German Hegemonic leadership in Europe in good times and bad: A cautionary tale and the lessons of history

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„In einer Währungsunion kann man sich große und noch anwachsende strukturelle Divergenzen zwischen den Ländern nicht leisten, denn sie können tendenziell explosiv werden. Und deshalb bedrohen sie die Existenz der Union, der Währungsunion",

--Mario Draghi (2015)

"The parallels between Europe in the 1930s and Europe today are stark, striking, and increasingly frightening. We see unemployment, youth unemployment especially, soaring to unprecedented heights. Financial instability and distress are widespread. There is growing political support for extremist parties of the far left and right." -- De Long and Eichengreen (2012)

"In order for the world economy to be stable, it needs a leading nation, a benevolent hegemon, a stabilizer. I am convinced that, with qualification, the same insight carries over to the European (Monetary) Union."[2] -- Wolfgang Schäuble (2010)

"There are twenty-eight countries in the European Union: Twenty-seven small countries and one big one." –Olli Rehn, European Commissioner for Economic and Monetary Affairs and the Euro and Vice President of the European Commission (October 28 2013)

Introduction

Pundits around the world are criticizing Germany for either trying to reshape Europe in its image or acting in its own self-interest with little concern for the health of the euro and the economy of the European Union. Germany. Germany has been accused of creating a new "empire," of pursuing a new *Sonderweg*, of "going global alone," of evasiveness, self-imposed isolation, and bullying. The U.S. Treasury and the IMF have accused Germany of pursuing "beggar-my-neighbor" policies with its trade surpluses that threaten the Eurozone and even the global economy. Germany protests that it is doing all it can to save the euro and contribute to European economic health. Who—if anyone-- is right and how do we know?

This paper takes a stab at answering these questions. It highlights the importance of an historical perspective for the understanding of present and future trajectories in the eurozone and in Europe as a whole. It argues that history suggests that hegemonic leadership is needed for the health of a monetary union.We show that Germany has long been Europe's economic hegemon, that in 'good times' it has indeed exercised hegemonic leadership in Europe and particularly in European exchange rate regimes (though that fact is often denied). Drawing on the historical

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[2] Authors' translation of "Damit die Weltwirtschaft stabil sein kann, benötigt sie eine Führungsnation, einen wohlwollenden Hegemon oder „Stabilisator". Ich bin davon überzeugt, dass sich diese Erkenntnis mit Abstrichen auch auf die Europäische (Währungs-)union übertragen lässt."

analogy of the Gold Standard we further argue that a particular kind of hegemonic leadership in the eurozone is required when times are bad.

Why do we look to history and particularly to the Gold Standard for insight? The Gold Standard of the 19th century and early 20th century and the European Monetary Union have much in common. Both are rigid forms of fixed exchange rates, both are characterized by the free flow of currency between individual countries, and both were thought to be(come) self-stabilizing at their time of inception with the market determining the real currency value in the absence of international coordination. We argue here that these common characteristics provide a cautionary tale: A free trade area bolstered by a fixed exchange rate regime or a monetary union is inherently unstable and, left to itself, will wreak havoc on the very economies the regime is intended to integrate.

Because of this tendency toward instability, fixed exchange rate regimes and monetary unions need intervention to reduce the effects that will destroy them. Following Charles Kindelberger, we argue here that a monetary union needs a hegemonic leader with the resources and willingness to come to the aid of the deficit countries so that they can avoid deflation while adjusting their economies and remaining in the monetary union. The stability of the Gold Standard of the 19th and early 20th centuries required the hegemonic intervention of Great Britain and the city of London to aid deficit countries; when Britain was no longer able to provide that aid, the Gold Standard—left to market forces alone—collapsed. The gold exchange standard of the last half of the 20th century required the hegemonic intervention of the United States; when the United States government refused to support the value of the dollar—the world's major reserve currency-- with gold, the fixed exchange regime collapsed. We will show that, similarly, the eurozone needs a hegemonic leader to intervene on behalf of deficit countries. We will also show that Germany has the capabilities to act as Europe's hegemon and has played that role within the European Union. However, Germany has refused to provide hegemonic stability to the Eurozone. We predict that, if Germany continues to refuse to play the role of the hegemonic leader, the European Monetary Union faces collapse.

It is the construction of these regimes as "self-regulating systems" that portends their collapse. Many will remember Geothe's "The Sorcerer's Apprentice";[3] it is an apt metaphor for fixed currency regime like the Gold Standard or the euro as it stands today. The apprentice magician, tired of his household chores, tests his nascent skills at sorcery by bringing useful household tools to life, giving them the power to accomplish their tasks on their own without the apprentice having to use them. At first, the plan works well, but eventually the tools take on a life of their own and run amok, leaving chaos in their wake.

Like the sorcerer's apprentice, the architects of the Gold Standard, gave it the power to function on its own. Currencies were pegged to a single value (gold), in order to reduce the transaction costs of trade; no manipulation of currency values was required or desired; deficit countries could simply deflate their economies or borrow extensively to pay their bills and balance their budgets while leaving the value of the currency intact. The „tool" worked well to stimulate trade, but the measures used to maintain the currency value ultimately wreaked havoc on the economies of the trading countries. Deflation led to high unemployment, giving birth to social unrest and political instability. Excessive borrowing triggered banking crises; the threat of such a crisis triggered panic and contagion, deepening crisis and fragmenting trade.

The euro is a similar tool, fashioned to "work on its own." All members of the eurozone use the same currency with its value set by international financial markets rather than monetary

[3] Disney popularized the story in its *Fantasia* film.

authorities. Members in deficit must deflate their economies or borrow heavily in order to pay their bills; the currency value remains untouched by economic circumstances, while the economies of the deficit countries suffer in order to protect the currency. The "tool" of monetary union worked well in the years following its inception, pushing down interest rates, stimulating free trade and growth. Indeed, it worked extremely well for Germany. But as a self-regulating tool, it eventually ran out of control, and deficit economies using suffered increasingly high unemployment as they struggled to reign in spending in an effort to balance spending and trade, giving rise to domestic unrest and crisis. Measures have been taken to protect the monetary "tool," but not the economies of those using it.

We begin by fleshing out the conceptual argument that because of the risky "sorcerer's apprentice effect," free trade regimes, fixed exchange rate systems, and monetary unions require hegemonic leadership to ensure the cooperation needed for stability. We then turn briefly to a discussion of the Gold Standard and the Gold Exchange standard and show that cooperation under both flourished under hegemonic leadership and collapsed without it. In the final section, we focus on the eurozone crisis, showing why the monetary union needs a hegemon. We show that Germany has the capabilities to provide hegemonic stability, has long acted as Europe's hegemon—particularly in its exchange rate regime, and has indeed paid the lion's share to stabilize the euro. Nonetheless, in this period of crisis, it has not exercised the hegemonic leadership necessary if the currency union is to survive.

