

Germany and the euro-zone crisis: the European reformation of the German banking crisis and the future of the euro

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By different paths of reasoning most analysis of the euro-zone crisis has concluded that the European Union's (EU) monetary union will endure. The optimists argue that the moves made by the euro-zone states and the European Central Bank (ECB) since 2010 have fundamentally strengthened the institutional foundations of the single currency, and endowed the union with much more supra-national authority (Yiangou *et al.* 2013; Bergsten and Kirkegaard 2012; Schimmelfennig 2014). More particularly they stress that the euro-zone now has much tighter fiscal rules, a permanent crisis resolution mechanism in the European Stability Mechanism (ESM), the legal basis for a singular supervision of euro-zone banks, and a central bank that will support member-state borrowing through market intervention. By contrast the more sceptical suggest that the euro-zone will persist despite the ongoing absence of economic convergence between its core and periphery members. Explanations of this mismatch range from divergences in competitiveness (Dyson 2010a; Shambaugh 2012), export-led and demand-led growth models, varieties of capitalism (Hall 2012, 2014; Boltho and Carlin 2013), and long-standing structural disagreement between EU members on a range of economic issues (Mourlon-Druol 2014). Achieving a change in national economic outcomes would in this context require a combination of structural reform in the periphery to improve external competitiveness (Argyrou and Tsoukalas 2011) and a more demand-oriented macro-economic approach in Germany (Feldstein 2012; Moravcsik 2012; Pettis 2013; Schwartz 2012; Hall 2014). The sceptics are also largely unconvinced by recent institutional reform. In particular they point to ongoing fiscal decentralisation (James 2012; De Grauwe 2011; Eichengreen 2012a; McNamara 2011; Featherstone 2011; Heise 2012; Cohen 2012), the absence of political union (McNamara 2011; De Grauwe 2011), the failure to create a full banking union, (James 2012 16-20; Eichengreen 2012a; 2012b; Shambaugh 2012), and inadequate crisis management mechanisms (Dyson 2012; 2013). In general terms they see, as Schmidt (2011) has said, the reforms only as a succession of 'half measures' that have ultimately failed. Nonetheless these sceptics still generally argue that the sheer political will to preserve credibility will keep the euro alive (Bergsten 2012; Bergsten and Kirkegaard 2012; Cohen 2012; Wolf 2012; Crum 2013), regardless of whether some individual states in the periphery leave (Eichengreen 2010). From this perspective the economic and political problems the euro creates do not ultimately matter for its durability; the euro-zone states simply cannot abandon the euro, however misconceived as a currency area

it was or badly designed it remains, because the price of failure in terms of the credibility of the EU is too high.

In making these arguments both optimists and sceptics also suppose, again for different reasons, that Germany's commitment to the euro is largely proven. The optimists (Guérot and Leonard 2011; Bergsten and Kirkegaard 2012) see Germany has having led the process of strengthening the institutional design of the euro-zone while the sceptics (Cohen 2012; Marsh 2011, 2013; Hall 2012, 2014; Matthijs and Blyth 2011) explicitly or implicitly take Germany's commitment to the euro-zone as either the basis for a future way out of the crisis through German leadership, or a reason grounded in German interests and credibility why the euro will not be abandoned.

Yet even at a general level these arguments can rest on a large assumption. As Webber (2013: 18) has argued there is a tendency among some EU scholars to presume from a largely theoretical perspective that the EU is so 'highly institutionalised' and the 'ties of economic interdependence are so strong that the EU cannot ... disintegrate', whilst giving insufficient regard to actual German preferences. More particularly many scholars and commentators on the euro have in practice eschewed specific analysis of German interests, preferences and policy action in relation to the details of the euro-zone crisis. As a consequence when discussion of Germany does come to the fore they are prone to take the domestic political narrative in Germany about the euro crisis at face value. Yet empirical scrutiny of Germany policy action and the incentives underpinning it shows this narrative to be problematic and indeed in good part disingenuous. Since the beginning of the crisis the German government has been dealing with a set of concrete economic and political problems generated by the intense difficulties faced by German banks. Without understanding German actions in light of these specific problems, analysis of Germany's present relationship to the crisis and its consequences for the sustainability of the euro risks missing both much of what has happened over the past five years and what is now at stake for the euro-zone's future.

In this light this paper considers the particulars of German policy during the euro-zone crisis and its implications for the sustainability of the euro through the lens of German preferences in relation to the interests of German banks. In taking this approach I do not wish to suggest that all German policy during the crisis can be reduced to German bank interests. Indeed in the very early stages of the crisis the German government eschewed acting immediately to protect the German banks. Neither do I want to claim that the future of the euro turns only on German decision-making. Rather I aim to argue that any attempt to draw conclusions about the past and future intentions of the German government towards the

euro requires serious analysis of the interests of the banks, the predicaments those interests caused for the German government, and the consequences of the German government's subsequent policy actions.

Of course beginning with interests in political explanation generates a set of methodological issues. The approach is open to the obvious criticism that it risks offering an account of a government's actions that derives intentions from interests without sufficient evidence to support explicit and implicit claims about motivation by interests. But without at least considering interests in political explanation, we are left defending the assumption that politicians and officials' own accounts of what they are doing, and the subsequent political reactions to their actions, are reliable indicators of the actual stakes of decision-making when palpably this is not necessarily the case. Obfuscation of interests by elite political actors is a long-standing political tactic. Indeed the nature of both democratic politics and EU bargaining positively encourages such camouflage behind collectivist rhetoric since open acknowledgement by political actors of the advancement of particular sectional interests invites the political losers to easy dissent and makes prevailing in distributional battles harder. In this instance, as the subsequent discussion will show, the incentive for the German government both to present as German sacrifice initiatives that have in fact served the interests of German banks and to spread the cost of supporting those banks beyond German taxpayers was acute and consequential. Whether these banking interests are a sufficient explanation of German policy is another matter. But in the first analytical instance these interests must be acknowledged in a way that has been absent in much discussion of the euro-zone crisis. If we want to draw conclusions about what the German government has done or might do in the future, we must consider the German interests at stake.

