and the UK.

⁹ It is also important to mention, however, that Germany has traditional been reluctant to exercise a leadership role in the IMS or to coordinate its macroeconomic policies with other G7 countries. See Putnam and Bayne (1987) for details, particularly about the 1978 Bonn Summit of the G7 and for the Louvre and Plaza Agreements of the mid-1980s.

4. CONCLUSION

This paper has argued that the transformation that the EZ is experiencing as a result of its crisis could radically transform the balance of power in the IMS. The European debt crisis has created a new EZ of debtors and creditors in which a new Berlin-Frankfurt axis has partially replaced the old (and more balanced) Paris-Berlin axis. Germany, thus, has emerged as a hegemonic power in the EZ, and it is using its newly acquired power to establish a new rules-based system of European economic governance that, if fully implemented, would partially Germanize the economies of southern Europe. Germany, however, does not feel fully comfortable with its new role. Since the creation of the European Economic Community in the late 1950s Germany has always preferred to “hide” behind Europe than to lead it. But it has realized that the current financial instability in the EZ provides an opportunity to force politically difficult reforms onto southern Europe, reforms that it thinks are indispensable to ensure the success of the EZ in a global economy in which emerging markets exhort greater competition in a declining West. Therefore, it has assumed a (temporarily) new leadership role whose main goal is to establishment a set to (irreversible) new governance rules that restrict the political space of EZ governments to pursue policies that Germany considers damaging for the strength of the European economy. These rules, which have been proposed by the European Commission and in which the European Parliament has also been involved, reflect, however, the new balance of power within the EZ: southern European countries have not been able to shape them as much as creditor countries. As a result, the Fiscal Compact, the “Six Pack” and the “Two Pack”, the intergovernmental ESM and the timing and sequencing of the Banking Union mainly reflect German preferences. It remains to be seen if, after these new rules are in place and the EZ moves towards deeper economic integration in the fiscal, financial and economic spheres, Germany decides to take a step back and abandons its attitude of explicitly leadership or not. However, even if it does, it would still be able to exercise structural power if its economic ideas become embedded in new EZ rules and institutions.

The second part of the paper has been dedicated to speculate about the implications of a reborn and Germanized EZ for the IMS. We have argued that it is unclear whether the role of the EZ would provide more or less stability. On the one hand, a greater internationalization of the euro (which would be based on market decisions and not on an explicitly political support of the European currency by European authorities) could facilitate the emergence of a competitive multicurrency IMS, which could provide more stability than the current flexible-dollar standard. On the other hand, a Germanized EZ could have a structural current account surplus that could exert a deflationary pressure in the global economy. This, in turn, could trigger transatlantic confrontation and open the door for some collaboration between the EZ and some emerging markets in specific issues, like global financial regulation or some sort of exchange rate coordination.

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