I. The problem of international cooperation and the need for a hegemonic leader

A. The Problem of Cooperation in a monetary union

States in the international system cooperate with one another to achieve goals that individual nations cannot achieve alone, (for example, they form multilateral organizations and enter into treaties). But achieving cooperation is difficult because all want its benefits while paying the least possible cost (Olsen 1965). Or they decide that, although cooperation benefits the group as a whole, it does not promote their individual goals as well as their own unilateral action would. Cooperation is uncertain because each is worried that others won't cooperate. In a world of sovereign states, members of a cooperative regime—even one as tightly integrated as the European Union-- can leave any time for these reasons.[1]

Cooperation to achieve free trade provides a good example of the conundrum of international cooperation. Free trade generates more wealth for all than would be available without trade. Based on the theory of comparative advantage, members of a free trade regime specialize in producing goods which they can make most efficiently instead of focusing on the production of the goods that others can produce more efficiently and cheaply. By specializing this way, production costs decrease and overall production increases. Trade based on specialization therefore stimulates economic growth in all trading countries, allowing them to export their most efficiently produced goods and import goods which would be more expensive to produce at home. Though some gain more from free trade than others, in theory, all are better off than before trade. Even the least competitive economies in a free trade regime eventually grow when they shift to the production of goods which they can produce most efficiently. Problems arise, however, for less competitive countries under free trade because they must begin to import goods made more efficiently elsewhere. Production of those goods at home disappears, causing unemployment. Unemployment can trigger political discontent until

production shifts to more competitive goods; governments often can't wait for the shift to materialize and are tempted to leave the international cooperative free trade effort in order to maintain domestic political stability. They prefer political stability to future economic growth that free trade promises. They erect trade barriers which then reduce their trading partners' exports and weaken their economies as well. Trading partners retaliate, setting off a cascade of rising trade barriers. All are worse off when each country attempts to protect its industries as a free trade regime disintegrates. They become prisoners of their own defection, captured in a non-cooperative equilibrium.

The same tension exists in a monetary union. States who trade with each other want to share a single currency because under national currency systems, exchange rate stability is not assured. Under a single currency, currency value is the same for all trading partners. This lowers the cost of doing business. Exchange rate volatility makes the value of traded goods uncertain. One partner in a business transaction will lose money if the currency of his trading partner is devalued. The more a currency's value fluctuates, the more likely that this loss will occur. This instability eventually makes traders more hesitant to conduct business. For example, prior to the creation of the euro, if a French trader wanted a product from Germany to sell in France, the merchant had to exchange French francs for German deutschmarks to pay for the product. If a fluctuation in the exchange rate between the franc and the deutschmark caused the deutschmark to be valued higher than the franc at the time the product is delivered, the merchant would lose profit, since he would have to come up with more francs to trade for deutschmarks to purchase the product.

Outside of a monetary union, the market forces of supply and demand cause exchange rates to fluctuate. But there is another reason for fluctuation: state intervention to manipulate currency value to meet national economic goals. If unemployment is on the rise, for example, states are tempted to devalue their national currency in order to stimulate exports and create jobs. Then trading partners are tempted to do the same. The problem is that currency devaluations can set off a chain reaction that will hinder trade. This uncertainty reduces the volume of trade and threatens a free trade regime that promises to benefit all. One advantage of monetary unions is that they reduce or eliminate transaction costs; especially those associated with large, unpredictable fluctuations in exchange rates. But members would still be tempted to leave it to protect their own economies when they deem it necessary to achieve political stability.

Ultimately there will always be a temporal contradiction between the requirements of a liberal trade and exchange rate regime and the requirements for national political stability. Individuals and firms are free to fail in the market, and the inefficient must fail for the sake of growth and prosperity for all. The basic anarchy of the market mechanism acting on its own—like the tools of the Sorcerer's Apprentice—produces instabilities in the lives of individuals and whole societies. Governments topple when society is unstable; they therefore act to protect their societies from the worst economic by withdrawing from the unregulated market.

B. What is a hegemonic leader and why is one needed to sustain cooperation?

Hegemonic leaders can soften the contradictions that liberal markets and fixed exchange rate regimes impose. More generally, a hegemonic leader can alleviate the tensions of cooperation by providing the bulk of a collective good, i.e., liquidity and/or a large, open market, thereby increasing the incentive of those who share in the consumption of that good to cooperate. Our definition of a hegemonic leader is the standard one first introduced in the literature by

Charles Kindleberger (1986), and elaborated by Robert Gilpin et. al (2002), Robert Keohane (1985), Barry Eichengreen (1990), and others in Kindleberger's tradition (i.e. Krasner, 1976, Snidel 1985): *a hegemonic leader is the state powerful enough to pay the costs required for cooperation and the state most instrumental in shaping the roles of cooperative institutions that can prevent defection from cooperation*[2].

How does a hegemon do this? A hegemonic leader of a free trade area and monetary union can raise the incentive to cooperate by providing resources for states facing a trade deficit to stimulate their economies and therefore maintain their membership in the regime. In the absence of hegemonic intervention, states in a monetary union who face trade and budget deficits are forced to take "austerity measures," e.g. deflate their economies, lay off workers, and reduce pensions and incomes in order to rein in inflation and imports. This hurts all trading partners, and therefore the temptation to deflate and to defect from the regime must be removed. A treaty commitment to remain in the union is simply not enough. Needless to say, austerity measures which put the burden of cooperation on weaker deficit countries will tempt those countries to leave the union.

Kindleberger (1985) claimed that in order to remove the temptation to defect from a free trade regime, the hegemonic leader must provide five incentives: a stable exchange rate (to provide certainty in cross-border trade), a market for distress goods (goods that cannot find a buyer, thereby stimulating the potential defector's economy and creating employment), countercyclical long-term lending (to balance deficits and possibly create jobs), macroeconomic policy coordination (to maintain sustainable government debt and build institutional arrangements that allow the correction of emerging imbalances), and real lending of last resort during financial crises. The hegemon might need to run a trade deficit with the crisis country to stimulate his exports; it would need extensive capital for countercyclical and last-resort lending. Finally, it would need to provide these incentives in order to gain agreement from other members of the union for the creation of stable institutions for policy coordination.

Leadership to strengthen cooperation in these ways is called "hegemonic" because the state willing to provide it has enough resources to provide the plurality of a common good. What are those resources? Robert Keohane lists five kinds of resources that a state must possess in order deserve the title of hegemon: control over raw materials, control over markets, control over sources of capital, a competitive advantage in the production of highly valued goods, and military superiority. After World War II, the United States was the only state left standing who could boast control in all dimensions; the United States was the world's hegemon (Gilpin, et. al. 2002). It lowered its trade barriers and ran trade deficits so that the economies of Europe and Japan could grow and cooperate in a free trade regime. It supplied Marshall Plan aid for European reconstruction and military security for its allies. In the creation of the first European Communities, the U.S. acted as the "external" hegemon, both paying the costs and taking blame for being heavy handed; the U.S.' provision of security and aid prevented any one state ***within*** Western Europe from appearing dominant in the cooperative effort.

Why would powerful states pay the price of cooperation and take on this task of being a hegemonic leader? Because they perceive that the benefits of the common good (i.e. a defense alliance or a free trade regime) outweigh the costs of providing it. A hegemonic leader of an alliance, for example, will pay the costs because a peaceful, cooperative environment is in its best interest, and the costs of providing it are lower than costs of arms races and wars. In a monetary union, a hegemon will underwrite cooperation in the ways outlined above because the

stable currency that cooperation offers will work to its benefit, promoting exports, creating certainty in good times and preventing competitive devaluations in bad.

The hegemon of a cooperative regime does not lead alone. Indeed, leaders have never had such a preponderance of power that they could provide the *all* resources needed for stability (Eichengreen 1990). But they must provide a disproportionate share of those resources. Indeed, it would not be a good idea to provide all. Charles Kindleberger (1981) suggests that shared leadership adds legitimacy and reduces the danger that leadership will be regarded as a cloak for domination. Shared leadership reduces the temptation of hegemons to bully. Certainly, cooperation among liberal democratic states requires leadership within institutions in which all members have a say.

It not altruism, but rather it is the provision of a *disproportionate* share of resources to underwrite cooperation that characterizes hegemonic leadership. Like other members of cooperative arrangements, hegemons gain the intangible benefits of stability, while also garnering reputational benefits and influence as a result of taking on the largest burden. But they also gain tangible benefits. In a free trade regime, for example, although in theory open markets benefit all, they benefit the strongest economy the most; its exports are the most competitive; they provide the most lucrative employment market. But though they gain the most, free trade is not a "zero-sum game" in which some win and some lose. In fact, it is considered a "positive sum game" in which the efficiency and innovation that free markets create benefits all, despite the asymmetry of benefits.