The first section of the paper considers different frameworks for accounting for Germany's actions during the euro-zone crisis, and argues that the incentives created for the German government by the problems of German banks from 2007 through the onset of the Greek crisis must be given significant analytical attention. The second section considers the reduction of exposure of German banks to the periphery in the period between the first Greek bailout and early 2012. It analyses the development of the German government's policy from the first to second Greek bailout through the lens of the changing interests of the German banks, and shows how the policy moves supported by the German government in terms of the new ECB programmes introduced from May 2010 established conditions that facilitated those changing interests. The third section examines the relationship of the German government to the French government during the crisis in light of their shared interests in averting national banking crises, and

considers the consequences of shifts in the Franco-German axis for the sustainability of the euro. The final section draws some conclusions. It argues that the German government's actions during the crisis in Europeanising policy solutions to the problems of German banks have weakened the foundations of the euro-zone and that Germany's ongoing commitment to the euro is unproven.

1. Bringing in the German banks

The narrative framework for much of the discussion of the German government's handling of the euro-zone crisis has centred on the question of how much domestic sacrifice Germany has made in order to hold the euro-zone together through both bailouts for states in the periphery and compromises of its ordo-liberal economic model, particularly in relation to the new ECB programmes. The corollary of this approach has been an analytical focus on whether the apparent sacrifices the German government has accepted have been done only on terms that advance German hegemonic power within the euro-zone (Kundnani 2011) or whether German domestic politics, either within the context of ordo-liberalism or beyond, has acted as a significant constraint on the capacity of the German government to shape a coherent response to the crisis (Bulmer 2014; Bulmer and Paterson 2013; Jacoby 2014). In this context Paterson (2011: 203) has argued that the crisis has 'catapulted Germany into a hegemonic role' that it has not 'sought'. Seen this way the question for the euro's future is whether Germany has sacrificed enough to support the periphery and whether the power it has amassed through those sacrifices can produce tolerable outcomes in the medium to long term for others. This discourse tends to produce a zero-sum game for understanding the euro's future (Kundnani 2011). Either Germany or the periphery must do more. Applying this notion to Germany itself either Germany must stop imposing unsustainable demands on the periphery and reduce its obsession with a trade surplus (Blyth 2013; Matthijs and Blyth 2011; Rodrik 2010; Moravcsik 2012), or others must accept that German-financed bailouts and ECB intervention can go only so far and cannot expect Germany to give up its political economy to save the euro (Bonatti and Fracasso 2013; Guérot and Leonard 2011).

In empirical terms it is certainly possible to see an ongoing tension for the German government between an imperative to bear the burden of adjustment to divergence and a corresponding desire to extract concessions in doing so, with considerable domestic political fallout ensuing from the shifting balance between the two. Having begun the crisis with an insistence that there would be no bailouts and entertaining the possibility of expulsions, the German government shifted its position at the EU summit

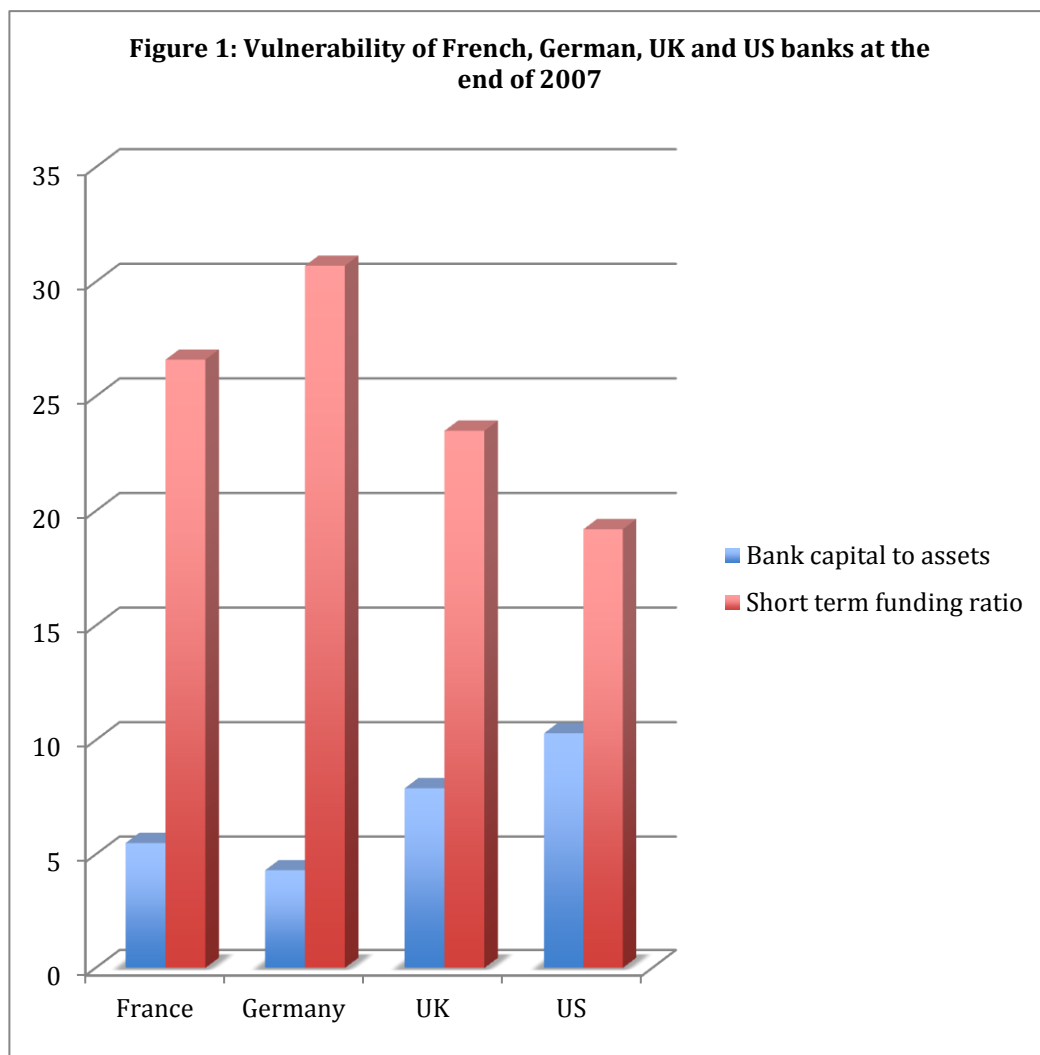
on 7-9 May 2010 by agreeing to a conditional loan package for Greece and the establishment of the European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism (EFSM) as crisis resolution mechanisms. This move was followed over the next few years by support for a second Greek loan, credit packages for Ireland, Portugal and Cyprus, and the creation of the ESM as a permanent crisis resolution mechanism. In exchange the German government began immediately after the first Greek bailout to push for other euro-zone states to entrench fiscal restrictions into national law in line with Germany's own move in 2009 to enshrine the requirement of a balanced budget constitutionally (Schäfer and Hall 2010). German pressure on this issue eventually produced the Fiscal Stability Treaty and the Macro-Economic Imbalance Procedure. Meanwhile the German government accepted, and indeed encouraged, the transformation of the ECB's authority away from the restrictions prescribed in the Maastricht treaty. In the wake of 7-9 May 2010 summit the ECB began the Securities Market Programme (SMP) whereby it could buy and sell government bonds in secondary markets and privately issued bonds in both primary and secondary markets. Then in December 2011 the ECB established a new programme for Long Term Financing Operations (LTFO) through which it could supply euro-zone banks with as much three-year euro funding as they bid for in auctions. In August 2012 the ECB replaced the SMP with Outright Monetary Transactions (OMT) as its mechanism for supporting sovereign borrowing after the ECB President, Mario Draghi, had declared that the ECB was 'ready to do whatever it takes' to preserve the euro (Wilson *et al.* 2012).