While hegemons provide absolute gains to the system, making their trading partners more competitive, over time, they will sustain relative losses by narrowing the wealth gap between them and themselves---even to the point of threatening hegemonic decline. Britian experienced relative decline as the leader of the 19th century free trade regime as its trading partners grew in economic might. In the last half of the 20th century, many Americans grumbled that U.S. military leadership in NATO and the defense spending required placed an unfair burden on the U.S., while NATO partners were free to pursue economic growth, thus closing the economic gap between themselves and the U.S. In the post-war international monetary regime, historical evidence shows that when the US *did* accept the costs of exchange rate stability, those costs ultimately undermined the U.S. economy (Gowa 1983).

When losses to hegemonic capability are too great, international cooperation--which depends on hegemonic stability--can become unstable over time as the hegemon balks in the face of his shrinking advantage. This happened to the exchange rate regime under the Gold Standard when British hegemony declined, eventually leading to the collapse of the regime. It happened to the postwar exchange rate regime under the United States as the U.S. deficit grew and the real value of the dollar weakened.

This resource drain-- which can destabilize the regime and lead to domestic backlash--threatens hegemonic leadership. The hegemon walks a tightrope between providing resources that sustain cooperation and dissipating his own power to provide those resources. Hegemonic leaders attempt to shape cooperative institutions and rules in order to protect themselves from this kind of resource drain. As noted above, paying a disproportionate share to maintain cooperation is not popular in a hegemonic state, and unpopularity threatens its government. Therefore hegemonic leaders try to spread the costs among all members while maintaining the economic strength required to provide an anchor for the system and protect their own interests.

But the point at which spreading the costs can lead to defection from cooperation on the part of weaker states is uncertain. Usually it is signaled by domestic political unrest in weaker

countries when the cost of cooperation does not seem worth the benefits. We can only approximate the resources needed to provide the hegemonic leadership needed to prevent defection from the regime, and we only have the 20-20 hindsight of history to tell us when spreading the costs too thickly can lead to the demise of the regime itself.

II. The Demise of the Gold Standard and the Absence of a Hegemon

A. Operation of the Gold Standard

The institutional (as opposed to legal) set of arrangements governing the Gold Standard dates back to the early 17th century. Until the creation of the Bretton Woods regime, there existed no international treaties governing it, only a "mentalité" that rested on a common set of beliefs (Eichengreen and Temin, 2010). In the absence of international law governing the Gold Standard, governments and people relied on the free flow of specie in good faith. In fixing exchange rates, the Gold Standard facilitated an unprecedented period of international trade and growth. David Hume argued that due to the Price-specie flow mechanism, the Gold Standard was self-stabilizing. As countries with current account surpluses amassed gold, their money supply increases (ignoring the possibility of sterilization) and, according to the quantity theory of money, this increase in money supply increases prices. Higher prices translate into a lower trade balance. The adjustment process was asymmetric in that it only fell on deficit countries and policy instruments beyond deflation (like devaluation) were not considered (Dam, 1982, Eichengreen, 1989, 1992, Jobst, 2009).

Kindleberger (1986) points out, however, that the system was in fact organized around the willingness of Great Britain (the Bank of England and the City of London, in particular) to support it by providing liquidity in the form of pound sterling. In this sense the Gold Standard was really a "Sterling Standard" in which the Bank of England used its monetary policy instruments to regulate the liquidity of the international monetary system: Given the industrial, military and economic power of the British Empire, the world economy was using sterling bills as reserve currencies. Temin (2013) describes how Britain ascended to the world's financial center using the proceeds of its industrialization-based export-led growth strategy and providing funds to ease the balance-of-payments problems of its (less-developed) trading partners. Rather than gold—which was heavy and difficult to transport, virtually all countries using the gold standard financed trade using the pound sterling.

B. The Demise of the Gold Standard

In changing the discount rate, the Bank of England was able to not only to affect credit conditions in its own constituency but also the costs of economic activity abroad (Triffin, 1964). Countries with developed capital markets were themselves able to adjust interest rates to bring their external balances into equilibrium, through raising (lowering) interest rates to attract (deter) capital flows. D'Arista (2009) shows that the period of the Gold Standard ushered in a period of steady growth in credit, trade, and income, but that this period was not built on the flow of gold, but London's financial services and Sterling credit.

World War I brought a moratorium of the Gold Standard. But after the war, most countries returned to it, some at pre-war parity and some at depreciated values. After turbulent times of German hyperinflation, British strikes, and the rise of Mussolini, the second half of the

1920s was a period of relative peace and relative prosperity with the Gold Standard semi-reinstated. Germany was able to partially recover from the war damage through provisions of private and public funds, coming mainly from the United States. France's economy entered the Gold Standard at an undervalued rate and was able to pursue export-led growth. While Britain's glory was in decline, it was still able to function as the world's financier through short-term lending (Minsky, 1986).

Temin (2013) argues, however, that because adherence to the Gold Standard removed changes in exchange rates as a policy instrument, this was a period of treacherous tranquility in which external imbalances were building under the surface. Germany and Britain relied on foreign lending or aid to maintain employment. France and the United States were accumulating large amounts of gold. Following Eichengreen (1992), Temin (2013) argues that this multitude of external imbalances let to a series of currency crises which pushed the struggling world economy into depression. In their wake, governments decided to defect from the international agreement to peg their currencies to gold.

After the stock market crash in 1929, the financial crisis in 1931 is seen as the decisive moment starting the Great Depression in most analyses. The collapse of the Creditanstalt in Vienna cascaded to Berlin and other major financial centers until the crisis reached London and New York (Kindleberger, 1986). For Friedman and Schwartz (1963) monetary policy was more destabilizing than financial markets. Ferguson and Temin (2003, 2004) argue that the financial or banking crises and monetary policy in the 1930s were not the cause but the collateral damage of the Great Depression which was initiated by an Austrian currency crisis. In either case and just as today, the fear of contagion of financial distress in a minor financial market gave investors jitters and threatened the integrity of the whole system. International policy coordination was weak and the whole system disintegrated.

While many policy makers took their economies off the Gold Standard, its mentalité stayed in their minds. Germany's Chancellor Brüning continued his emphasis on austerity and deflation and did not utilize the newly gained degree of freedom in the current account (James, 1986, Eichengreen and Temin, 2000). The same holds true for actions of the Bank of England and Hoover in the United States. Money supply contracted sharply and deflation and depression replaced the belle époque. To counter both, countries engaged in competitive devaluations which, in combination with restrictive trade policy, lowered cross-border trade and capital flows. Each nation did what it deemed best in its interests (Gisselquist, 1981).

Kindleberger (1986) argues that the international economic order became unstable during that time because no nation was strong enough to enforce cooperation to sustain external and internal balance within the Gold Standard in Europe and the world as a whole. This absence of hegemony was the ultimate reason why the lingering recession became the Great Depression. Britain was already transitioning to the periphery, and the United States was either unwilling or unable to take its role until after 1945 under the Bretton-Woods era (Cairncross and Eichengreen, 2003). This had dire consequences: because"… every country turned to protect its national private interest, the world public interest went down the drain, and with it the private interests of all…"(Kindleberger, 1986).

III. German Hegemony and Economic Cooperation in the EU and in the Eurozone

Creating and maintaining cooperation within a free trade regime is the primary raison d'être of the European Union. To create and sustain free trade in Europe, the EU was built as an

organization with a regulatory structure built to reduce transaction costs in a single market and to provide incentives for cooperation. Indeed, 94.2 per cent of the EU budget is devoted to shoring up and administering the free trade regime. The regulatory structure, for example, includes production standardization, standard environmental regulation, standard rules for high technology exports. Incentives for cooperation within the regime include cohesion funds to protect the less competitive and stimulate poorer regional economies: The Common Agricultural Policy, Rural Development and Fisheries Administration, Regional Competitiveness, and Economic Cohesion. The composite effect of these expenditures is to create a regime within which equal standards and economic conditions will allow for efficient free trade.

A. German Hegemonic Resources

While it is commonplace to note that cooperation within this regime depends upon a pooling of resources and a political compromise between France and Germany as the two largest members, a closer look reveals that it is Germany that has provided the kind of hegemonic leadership required for cooperation. With regard to Germany's capability, as noted above, we follow Robert Keohane (1984) in asserting that there are five resources that a state must possess in order deserve the title of hegemon: control over raw materials, control over markets, control over sources of capital, a competitive advantage in the production of highly valued goods, and military superiority.

We should note here that to assert that Germany has the resources to be a global hegemon would of course be ludicrous. Certainly as the world's fourth largest economy, and second largest exporter, it is considered a global „great power", but it lacks the military resources to provide traditional security in a European alliance, or to be a malevolent, land-grabbing imperialist. But military power is not relevant in the context of the European Union. Despite efforts to expand its powers in other issue areas, including a common foreign policy, since the 1980s, the EU is indeed primarily a free trade regime. What Germany *does* have is resources to underwrite that free trade effort and thus exercise hegemonic leadership within that regime.

Germany is, like most EU states, dependent on other nations for raw materials, particularly energy. Indeed, Germany's lack of raw materials has historically been a justification for aggressive expansion. Although Germany may never "control" sufficient energy resources within its borders, its energy independence is growing faster than any other industrial nation (Buchan 2012). It is the largest producer of renewable energy in Europe (Eurostat 2012), and its connections with global energy suppliers are geared to assure a secure energy supply through its export dominance (Germany is the largest exporter to the Middle East) and the expansion of German board memberships in foreign energy corporations. As two observers put it: "German capital very much guards the energy back door of the EU, reaping a range of related benefits in ... commercial exchanges." (van der Pijl, K. et. al. 2010).

The second of Keohane's measures is control over markets. As noted above, no two countries benefit equally from a trading relationship. Depending on the size and structure of their economies, one country (usually the one with a lesser economy) may become disproportionately dependent on the other even as it becomes better off than it was before that relationship. When commerce with a larger country accounts for a very large proportion of the total imports and exports of a smaller economy, the latter is increasingly vulnerable to the larger country's influence. Germany and its neighbours find themselves in this position of dominance and vulnerability. Germany exports more goods and services to other EU states than any other

member3 and remains the biggest exporter and import market in Europe. EU countries absorbed 59 percent of Germany's exports in 2011, and few other European exporters can supply the products that Germany produces at the price that EU and euro-zone membership affords. Clearly, Germany's exports also depend on the EU market,4 but its trade focus is gradually shifting to Asia and the developing world. Indeed, Germany dominates the EU's global trade;5 and is the largest exporter to China and Russia. In 2012 Germany had by far the largest trade surplus of any EU member state; France and Britain, the second largest economies in Europe, ran trade deficits.6

The third source of hegemonic power is control over sources of capital. Companies in countries with large capital markets have deep pockets; they can draw on savings and their own export earnings in order to invest domestically and abroad while growing through cross-border mergers and acquisitions. Governments can leverage such large capital markets to advance foreign policy objectives, controlling access to it in quid pro quo negotiations. Thanks to its steady, booming economy, large trade surplus, and the highest ratio of savings to GDP in Europe,7 Germany became a magnet for foreign capital, rapidly becoming the largest capital market in Europe, providing ample credit for investors both in Europe and in the rest of the world. Germany became the main supplier of intra-EU foreign direct investment (FDI)8 and Europe's preeminent destination for FDI from both European and nonEuropean firms.9 Bursting with profits, German firms have achieved an unprecedented global centrality in interlocking directorates among the world's largest corporations,10 and because Germany was the only major eurozone nation to escape the credit downgrades that have hit its neighbors, foreign investors continue to overwhelmingly prefer to cache money in German banks.

Finally, a hegemon must be the largest producer of value-added goods. It imports products that are labor intensive or produced with well-known production techniques. It produces and exports the most profitable products and those that will provide the basis for producing even more advanced goods and services in the future. Germany has a competitive advantage in the production of these goods in Europe, and maintains the largest share of manufactured goods as a percentage of GDP in Europe. Germany's share is 28 per cent; France's share is 18 per cent, and Britain's is 21 per cent[11] Additionally, the German industrial worker remains the most productive in Europe, as the country is the European leader in heavy industry, and in the production of high technology manufactured goods. In terms of patent applications per capita (measured per million inhabitants), Germany also ranks first in Europe. Moreover, Germany has the highest percentage of employees in knowledge-intensive services in the EU.12 Germany dominates European trade in transport equipment and machinery, chemicals and other manufacturing goods.

Finally, Keohane notes, a hegemon must possess superior military power. But traditional military power has been rendered increasingly useless in a world where states no longer have a monopoly on violence, where overwhelming modern force cannot defeat tribal combatants living in caves, where computer hackers can potentially shut down a nation, where threats to the "national interest" can come from the earth's atmosphere, where a crisis of confidence in a single economy (like Greece's) can bring the globe to the brink of economic disaster, and where, as Konrad Jarusch has written, "havoc created by global capitalism . . . is beginning to rival the suffering caused by the nation state." Asking who won a given war in the last half of the 20th century and in the first decade of the 21st century is like asking who won the San Francisco earthquake. Germany is exceptional in that it has all but abanded this halmark of hegemony at

an ironic point in history in which its very usefulness to provide security has increasingly been called into question.

In sum, Germany possesses advantages that permit it to underwrite the free trade regime—or act as a hegemonic leader-- in Europe. But has Germany been willing to do so? In what follows, we argue that in the twenty years since the Wall fell, the answer has been yes. Germany has taken the lead in shaping the European institutions that bolster free trade, both to stabilize the free trade regime and to serve its own self interest. It does not, however, shape those institutions alone. And as we have noted above, hegemonic leadership has an Achilles heel: expenditure of resources to maintain cooperation can drain hegemonic power and cause domestic backlash; and not expending enough resources will cause the hegemon to lose legitimacy in the eyes of its partners, even triggering defection from cooperation. And as we shall see, although Germany has exercised hegemonic leadership in "good" times, the Achilles heel of hegemony may prompt an unwillingness or even an inability—to exercise that leadership in bad times.

B. Evidence of German hegemonic leadership in Europe

Throughout history, many states have achieved economic hegemony by the strengths enumerated here, but few have provided the kind of leadership that is necessary for cooperation in free trade regime. Germany, however, has provided that brand of leadership, in providing the most support for cooperation in the EU as a whole, making side payments for cooperation in specific issue areas, and in constructing European institutions that codified cooperation and burden sharing.13 German hegemony is "embedded" in the EU (Crawford 2007).

Germany is the largest net contributor to the EU budget, consistently paying almost twice as much as it has received. In contrast, France and the UK maintain relative parity between payments and receipts. France, in particular, has reaped the most benefit of any EU member from the CAP funds to subsidize its farmers. In the realm of nonproliferation policy and export control, Germany also continues to be the leader in cooperative efforts to stem the tide of weapons proliferation, imposing stringent restrictions on its own high technology exporters compared to other members.14 Being by far the largest of the environmentally progressive countries in the EU, it is the most important of the three leaders in EU environmental policymaking. In diplomacy, Germany has been called the most important member of the EU 3 negotiating team in the Middle East.15 Germany was the undisputed architect of European Monetary Union and took the lead in the EU to curb the spread of technology that can be used to create WMDs. Furthermore, to assuage fears of its dominance, Germany agreed to the relative overweighting of the less populous France and Britain in EU voting and is notably underrepresented in qualified majority voting in the Council of Ministers.16 Germany has contributed 27.1 per cent of the ECB's €6.36 billion in capital, but has the same voting rights as Malta, which has paid less than 1%. Austria paid only 2.8 per cent.17

As German strength attests to, leadership and self-interest in a free trade regime can be quite compatible. Hegemonic leaders benefit from the cooperative arrangements that they support, but that does not mean that others are disadvantaged. In analyses calling Germany a „political dwarf" in Europe, what is forgotten is that the EU was and continues to be *primarily* a free trade regime. Still, the greatest economy benefits more from free trade than others. Even before unification, Germany as a „reflective multilateralist" with the biggest economy benefitted

from each decision to enlarge and deepen the single market and to make it more efficient. Germany's growing export surplus affirms this fact.