Undoubtedly the succession of moves made to 'save' the euro was unpopular in Germany. Many German citizens perceived the decisions made at the 7-9 May 2010 summit as German acquiescence to the unacceptable. Proissl (2010: 8) has described the triple move to a bailout for Greece, establishing the EFSF and EFSM, and the SMP as prompting a strong collective belief in Germany that 'the model of [monetary union] that the Germans had agreed to participate in' had been destroyed. The backlash contributed to the loss of the Christian Democrat/Free Democrat Coalition's majority in the Bundesrat after the defeat of the coalition between the two parties in the state election on 9 May in North Rhine-Westphalia. From May 2010 the Bundesbank also became severely critical of the ECB. Axel Weber, the then Bundesbank President, voted against the ECB move on the SMP, and the day after the 7-9 May summit ended the Bundesbank formally declared its opposition to the programme (Alessi 2013). Over the next three years the preferences of the Bundesbank President on the Governing Council of the ECB were increasingly marginalised. This perception of German defeat was compounded by the failure of German

representatives on the ECB to reverse the ECB's support for government borrowing in the periphery, producing the belief among many Germans that there has been a fundamental transformation of the ECB's purposes, in Brendan Brown's (2012: 179) words 'in pursuance of French ambition'. In October 2010 Weber (2010: 2) said that the SMP should be phased out because it risked 'blurring the different responsibilities between fiscal and monetary policy'. When no policy change was forthcoming Weber announced in February 2011 his intention to resign, as seven months later did Jürgen Stark, a German member of the ECB Executive Board. Weber's successor as Bundesbank President, Jens Weidmann, has regularly been at odds with Mario Draghi since the Italian's appointment to the ECB presidency (Seith 2013). Indeed Weidmann was outvoted in August 2011 on the use of SMP to buy Italian and Spanish bonds to try to push down yields (Atkins 2011). In the autumn of 2011 Weidmann went public with his opposition, insisting that what the ECB was doing was an 'absurd' disregard for the law (Financial Times 2011). Weidmann was then the sole vote in the ECB against OMT (Steen, 2012). After the ECB meeting on OMT the Bundesbank said that Weidmann 'regards [such] bond purchases as being tantamount to financing governments by printing banknotes' (Quoted in Steen 2012). Put more schematically these programmes, in particular the move to OMT, look like the ECB prevailing over German opposition to act as a lender of last resort (Bulmer and Paterson 2013: 1396).

The political issues that both the bailout provisions and the ECB's new authority created in Germany have been reflected in the recent set of appeals to the German Federal Constitutional Court. In September 2011 the Court upheld the constitutionality of the first Greek bailout, but insisted that the Bundestag had to retain sovereignty over the German budget and consequently have a larger say in future bailouts through the prior approval of the Bundestag Budget Committee. A year later the Court provisionally ruled that Germany's contribution to the ESM could only exceed a €190 billion liability if the German representative agreed and that the position of the German representative must be authorised by the Bundestag (Spiegel International 2012), a position it then offered as a final ruling on in March 2014. In June 2013 the Court held hearings on a challenge to the constitutionality of OMT, and the Bundesbank President, Jens Weidmann, testified in support of the plaintiffs. When in February 2014 the Court referred the case to the European Court of Justice as a possible violation of EU treaty law, eight of the judges declared that OMT might be an *ultra vires* act that German authorities could have no obligation to implement (Wagstyl and Jones 2014).

However looking at only the public face of the shifts in German policy and the domestic fallout assumes that we can understand the German government's policy response to the crisis entirely through a spectrum on which at one end which lies domestic sacrifice and at the other external hegemony, as if there were no German economic interests at stake in the periphery sovereign debt crisis beyond the financial and political cost of providing new loans and ECB support to debtors. To the contrary even a minimalist analysis of the position of German banks from the period of the summer of 2007 when the financial crisis began to the beginning of the euro-zone crisis in the autumn of 2009 shows this reckoning is problematic. In reality German banks were structurally hugely vulnerable to crisis once the financial boom ended because of their funding models and high leverage. As figure 1 shows the German banks had poorer capital to assets ratios and were more dependent on funding from wholesale markets than those in either the UK, the US or France.