In guiding policy development for the union as a whole, Germany is less than altruistic. For example, in environmental policy, Germany vied to have its standards accepted by the European Community as a whole in order to "level the playing field" so that German exporters would not suffer from regulatory restraints that its European competitors did not share (Sbragia 1992). The same is true of the export control regime; German controls on high technology exporters were more stringent than those of their European competitors, and exporters wanted European standards to rise to Germany's level. Self interested? Certainly; but most would agree that stiffer regulations to protect the environment or curb the export of dangerous high technology serve the common good in ways that go beyond creating a level playing field for trade. Finally, although Germany is the top contributor to EU Cohesion funds, it is also the top *indirect* beneficiary of cohesion payments. Each euro that Germany pays into EU cohesion funds generates 1.25 euros in revenues from exports to new member states (EU Business 2012). Germany benefits most, but EU members agree that enlarging the single market and aiding underdeveloped regions benefits all. Self-interest is not the antithesis of hegemonic leadership. And hegemonic leadership does not call for altruism or the negation of self-interest.

Attention to self-interest deflects domestic criticism of hegemonic leadership. Exporters in Germany have benefitted tremendously from the single market and from pan-European regulations that rise to German standards in order to create what exporters call a "level playing field". These policies support not only domestic interests but deeply entrenched norms: German export philosophy regarded exports as a *right* of business; all state interventions needed specific and explicit authority.'When important social groups benefit and a deeply entrenched world view is upheld, hegemony is bolsetered domestically.

As noted above, hegemonic leaders do not lead alone, and Germany in Europe is no exception (Pedersen 1998). It is commonplace to note that Germany and France as the original founders of the ECSC, have long been the two "pillars" providing dominant support for the European project—with, as Charles de Gaulle noted, Germany the horse and France the coachman of the European "coach." This image was fine for public consumption—France's need to assert great power status and Germany's need to keep a low profile after its defeat in World War II. In reality, however, it was Franco-German *agreement* as equal partners that was required for Europe to move forward. When Germany rejected France's intergovernmental Fouchet Plan, it fell through. The Franco-German Friendship treaty, codified the *equal* status of the two countries. As we shall see in a moment, as German power grew, Germany got the euro it wanted when France caved in to German conditions. When France attempted to create a European aerospace industry to rival Boeing, Germany rejected it and it fell through. France was not able to convince Germany to lift an EU arms ban for the Syrian rebels, to join the intervention in Lybia. And France was not able to tame Germany's demands for austerity in the Eurozone crisis. Germany is a co-leader in a number of issue areas. In diplomacy, Germany is one member of the EU 3 with Britain and France, shaping policy together, albeit with Germany in the lead. In EU environmental policy, Germany leads together with Sweden and Denmark, the top three „green" members of the EU. Although all 17 members of the European Monetary Union are represented on its governing board, Germany, along with France and Italy, has a permanent seat with two votes on the ECB's executive committee.

Only recently since the gathering storm of the euro crisis, have pundits begun to Germany as a "hegemon." The reference to Germany as a hegemon is found primarily in

journalistic accounts of the crisis and then only in the negative sense discussed above (Pederson 1998 and Crawford 2007 are the exceptions). In most of these accounts, Germany is described as the dominant but most blatantly self-interested state in Europe with the power to lead but reluctance to do so. Some reports and opinion pieces read as if Germany has dominated Europe since unification but has acted in a short-sighted, self-interested, self-centered manner, imposing costs on others in order to reap the benefits of disproportionate power. Other pieces read as if self-serving German hegemony arrived full-blown on the scene with the wave of the euro crisis, whereas previously German hegemony was not acknowledged.

In contrast to these accounts, I have suggested here that, with ample resources to underwrite cooperation, German foreign policy in Europe has evolved into that of a hegemonic leader as defined in the standard literature on hegemonic stability theory. Germany has been far from reluctant to underwrite cooperation: Germany assumes the largest financial burden in the EU, provides leadership in key issue areas, and as the largest economy and exporter, reaps the benefits of leadership in decisions that enhance the single market. There has been no evidence of reluctance, and evidence of self-interest is not evidence of policy „change" unless self-interest harms the interests of others.[18] Hegemonic stability theory explains why Germany agreed to rules that would ensure that the state with the strongest economy would make the greatest contribution to the EU budget. It explains why Germany has not led alone, and why it acts to protect its interests in the free trade regime. Germany has neither been a "reflexive multilateralist," a "normal" narrowly self-interested power, nor a "free rider" on multilateral institutions. German hegemony in Europe has been the long unacknowledged elephant in the room, and in the halls of power, largely continues in that role. Indeed, even in 2013 Chancellor Merkel refused to accept the label of "hegemon" for Germany within the EU.[19]

This does not mean that Germany will always be capable and willing to be a hegemonic leader in Europe. Below is a brief case study illustrating Germany's role in Europe's road toward monetary union. We show that Germany *did* play a leadership role, calling the shots and underwriting cooperation, but since the onset of the 2009 financial crisis, has stopped short of providing stability to the monetary regime. Germany may indeed prove to be a hegemonic leader only in "good" times.

C. German Leadership (and lack thereof) in European Monetary Cooperation

i. Snake

The history of monetary union in Europe provides a good case study of German regional hegemonic leadership in good times—and highlights the consequences of the absence of leadership in bad times. The absence of leadership and the role of that absence in intensifying Europe's financial crisis supports the argument about the need for hegemonic leadership in a free trade regime. Again, monetary union supports a free-trade regime by lowering transaction costs and eliminating currency volatility. The blueprint for monetary union was a 1969 agreement (the 'Werner Plan') which was shelved because of disagreements over how the burden of cooperation should be shared—whether surplus (France's position) or deficit (Germany's position) countries should bear the lion's share. (Crawford 2007: 124-126). Germany was not strong enough to get its way. In 1972, Germany introduced a substitute, called the 'snake,' which lined up European currencies in "bands" allowing for upper and lower limits of currency value. Snake members agreed to joint intervention in exchange rate markets to keep member

currencies within the band, buying up currencies that were dropping in value, and selling those that were appreciating.

In actuality, they did not have the resources to do so. Liquidity was in short supply, and interventions were few and far between. In fact, interventions were provided by Germany alone. This meant that deficit countries would have to deflate their economies, and/or leave the band altogether. And of course they left rather than deflate. By 1974, the "snake" had failed, but Denmark, the Benelux countries, France, Austria, Norway, and Sweden pegged the value of their currencies to the deutschmark, creating a zone of exchange-rate stability. But the peg to the deutschmark meant that members would have to adhere to German preferences, coordination of macroeconomic policies to tighten belts if necessary in order to maintain price stability, converging with German inflation rates.

ii. EMS

But because this deutschmark zone was German-dominated, German Chancellor Helmut Schmidt launched a multilateral initiative in 1978, a new set of common "bands," and a new set of rules that would be embedded in a new institution, the European Monetary System (EMS). Like the rules of the deutschmark zone, the rules of the EMS conformed to German preferences: exchange rate stability would be backed by increased policy harmonization according to antiinflationary standards. The EMS was also backed by two 'safety nets' for those with weakening currencies: liquidity and intervention, and though the EMS was supposed to provide those safety nets, they were actually provided by Germany.