Source: International Monetary Fund, *Country Report: Germany 2008*, January 2009, p. 15.

German and French banks were also the most exposed in 2009 to the periphery of the euro-zone. As table 1 shows just under half of foreign claims on Portugal, Ireland, Italy, Greece and Spain in the final quarter of 2009 belonged to Germany and France.

Table 1: Foreign claims on the euro periphery in Q3 2009 in millions of dollars

	<i>Greece</i>	<i>Ireland</i>	<i>Italy</i>	<i>Portugal</i>	<i>Spain</i>	<i>Total</i>
Germany	43 236	193 271	209 295	47 261	240 296	733 359
France	78 571	52 130	484 103	36 359	172 805	823 968
Austria	6337	8968	21 121	2 634	9276	48 336
Belgium	8292	42 443	52 457	11 707	47 389	162 288
Ireland	8717		46 669	5 809	33 534	94 729
Italy	8753	22 597		6 664	32 925	70 939
Japan	8 777	21 940	53 163	3 529	27 551	114 960
Netherlands	12 054	32 090	74 551	13 171	125 805	257 671
Portugal	10 453	4 857	5 722		30 116	51 148
Spain	1 157	14 612	51 376	87 403		154 548
UK	12 492	191 849	81 966	26 264	120 723	433 294
US	19 448	73 759	68 753	6 202	68 194	236 356

Source: Bank of International Settlements, International Banking Statistics. Accessed 2 January 2015.

Although the German exposure was less than the French both in total and in Greece, as table 1 also shows German banks had an acute interest once the Greek crisis broke in October 2009 in avoiding contagion across the periphery, especially to Italy and Spain.

The German government responded to the general financial crisis of 2007-8 by establishing a €480B federal bank rescue fund, while several Länder gave financial support to individual Landesbanken. By mid-February 2009 the cost of German financial stabilisation amounted to 3.1 per cent of GDP, compared to 1.8 per cent for France and 0.9 per cent for Italy (IMF 2009: 48). In the summer of the same year the German government introduced legislation to allow banks to move toxic assets to bad banks and thus reduce their capital requirements (Zohlnhöfer 2011: 232).

With the onset of the Greek crisis the German government then faced a serious dilemma. If it upheld the Maastricht principle of no bailouts for euro-zone states, it would either have to let the support system it had erected for Germany banks unravel or engage in a further round of direct bailouts of these banks. If, by contrast, it accepted bailouts for other euro-zone member states, it could secure a less transparent bailout of German banks at the expense of having to re-secure domestic support for monetary union on new terms.

The Merkel government's initial response appeared to be hope that Greek action could make the predicament go away. Merkel's stance brought her into some conflict with the large German banks that were most exposed in Greece. In February 2010 the CEO of Deutsche Bank, Josef Ackermann, travelled to Athens with a plan to supply Greece with a €30B loan. Merkel, however, dismissed the proposal, with her then chief economic advisor, Jens Weidmann, telling Ackermann: 'You cannot tell the Greeks that this is a German government offer' (Quoted in Walker *et al.* 2010). In late March 2010 Merkel's public stance still remained that a Greek bailout was unnecessary. In one radio interview she pronounced: 'There is no looming insolvency. I don't believe that Greece has any acute financial needs from the European community and that's what the Greek prime minister keeps telling me' (Quoted in Guardian 2010).

This illusion was shattered by the deterioration in Greece's position in the bond markets between late March and early May 2010 and the consequent spread of higher borrowing rates across the periphery. Once the hope that the crisis could be solved by immediate Greek fiscal consolidation unravelled, the Merkel government had to choose, and it chose to sacrifice the principle of not bailing out other member states to the advantage of bailing out German banks through euro-level action. Acknowledging this fundamental fact about the German predicament makes much of the narrative of German domestic sacrifice in regard to the commitments first made at the 7-9 May 2010 summit redundant. In outcomes the periphery bailouts effectively moved liability for bad loans made by German banks to the IMF, EU, ECB and EFSF for which Germany bears a share of responsibility but not the whole.

Seen in this light Eichengreen's (2012a: 132) puzzle as to 'why the German government ... finds it even more difficult to sell its constituents on the idea that taxpayer money should be used to recapitalise the country's own banks than to bail out Greece and Ireland' is not quite the question. If periphery bailouts were unpopular in Germany it is because they have not been presented for what they were, which was an opportunity for the German government to Europeanise the problems of the German banking sector. This is not to suggest that Eichengreen is wrong in saying that there is a paradox at work in German policy, but rather to say that the puzzle concerns the relationship between the practical utility and political difficulty of the options available. The more practically beneficial option of periphery bailouts appeared more domestically politically difficult yet explaining its utility to the domestic political audience would have lessened the practical opportunity both to impose the costs of the Germany banking crisis generated by periphery exposure almost entirely on the debtor states and to change economic policies in the periphery through institutional reform.

2. Reducing the exposure of German banks

In the months after the 7-9 May 2010 summit the German banks were able to reduce their exposure to the periphery. As table 2 shows the claims of German banks in the periphery fell by more than 50 per cent between the third quarter of 2009 and the last quarter of 2012, a rate significantly higher than that for banks in any other large-economy state.

Table 2: Foreign claims on the euro periphery from Q3 2009 to Q4 2012 in millions of dollars

	2009 Q 3	2010 Q4	2011 Q4	2012 Q4	Reduction	Percentage reduction
France	823 968	646 491	540 628	508 908	315 060	38
Germany	733 359	524 814	418 942	358 461	374 898	51
UK	433 294	347 187	301 846	277 083	156 211	36
US	236 356	142 386	135 723	146 633	89 723	38

Source: Calculated from Bank of International Settlements, International Banking Statistics. Accessed 2 January 2015.