Growing stronger by the day as a result of its increasingly important role as an international reserve currency, the deutschmark provided a central source of liquidity for the system.20 By the mid-1980s, Germany's reserve currency status required it to run a current account surplus. Throughout the decade, the Bundesbank bought falling currencies and lowered the discount rate to provide counter-cyclical lending. With Germany providing the resources, coordinated decisions on adjustment, providing liquidity, and intervening in crisis, the EMS proved to be remarkably successful in stabilizing exchange rates. With its success, German monetary hegemony grew and stable exchange rates benefitted German exporters in turn.

But the single market could not ensure continued economic growth, particularly because the dollar devaluation after 1985 made European exports to the world relatively more expensive. Despite the liquidity that Germany provided, and the currency interventions and discounts that did occur, European exports slowed, unemployment in deficit countries grew, and economic growth was reduced to a snail's pace. As the situation in the deficit countries worsened, Germany proved unwilling to provide them with adequate loans, since German officials believed that increasing liquidity in a recessionary period would put inflationary pressure on the system. The increasingly dire situation was exacerbated because the currencies of EMS countries of both deficit and surplus countries were interlocked; economic fluctuations between them were reflected directly in rising unemployment and cuts in the deficit members spending rather than in depreciation in value of their currencies. Many analysts attributed the worsening situation to the anti-inflationary (read deflationary) bias of the German-dominated exchange rate system. Although they benefitted from the credibility that the DM 'anchor' had given their currencies, deflationary pressures and the pressure on exports rendered adherence to EMS rules increasingly painful, for all but Germany, whose exporters continued to accumulate a surplus in intra-regional trade. As Kindelberger's argument would predict, cracks began appearing in EMS cohesion, , as

members—who were tied to the fixed exchange rate system-- were tempted to set their own economic policies to alleviate the budget stresses of trade deficits.

In short then, although Germany took on the hegemonic task of providing stable exchange rates in good times, it was unwilling to undertake the task of stabilizing the system through aid to deficit countries in bad times. In Germany's eyes, stability in bad times was the task of deficit, not surplus countries. But the EMS made no provision for deficit countries to tighten their belts in order to bring trade into balance. German leaders began therefore to prefer a tighter monetary union that would *require* deficit countries to deflate their economies.

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

iii. Eurozone

In 1988, France and Italy took the initiative that led to EMU and the creation of a European Central Bank (ECB). This bank would allow the deficit countries' 'voice' into the development of EU exchange rate policy. *But the core rules of EMU were not subject to a vote, and those rules were constructed according to German policy preferences*. Indeed, Germany quickly came on board in order to shape the new system, demanding an independent central bank dedicated to price stability, constraints on members' deficits and inflation, and tight sanctions on 'defectors.' Gone were the „safety nets" of the EMS. Germany then required a deliberate process of economic convergence among EMU members according to specified 'convergence criteria.' Indeed, Germany would not agree to a date for the final stage of monetary union until others agreed that those criteria must be met before a potential entrant could join the eurozone.21

The "convergence criteria" for membership in the eurozone represented a German effort to wrest some control over national budgets from member governments in order to achieve "burden-sharing" on the part of deficit countries. The criteria established common rules to ensure that members who made painful economic reforms would not face higher interest rates caused by countries who did not make the same reforms.22 The rules defined 3 per cent of GNP as the upper limit for public deficits and 60 per cent of GNP as the upper limit for public debts. Members also promised to maintain an inflation rate not more than 1.5% above the rate of the three members with the lowest inflation rates. In 1996 the convergence criteria were strengthened when Germany insisted on a "Stability and Growth Pact" (SGP) that created sanctions for defection. Any country breaching criteria for three consecutive years was subject to fines that could run to billions of euros. And of course, the European Central Bank as the guardian of price stability was not permitted to provide countercyclical loans or be a lender of last resort for members breaching criteria.

Germany's insistence on these measures was its way of diffusing the burden of adhering to a currency union. But in doing so, Germany relinquished a key function of hegemonic leadership that it had provided under the "snake" and the EMS; neither Germany nor the ECB

would provide loans or intervene in any other way to reduce recessionary pressures on members' economies. The strong German economy did provide one important component of Kindleberger's requirement for hegemonic stability: stable exchange rates.

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

But something was about to shift. Beginning in 1996, Germany fell into a sustained period of low growth and mounting fiscal burdens as unemployment skyrocketed, the population aged, and health-care obligations festered. In order to ease fiscal burden, the German government could have borrowed from within the EU capital market, (to which they were the largest contributor), but borrowing would have raised interest rates across the EMU region, further contributing to deflationary pressures. Germany attempted to adhere to the SGP, cutting government spending to meet the requirements, and shoving the economy into deeper economic crisis. By 2002 it had violated the pact and refused to pay the fine for doing so, following Portugal and paving the way for France to break the pact as well. Germany flouted the SGP for four years, and in doing so, weakened the very regime that it had created. It would now be difficult to ask other eurozone members with chronic deficits to curb their borrowing and spending.

This did not seem to matter to the German leadership because Germany—as Europe's main exporter-- was the chief beneficiary of the lower transaction costs that the euro introduced. And because the value of the euro was far below what the value of the deutschark would have been,22 German exports were therefore cheaper, not only vis-a-vis the exports of other major industrial nations but against all other members of the euro zone.23 A Deutsche Bank study in January 2013 calculated that Germany's higher value-added export products would only start to be disadvantaged when the exchange rate exceeded $1.54. Until that point, there is little damage to the German economy and indeed there is benefit in a strong euro because it keeps the prices of imported goods and hence inflation in check.[24] So rather than providing a market for their trading partners' goods, Germany began to rack up a huge trade surplus with the rest of the EU. Indeed, German exports increased four-fold from 2002 to 2010. In 2012, its share of the wealth created by the euro was almost half the EU total.25

German banks went wild with pro-cyclical lending. During the economic boom of 2003-2008, Germany extended credit on a massive scale to the eurozone's Mediterranean countries.26 And with that credit, they gobbled up German products while Germany bought little from them. Between 2000 and 2007, Greece's annual trade deficit with Germany grew from 3 billion euro to 5.5 billion, Italy's doubled, Spain's almost tripled, and Portugal's quadrupled. In Germany, consumption of imports dropped, and the savings rate increased.27 But as the financial crisis escalated in 2009, lending abruptly stopped, and Germany had thus failed the two tests of a hegemonic leader: providing countercyclical lending and providing a market for distress goods.28

D. The European Monetary Union and the Financial Crisis: Abdication of hegemonic leadership?

Recalling Kindleberger's argument, we remember that without hegemonic leadership in the form of a market for distress goods and aid to deficit countries, a fixed exchange rate system, and by extension, a monetary union will not survive. Germany had no intention of providing such a market, and EMU had no provisions for such aid. Of course, between 2003 and 2009 it appeared that a hegemonic leader was not needed. As expected, the pooling of risk in the eurozone kept interest rates low, and along with Germany's liberal financing, allowed deficit countries to fund deficits and buy German goods.

But low interest rates were a temporary privilege, given the growing imbalances in the eurozone. In addition to funding the shopping sprees of debtors, low rates also spurred inflation in wages and goods in the economies of Germany's trading partners, which in turn made the exports of the Mediterranean countries more expensive and left imports relatively cheaper. Of course, the possibility of currency manipulation had been erased by the euro. In 2009, it became apparent that five members of the eurozone – Greece, Portugal, Ireland, Italy, and Spain – had failed to generate enough economic growth to pay back their debts. Investors were exposed and the threat of bank failures loomed. When the 2008 U.S. financial crisis hit Europe, a lender of last resort was nowhere to be found.

European leaders held a series of panicky meetings in spring 2010 to find such a lender. German Finance Minister Wolfgang Schäuble (2010), had apparently read his Kindelberger, and declared that the hegemonic stability thesis was more relevant than ever in Europe's current situation: He suggested that Germany and France should revive their old alliance and together become the hegemon of Europe---the hegemon that was missing in the 1930s.

But for the next three years, this was not to be. Briefly it appeared that Germany would back the ECB as a lender of last resort. Members pooled their resources to raise €500 billion in conditional loans, and for the first time, the ECB intervened in markets to buy debt. But because Germany provided the largest share of contributions (30% to France's 20% and Italy's 17%), German voters threatened a backlash. Chancellor Merkel insisted on bringing in the International Monetary Fund (IMF), which lent €250 billion in a move meant to ensure that Europeans would not bail out Greece alone.

Soaring interest rates and slowing growth in Spain, Italy, Portugal, Ireland, and France triggered more concerted action within the eurozone to create a lender of last resort. In late 2012, eurozone members created the European Stability Mechanism (ESM), a treaty-based organization capitalized at €700 billion with a lending capacity of €500 billion. Providing the bulk of ESM's capital, Germany retained veto power over its decisions. Borrowers are required to implement austerity measures and belong to the "Fiscal Compact," a more strict replacement of the SGP. In addition, the ECB agreed to purchase bonds from countries in distress who promise to undertake austerity measures, in effect, forcing deflation.

One task of a hegemon, according to Kindleberger, is to lead an effort to coordinate macroeconomic policies. Germany insisted on austerity as the coordinating mechanism without any stimulus to spur growth. And austerity in the southern European periphery became the condition for the receipt of bailout funds. By April, 2013, the number of unemployed workers in Spain and France had reached all-time highs; the number of unemployed in Spain—with an unemployment rate of 27.16 per cent-- topped six million for the first time in history; five million were jobless in France, with an unemployment rate of over ten per cent. The Greek

economy contracted 20 per cent between 2008 and 2013. Meanwhile popular trust in the EU plummeted.[29] Photoshopped images of German Chancellor Merkel dressed in a Nazi uniform became a common sight at angry protests across Europe. European support of Germany as the EU's hegemonic leader all but disappeared. Although Germany has now signalled that it will do whatever it takes to save the euro, it has signaled that it will do nothing to help the struggling economies of the eurozone's deficit countries—in fact, saving the currency union as a self-regulating appears to be more important than helping to create the economic conditions necessary for cooperation within that union.

Indeed, austerity policies and their consequences signal the deepest failure of German hegemonic leadership in the monetary union: the failure to underwrite cooperation by creating conditions under which countries are better off with cooperation than without it—the failure to serve the common good by alleviating the stresses of free trade for deficit countries. By 2013, the temptation to defect from the monetary union had increased, with little prospect of Germany rising to the occasion to create economic stability. Whether the ESM will prove to be an effective lender of last resort remains to be seen. Germany has provided the bulk of the lending, but has not provided the necessary hegemonic leadership to stabilize the monetary regime in crisis.

Whether the ESM will prove to be an effective lender of last resort remains to be seen. Germany has provided the bulk of the lending, but has not provided the necessary hegemonic leadership to stabilize the monetary regime. But we must not forget that in the past, Germany has stepped up to the plate, and the story of monetary union is not yet over.

IV. Conclusion

Growing power has both permitted Germany to bear the lion's share of the burden of European cooperation and permitted various German governments to *shape the terms of cooperation* in the European Union. Beginning in the 1980's and in the twenty-three years since the Wall fell, Germany has been *willing* to provide the leadership role that is expressed in the concept of hegemony.

This does not mean that cooperation is shaped to serve only Germany's narrow interests—cooperation is a non-zero sum game. All benefit from the cooperative endeavor and are better off than they were before cooperation, even though some will benefit more than others. We have seen this in issue areas as diverse as environmental policy, EU foreign policy, export control of high technology, and European monetary union, to name an important few.

The cautionary tale that we have told here suggests that international cooperation in a monetary union can spiral out of control, like the broom in Disney's fantasy of the Sorcerer's Apprentice. As Eichengreen and Temin (2010) note, "Fixed exchange rates facilitate business and communication in good times but intensify problems when times are bad." The 1919-1939 interwar period taught the world many lessons cruelly and painfully about how to solve problems in bad times. At least three of them are important for our discussion of the role of hegemonic power in stabilizing the Eurozone: First, in order for members of a free trade and fixed exchange rate regime to be prosperous, adjustment to macroeconomic disequilibrium needs to be undertaken by both "surplus" and "deficit" economies--not by "deficit" economies alone. Second, in order for crises to be successfully managed, the lender of last resort must truly be a lender of last resort: it must create whatever asset the market thinks is the safest in the economy, and must be able to do so in whatever quantity the market demands. And finally, in order for

any monetary union or fixed exchange rate system larger than an optimum currency area to survive, it must be willing to undertake large-scale fiscal transfers to compensate for the exchange rate movements to rapidly shift inter-regional terms of trade that it prohibits. All three of these measures require hegemonic leadership.

The cautionary tale we have told here suggests that Germany has only partially carried out its role as hegemonic leader of the eurozone. It has made the dominant contribution to relief for debtor members and the banks who loaned money to them, and it has insisted on making the rules. Those rules increased Germany's *relative* gains from free trade, bolstering its economy far more than the economies of others. Germany has taken "burden-sharing" too far, in insisting that the burden of cooperation be placed on the backs of deficit countries.. Not every member of a free trade regime can be a surplus country. Leadership means not only shaping the terms of cooperation, but using resources to stabelize the regime by helping those in deficit who are tempted to defect. A pessimistic strand of hegemonic stability theory focuses on *relative* gains only, and asserts that a hegemon uses the cooperative effort and creates rules for it in order to increase its own power and reinforce its dominance (Gilpin 1987, Grieco 1990). Rather than remaining an economic stabelizer, Hans Kundnani (2011) argues that Germany is behaving as a geo-economic power.

The saga of Germany's role in European monetary union, however, is still unfolding. It appears that, though Germany insists on setting the terms of monetary union, and it does carry the bulk of the burden of cooperation in its contribution to relief for debtor members and the banks who loaned money to them, the jury is still out on whether this constitutes real leadership in the eurozone. Leadership means not only shaping the terms of cooperation, but using resources to stabilize the regime. We are conclude this essay with a question: will Germany hear our cautionary tale, heed the lessons of history, and continue its role of the hegemonic stabilizer in Europe—even in hard times?

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[1] Germany violated the Treaty of Versailles; The United States violated all of the treaties it made with Native Americans; it violated the Convention against Torture in 2006, and the Vienna Convention in 2009; India, Pakistan, and Iran have violated the Nuclear Non-Proliferation Treaty. In 2013 Britain threatened to leave the EU.

[2] Hegemony is a fraught term. When most observers of international politics use the term they mean "the most powerful state," one who often calls the shots or mobilizes advantages to achieve its own interests (Mullins, Lesser, and Rosenau, 2001, Rachman, 2012). Many assume that a hegemon is dominant militarily or has the capability to be so.

3 Germany was the largest contributor to intra EU-27 exports of goods in 2010 with 22.8% of trade, followed by the Netherlands with 13.1%, France with 9.4% and Belgium with 9.0%. In 2011 three quarters (75.3 %) of the total German trade surplus was due to the export surplus with the other 26 EU countries –half of this surplus (50.8 %) to the Euro area alone. (10 December 2010). "Eternal and Intra-EU Trade- statistical Yearbook." *Eurostat*. Online. Available as PDF. http://epp.eurostat.ec.europa.eu/portal/page/portal/product_details/publication?p_product_code=KS-GI-10-002. (Accessed 20 December 2012).