Understanding both the consequences of this reduction in exposure and the mechanisms by which it happened illuminates just what was stake in the German government's decision-making between the commitments made in May 2010 and the second Greek bailout that was implemented in March-April 2012.

For the most part this reduction in exposure occurred without the German banks incurring significant losses. On the surface the failure of the decisions made at the 7-9 May summit to resolve the euro-zone crisis left the German banks in a vulnerable position. With the prospect of further loans to the periphery states looming, the Merkel government's rhetoric turned in the autumn of 2010 towards extracting tough terms in the future from creditors. At a bilateral Franco-German summit in Deauville in October 2010 Merkel appeared to do a deal whereby she secured agreement from the French President, Nicolas Sarkozy, to a treaty-based crisis resolution mechanism to replace the EFSF that would include Private Sector Involvement (PSI) and consequently creditor losses in any future bailouts (Gardner *et al.* 2010). However the detail of the subsequent agreement, which created the terms for what later became the ESM, revealed that PSI would only apply to new bonds issued after 2013 (Economist 2011). When, within a month of the Deauville deal, Ireland asked for emergency financing, the Merkel government

directly averted any burdens being placed on German banks by excluding PSI from the deal. Having now twice protected creditors, Merkel appeared to come under strong political attack. In December 2010 the former Social Democratic Foreign and Finance Ministers, Frank-Walter Steinmeir and Peer Steinbrück, penned a *Financial Times* column calling for a haircut on holdings of Greek, Irish and Portuguese debt (Steinmeir and Steinbrück 2010). But even in this line of criticism the claim of German banking interests on German politicians' judgement was still clearly discernible, with Steinmeir and Steinbrück (2010) insisting that the 'entire outstanding euro zone debt of stable countries', explicitly meaning Italy and Spain where the bulk of German bank exposure lay, must be guaranteed. However popular in principle the idea of making creditors pay was, the Merkel government would not come under domestic pressure to enact policy change that would either inflict significant costs on German banks or require national bank bailouts.

Only in the middle of 2011 in regard to Greece did the Merkel government move towards accepting the principle of PSI and some creditor losses. Understanding when and why this policy shift happened, however, only reinforces the argument that German banking interests were crucial in the development of the German government's policy and that Merkel's decisions protected them at considerable cost to periphery euro- zone members. In May 2010 the German government had insisted that the first Greek bailout should include no debt reduction. By contrast the second Greek bailout, agreed in principle in October 2011 and finalised in February 2012, did include PSI and a significant haircut for creditors. Crucially this change of judgement came against the backdrop of the changed interests of German banks. As table 3 shows the German banks were in a much stronger position in regard to their exposure in Greece in late 2011 and early 2012 than they had been when the Greek crisis began in October 2009. Indeed by the first quarter of 2012 the exposure of German banks was less than UK banks, despite being more than threefold the UK exposure in the third quarter of 2009.

Table 3 Foreign claims on Greece in Q3 2009, Q3 2011 and Q1 2012 in millions of dollars

	2009 Q 3	2011 Q 3	2012 Q 1
France	78 571	47 899	41 725
Germany	43 236	18 636	6 319
UK	12 492	11 546	8 503
US	19 448	6 007	3 897

Source: Bank of International Settlements, International Banking Statistics. Accessed 2 January 2015.

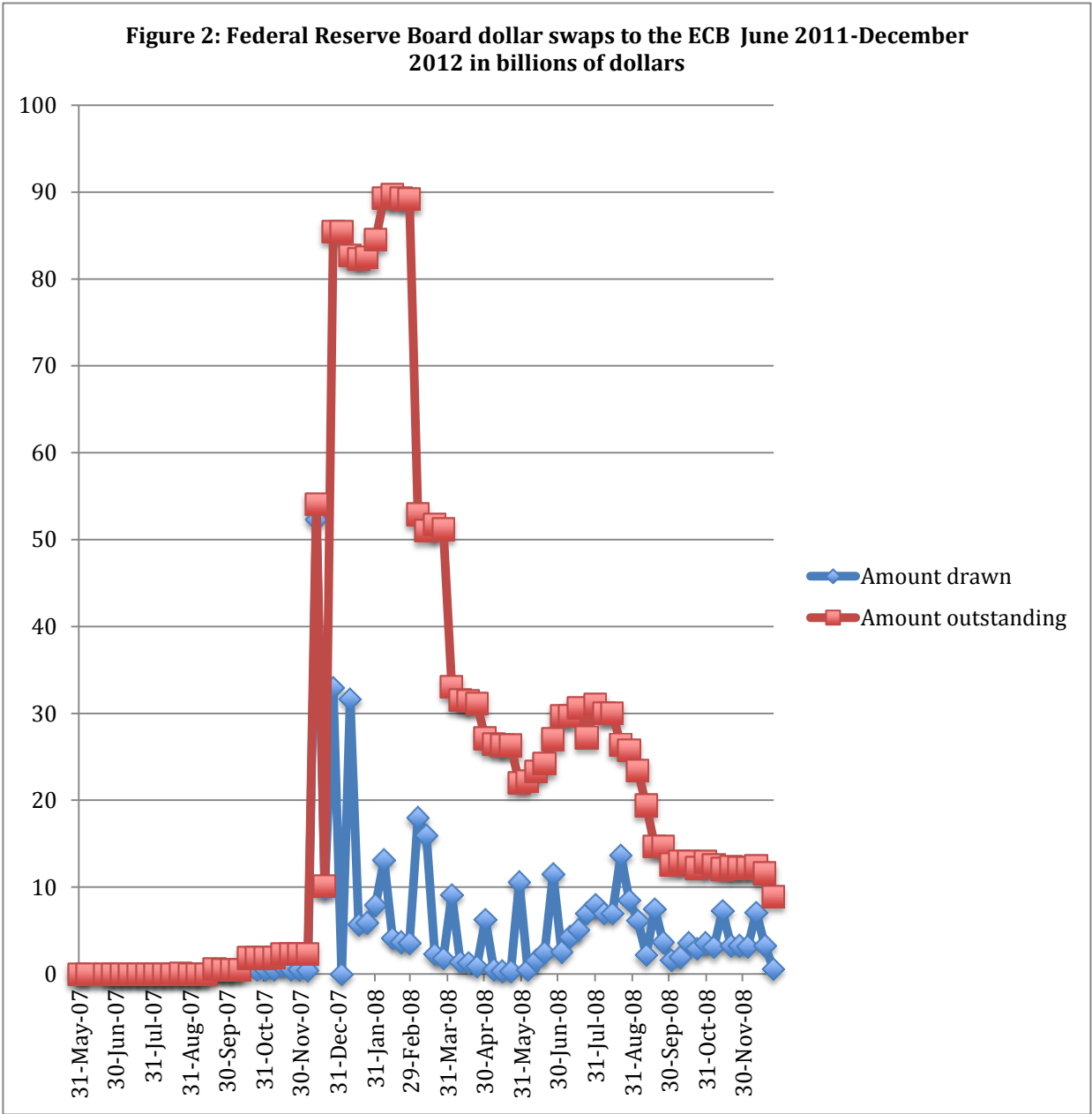
From the Greek perspective the postponement of PSI until the end of the first quarter of 2012 was lethal (Zettelmeyer *et al.* 2013: 38). As the IMF (2013) has argued the absence of any debt restructuring in May 2010 inflicted huge problems on the economy and made the projections on which the IMF programme rested untenable. Moreover the German government's unwillingness to reduce debt through PSI in May 2010 contrasted sharply with the acquiescence of creditors to debt restructuring in debt crises involving the IMF since 2000 and at odds with all independent analysis of the sustainability of Greek debt (IMF, 2013: 27-28). The argument made for this refusal was, the IMF noted, that 'for the euro-zone as a whole, there might be limited gain in bailing in creditors who subsequently might themselves have to be bailed out' (IMF 2013: 27). Those creditors were, of course, first and foremost German and French banks.

Put simply the Merkel government's stance in May 2010 bought time for the German banks exposed in Greece. As the exposure of German banks diminished, the Merkel government could shift position and start decision-making from the underlying reality that a restructuring of Greek debt that included creditor losses was unavoidable. From the point of view of the German banks accepting PSI was obviously unwelcome. Yet the alternative was waiting for a future Greek default and potentially dire contagion across the periphery. At this point their interest lay in keeping PSI as low as possible without risking a further round of restructuring in the future. In this context from the moment it became clear in July 2011 that the Merkel government had accepted the need for PSI to reduce Greek debt, the exposed German banks were involved in the policy-making processes on the terms of the restructuring whilst continuing to receive full bond repayments until March 2012. Acting as the chair of Institute of International Finance, which represented the largest creditors, Josef Ackermann maintained a direct line to Angela Merkel through the negotiations from July 2011 to February 2012 between the banks, the Greek government, the Commission, the other euro-zone national governments, the ECB, and the IMF (Baker and Sassard 2012). Certainly the German government pressurised the banks to accept a more substantial haircut than they had initially envisaged with the losses to Greece's creditors rising from an initial offer of around 21 per cent in July 2011 to more than 50 per cent in the eventual deal (Zettelmeyer *et al.* 2013). Nonetheless in other ways the banks won significant concessions. Most consequentially the final agreement included significant financial sweeteners, shifted the bulk of what remained of Greece's sovereign debt away from German and French banks to Greek banks and official institutions, made the new bonds issued subject to English law ensuring that in the event of a Greek exit from the euro these bonds could not be re-dominated into a reissued

Greek national currency. Moreover the agreement still left Greece with a debt burden that most independent observers deemed unsustainable (Zettelmeyer *et al.* 2013: 37-41; Roubini 2012).

The reduction in the exposure of German banks in the periphery in general and Greece in particular that demarcated the journey from the first to the second Greek bailout was facilitated by the very actions of the ECB that so angered the Bundesbank. First the SMP and then the LTFO provided mechanisms by which German banks could dispose of periphery assets. The LTFO gave periphery banks the money to buy German holdings of periphery bonds. German banks were also able to use subsidiaries in the periphery to secure LTFO funding (IMF 2012: 33). The result was a sharp repatriation of capital from the periphery to the core of the euro-zone and, by 2012, a significant inflow of capital into Germany (Cecchetti *et al.* 2012).

The ECB's post May-210 programmes also indirectly supported the German banks and their counterparts in other core euro-zone economies in the funding difficulties they faced as the euro-zone crisis deepened in 2011. During this period the American money markets became extremely difficult for German and French banks (Fitch Ratings 2011). Given their high dependency on wholesale funding German and French banks had to find alternative sources of short-term money. Their needs were in part met through the Federal Reserve providing dollar swaps to the ECB, which were then distributed to euro-zone banks. While the ECB does not publish data on which euro-zone banks received money through this channel, by definition the recipients were the ones with the largest dollar funding requirements and that means the flows must predominantly have gone to German, French and Dutch banks. The Federal Reserve Board data shows that there are clear euro-zone funding peaks in late 2011 and the summer of 2012 that correspond with the timing of ECB moves first on LTFO and then OMT.



Source: Federal Reserve Bank of New York, Federal Reserve Foreign Exchange Swap Agreements.

Obviously the coincidence of timing is far from sufficient evidence to suggest that the ECB’s actions were motivated by a desire to protect the interests of German and French banks. Nonetheless the size of dollar funding requirements does show that the crisis for the euro-zone in late 2011 and the summer of 2012 was double-sided. Banks in Germany and France had an acute interest in additional funding at a time of negative market perception as did their counterparts in the periphery. In this context by providing a

means for banks in the core of the euro-zone to reduce their periphery exposure LTFO improved the balance sheets of German and French banks and with it their prospects in the money markets.

Seen in these terms the Bundesbank's disquiet at the ECB's actions is unsurprising. From May 2010 the ECB elided monetary policy with other objectives, violating the Bundesbank's strict conception of what the monetary pursuit of price stability entails. However the Bundesbank's opposition to the SMP and OMT cannot be used as an evidence to support an argument that the German government's stance has been based on the acceptance of German domestic sacrifice. Whatever other considerations the Bundesbank has brought to bear on the issue, the ECB's actions have in outcome advanced the interests of German banks in a manner that suited the preferences of the German government since May 2010 to find EU-level solutions to the German banking crisis.

3. The relationship with France

The analysis offered thus far begs the obvious question of how we should understand the relationship between the German and French governments during the crisis given the similarity of interests between the German and French banks. If banking interests have helped shape the preferences of the German government, how can we explain the early disagreements between Merkel and Sarkozy over a number of policy measures and the deeper conflicts that have emerged after Hollande's election in May 2012?

Here it is important to return to the specifics of the shifts in German government policy that have occurred during the course of the crisis. As noted earlier once in 2010 the contagion threat deepened the German government had a choice between upholding the legal provisions of the Maastricht Treaty and protecting itself from another round of national bank bailouts. By contrast the French government was always focused on finding a European support mechanism for French banks. For Sarkozy the Maastricht provisions and Merkel's concern for them were only ever an impediment in the way of his desired outcome, which was always to secure a Greek bailout and ECB support for debt. Unsurprisingly in the aftermath of the 7-9 May 2010 summit Sarkozy declared that '95 per cent' of the agreement struck was made in France and the French European Minister proclaimed that in effect France had 'changed the Maastricht treaty' (Quoted in Proissl 2010: 31-33).

In this context Bulmer and Paterson (2010: 1071) have argued that the May 2010 summit 'indicated that Germany could not prevail in a national interest strategy without French support'. Yet this particular shift in German policy in a French direction was limited to the need for a common Franco-German

approach to periphery bailouts in the wake of the shared interests of German and French banks. Beyond the logic of those bailouts for German banks, German singular preferences on other euro issues remained in tact. The subsequent disagreements between Merkel and Sarkozy on the Fiscal Stability Pact and automatic enforcement from the Commission on the Macro-economic Imbalance Procedure (MEIP) are particularly instructive here. In late 2011 Sarkozy took the supposed absence of automatic enforcement on MEIP as a defeat for German preferences, but once MEIP was operational it manifestly did provide the Commission with authority to fine euro-zone members in a way that is unlikely to be significantly compromised by the resistance of member states. By May 2013 the Commission had presented France with a long list of recommendations for urgent structural reform and Sarkozy's successor was left to complain that the Commission had no right to 'dictate' what France should do (Peel and Carnegie 2013). In sum the fact that the German government acted to Europeanise the problems of German banks and had French support to do so does not in itself reveal a weakness in the ability of the German government to approach the euro zone crisis on its own terms.

Some scholars have seen a second shift in German policy towards more generous terms for the periphery from the middle of 2012 after François Hollande's arrival in the Élysée Palace (Blyth and Matthijs 2012; Schwarzer and Lang 2012). Undoubtedly the Franco-German axis over the periphery weakened after Sarkozy's departure. Indeed at the EU summit on 28-29 June 2012 there appeared to be a new triumvirate of Hollande, Mario Monti and Mariano Rajoy allied against Merkel. The Spanish Prime Minister, Rajoy, left the summit believing that he had procured Merkel's agreement for the direct use of the ESM to recapitalise banks, a move that would have been hugely beneficial for Spain in breaking the link between its banking and sovereign debt crises (Carnegie *et al.* 2012). Yet whilst there does appear to have been a change in the stance of the German government on bailouts in relation to the banking sector from the middle of 2012, the shift is not one that supports an interpretation of any re-orientation towards French preferences. In practice after June 2012 German policy toughened both on the ESM and banking union despite increased co-operation between France, Italy and Spain. By September 2012 the German government had cast public doubt on any notion that it had agreed that the ESM could be directly used for bank capitalisation in Spain (Spiegel International 2012). During the following month Standard and Poor's downgraded Spain's sovereign bonds to near junk status precisely because it saw the German view that the ESM should not have the capacity 'to recapitalise large ongoing European banks' as victorious, in contrast to the rating agency's 'previous assumption' that 'official loans to distressed Spanish financial

institutions would eventually be mutualised among euro-zone governments' (Quoted in Keohane 2012). When in December 2012 Spain finally took a loan of €39.5B from the ESM for the purpose of bank capitalisation, the ESM (2013) made explicit that the loan was to the Spanish 'sovereign' and 'the Spanish government remains responsible for its repayment'.

With Cyprus' request for support the German line on the use of ESM funds hardened even further. The Cyprus agreement that was struck in March 2013 imposed losses on the bondholders and large depositors of banks and prohibited the Cypriot government using the €10B loan granted to capitalise the country's two largest banks. While the German government was certainly not alone in insisting on these terms, it was explicit that it could not be expected to provide German taxpayer support to bail out what it deemed Cyprus' "unacceptable" off-shore banking sector (Kambas and Tagaris 2013). Following the Cyprus agreement, the German government pushed further to keep bank liabilities away from euro-zone institutions and taxpayers. This approach culminated in the provisional agreement in June 2013 by EU Finance Ministers on a 'bail-in' regime from 2018 that will impose the primary costs of bank failure on bondholders, shareholders, large depositors, and national governments as a condition of access to ESM funds (Barker 2013).

Put more schematically once the mutual exposure in the periphery of German and French banks diminished the acute underlying divergence of interests and macro-economic preferences between the German and French governments, which had never gone away, returned to the fore. At the level of interests Germany's economy, as Bulmer and Paterson (2013: 1395) note, is on every significant indicator stronger and more competitive than the French. Moreover the crisis has magnified the difference in performance. Whatever the past strength of the French-German axis (Krotz and Schild 2013) the problems of the French economy now have more in common with those of the Spanish and Italian than they do the German. At the level of macro-economic preferences the German government remains much more committed than the French to price stability and balanced budgets. These fundamental differences cannot but have serious consequences for the ability of the German and French governments to agree on problem-solving measures for the euro in the future. Moreover the decline in the shared interests of the two states' banking sectors leaves the German government in a freer position to decide on its future commitment to maintaining the euro.

4. Conclusions

The conditions for success of any monetary union between states are demanding. As Cohen (2004: 157) has argued an effective monetary union structurally requires either a 'powerful state committed to using its influence to keep a monetary union functioning effectively on terms agreeable to all', or 'a broad constellation of related ties and commitments sufficient to make the sacrifice of monetary sovereignty whatever the costs, basically acceptable to each party'. Conceived in these terms the sustainability of the euro-zone depends on Germany's ability and willingness to meet either condition. Either Germany needs to use its power to strengthen the institutional foundations of monetary union and increase the currency's practical benefits for the core and the periphery; or it has to establish a broad consensus of preferences around its own that reflect underlying common interests between member states such that the policy autonomy loss of the single currency seems redundant given substantive economic outcomes.

In practice the German government's management of the euro-zone crisis has yielded little evidence it has actively decided to use its power to sustain the euro on terms that are agreeable to others, especially in the periphery. By whatever route the decisions of the German government were reached, German policy in outcome has served the interests of the German banks and the consequences of German decision-making have intensified the crisis in the periphery. Nowhere was this clearer than in the long delay on any restructuring of Greece's debt.

Neither has the crisis produced convergence towards German preferences and interests, which if it had occurred could in principle have facilitated the creation of a broad coalition of support to address the union's structural weaknesses. To the contrary in several crucial ways the policies the German government supported have intensified the divisions of interests and preferences that made the euro-zone such a difficult currency area at the onset. Again the terms of the first Greek bailout and its fallout graphically demonstrate what has occurred.

At the level of policy preferences the divergence within the euro-zone is now more acute than it was at the start of the crisis. The German government has imposed its preferences for structural reform on the periphery without economic outcomes in the periphery starting to resemble those in the core in ways that would allow for future convergence. Meanwhile Germany's commitment to fiscal *ordo-liberalism* is now domestically more entrenched than ever. Even if it wished to the German government could not loosen its fiscal policy to try to find a short-term compromise of preferences to lessen the pressure on the periphery without undoing the balanced budget amendment to the Basic Law and inducing a domestic political

crisis. Dullien and Guérot (2012: 10) may advise that ‘when negotiating with Germany, its European partners should focus on issues where some movement in the German position can be expected, rather than expect a change on issues on which there is a consensus in Germany’, but the centrality of those latter issues to the essential disagreement about macro-economic policy between Germany and others leave very little space for consequential preference convergence.

Meanwhile the breakdown since 2010 of financial interdependence between the core and the periphery realised through the actions pushed and supported by the German government has produced a widening conflict of economic interests within the euro-zone. At the beginning of the crisis creditors in the core and debtors in the periphery were at least bound to the same of problem of the risks of default and redenomination. Now that minimal commonality of interests in the debt crisis has been broken by the various policy moves that allowed German and French banks to withdraw much of their money from the periphery. States and corporations in the periphery will now largely have to be reliant on domestic banks to finance themselves, and they will have to do so at higher rates of interest than prevail in the core. Consequently, as Dyson (2010b; 2012) has argued, the conflicts of interests created between creditors and debtors will continue to incite confrontation. Privileging the interests of German and French creditors over periphery debtors was not the necessary cost of saving the euro-zone for the collective whole. Rather it was a conscious act of two core states that served their preferences to avoid further national bank bailouts at the expense of states in the periphery, which were then left to manage the severe political consequences of debt deflation. Once the policies pursued had successfully advanced creditor interests, the distribution of the burden of adjustment has changed too, once again in favour of the core. The primary private creditors of the periphery are now banks in the periphery, and thus it is periphery creditors that will endure the costs in future bail ins.

In principle the fear of a loss of credibility could serve as a partial substitute for at least the convergence of perspectives of ultimate tolerability in maintaining the euro. As Cohen (2012) has argued the euro does not have to succeed to endure. Even the conflict-ridden politics created by creditor-debtor clashes of interest could in principle be the price that is paid by the periphery for the impossibility of collective retreat. Yet to reason from this possibility to the conclusion that the euro will indeed continue supposes that the inviolability of the euro for Germany, regardless of the outcomes it produces for German economic and monetary preferences and interests, has been demonstrated by the German government’s handling of the crisis. In practice, given the interests created for the German government by the

precariousness of German banks, it is far from clear that any such commitment has been made manifest. Contrary to the myth of German sacrifice, the German government could not have eschewed bailouts for the periphery without inflicting such significant damage on its banks that acting otherwise than it did once the German government had accepted the scale of the problem and ruled out further national bailouts is scarcely conceivable. Thereafter, as the exposure of German banks to the periphery has lessened as a result of action advanced and supported by the German government, German policy has shifted to reduce the euro-level support for the periphery. Most significantly virtually all the moves made by the German government from July 2012 have been away from debt mutualisation and towards pushing liability for unsustainable debt onto national actors.

Interests matter in general in understanding political outcomes around distributional conflicts, and the euro-zone crisis is no exception. Under conditions of profound underlying divergence the interests of German banks are now significantly less bound to the periphery than they were at the beginning of the crisis and this change has reworked the parameters of the options open to the German government. Certainly the corollary of the manner in which this outcome has occurred has potentially created euro-zone level liabilities for the German central bank through the euro-zone payment system, TARGET 2, even if the practical magnitude of these liabilities in the event of any eventual break up of the euro-zone is far from clear (De Grauwe and Ji 2012). Nonetheless rather than Germany having offered domestic sacrifice in exchange for the exercise of more overt leadership of the euro-zone, German policy choices have in themselves, and in their consequences, intensified the structural clash of interests between creditors and debtors that has now been layered on top of long-standing macro-economic disagreement between Germany and most other member states. Recognising this reality does not of course in itself say anything about the strength or otherwise of the German government's commitment to the euro. It does mean, however, that German support for maintaining monetary union has not been put to the test.

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