4 Germany maintains a trade surplus with all of its European trading partners. See Fontes, N. (15 January 2013). "Euro Area Trade Surplus Widens in November." Trading Economics. Online. Article and accompanying statistics available as HTTP. http://www.tradingeconomics.com/euro-area/balance-of-trade. (Accessed 16 January 2013).

5 It has the largest share of EU trade with the world (28%)—almost three times as large as the UK and France. In 2011, Germany contributed 27.7 % of the EU-27's exports of goods to non-member countries and accounted for almost one fifth of the EU-27's imports. In comparison, the next two largest exporters of goods were the United Kingdom (11.5 %), France (10.7 %) (29 November 2012). "EU Bilateral Trade and Trade with the World." *European Commission*. Online. Available as PDF. http://trade.ec.europa.eu/doclib/html/147269.htm (Accessed 20 December 2012).

6 Fontes, N. (15 January 2013). "Euro Area Trade Surplus Widens in November." Trading Economics. Online. Article and accompanying statistics available as HTTP. http://www.tradingeconomics.com/euro-area/balance-of-trade. (Accessed 16 January 2013).

7 In 2011 German savings were 24 per cent of GDP, compared to French savings at 18 per cent and British savings at 13 per cent. 'Gross Savings (% of GDP). *World Bank*. Online. Avaialble as HTTP. http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS (Accessed 20 December 2012).

8 Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.

9 In 2011 Germany was listed as the fifth most attractive destination for foreign investment world wide. See (23 April 2010). "FDI Confidence Index: Investors Rank Germany First in Europe." *Research in Germany: Land of Ideas*. Online. Available as HTTP. http://www.research-in-germany.de/news-archive-2010/news-archive-april-2010/45150/2010-04-23-04-22-2010-fdi-confidence-index-investors-rank-germany-first-in-europe,sourcePageId=65148.html. (Accessed 21 December 2012).

10 van der Pijl, K. and Holman, O., and Raviv, O. (2010) "The Resurgence of German Capital in Europe: EU Integration and the Restructuring of Atlantic Networks of Interlocking Directorates After 1991". *Review of International Political Economy*. Volume n18. Issue 3. Pp. 384-408.

[11] See (2012) „France: Economy Overview." *CIA World Fact Book*. Online. Available as HTTP. https://www.cia.gov/library/publications/the-world-factbook/geos/fr.html (Accessed 19 December 2012) and (2012) „Germany: Economy Overview." *CIA World Fact Book*. Online. Available as HTTP. https://www.cia.gov/library/publications/the-world-factbook/geos/gm.html. (Accessed 19 Decemebr 2012).

12 (October 2011). "High Tech Statistics." *Eurostat.* Online. Available as HTTP. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/High-tech_statistics. (Accessed 27 November 2012).

13 Germany had, as part of its European vocation, been reluctant to fully exploit the advantages of its size in negotiations, preferring often to rely on side-payments to persuade smaller and poorer partners. Paterson 2011 Awkward Partner Within the Council of Ministers, enlargement has tilted power away from all of the larger, richer member states. Contrary to assumptions that their influence would be limited by diversity and limited intra-regional coordination (see Goetz 2005: 254), analysis of Council voting data led to Thomson to conclude that 'small member states have enjoyed considerable influence over decision outcomes in the European Union, both in the EU 15 and in the enlarged EU' (Thomson 2010: 255).

14 Crawford, B. (2007). *Power and German Foreign Policy: Embedded Hegemony in Europe*. New York: Palgrave Macmillan Publishing.

15 Britain's role in the Iraq war has undermined its credibility in the Arab world, and France's ties to Algeria, Syria, and Lebanon raise suspicions in both Israel and the United States about its objectivity. This leaves Germany in the lead role of the honest broker on the European side. And Germany is in a position to influence Iran; not only is it Iran's largest trade partner, but 75% of Iran's small and medium industries rely on imported goods and technology from Germany. See Westcott, K. (16 July 2008). „Germnay's Success as Mid-East broker." The BBC. Online. Available as HTTP. http://news.bbc.co.uk/2/hi/middle_east/7504194.stm (Accessed 5 December 2012) and (4 November 2012). „Trade Between Iran and Germany Booming." *The Tehran Times.* Online. Available as HTTP. http://tehrantimes.com/politics/103012-trade-between-iran-and-germany-booming. (Accessed 22 December 2012).

16 Posen, A. (2005) "If America Won't, Germany Must" Internationale Politik (Summer). p. 32.

- 17 Lawton, C. (6 November 2012, 12:02 PM). „Nowotny Opens a Can of Worms With Comments on ECB Votes". The Wall Street Journal. Online. Available as HTTP. http://blogs.wsj.com/eurocrisis/2012/11/06/nowotny-opens-a-can-of-worms-with-comments-on-ecb-votes/ (Accessed 1 December 2012).

[18] There are numerous instances of German self-interested behavior in the period before 1989.

[19] In April 2013 Merkel is quoted as saying that "To me this hegemonial [concept] is completely alien" See "No German 'hegemony' in Europe, Merkel Says," in The EU Observer, April 22, 2013.

20 Germany, over the 1980s, moved to become a major net creditor to Europe and even to the rest of the world. They became the second largest creditor nation after Japan See Marsh, D. (1992). *The Bundesbank: The Bank that Rules Europe*. London: William Heinemann Ltd. p. 7. The Bundesbank, consented to the growth of foreign central banks' DM holdings, and even encouraged them to acquire DM. See Ungerer, H. and Evans, E. and Mayer, T., and You P. (December 1986). *The European Monetary System: Recent Developments*. Washington: International Monetary Fund. p. 5. Throughout the life of the EMS, all the major currency realignments within the EMS were carried out in terms of DM denominated See Ungerer , H. and Hauvonen, J.J. and Lopez-Claros, A. and Mayer, T. (1990). *European Monetary System: Developments & Perspectives.* Washington: International Monetary fund. pp. 53-7.

21 Crawford, B. (13 March 1998) Interview with Gerhard Stoltenberg, German Minister of Finance under Chancellor Helmut Kohl.

22 Economists calculate that the value of the deutschmark would have been 18 – 25% higher than the value of the euro in 2011. "While the deutschmark was regarded as a safe haven currency, as is the case for the Swiss franc currently, the euro is less susceptible to strong appreciation on the currency market. "And as a result, exported products benefit from competitive advantages," Frank Mattern, director of McKinsey said." as quoted in (26 December 2011). "Despite crisis, Germany benefits from euro." *The Local: Germany's News in English*. Online. Available as HTTP. http://www.thelocal.de/national/20111226-39735.html#.URFYkOj7jzd. (Accessed 18 December 2012).

23 Norris, F. (22 April 2011). "Euro Benefits Germany More Than others in Zone." *The New York Times*. Online. Available as HTTP. http://www.nytimes.com/2011/04/23/business/global/23charts.html?_r=0 (Accessed 10 December 2012).

[24] John, Mark (2013) "Analysis: France runs into wall on German growth drive" Reuters, Feb. 10, 2013 http://www.reuters.com/article/2013/02/10/us-eu-france-idUSBRE91903J20130210.

25 McKinsey management consultants attributed two-thirds of German growth between 2002 and 2012 to the euro's introduction. See Buergin, R. (10 January 2012, 8:33 AM PT). "Germany Reaped Most Benefit From Euro Membership, McKinsey Study Shows." *Bloomberg*. Online. Avaialble as HTTP. http://www.bloomberg.com/news/2012-01-10/germany-reaped-most-economic-benefit-from-euro-mckinsey-2010-study-shows.html (Accessed 10 December 2012).

26 De Guzman, J.C. and Ross, K. and Waysand C. (1 December 2010). "IMF European Financial Linkages A New Look at Imbalances." *International Monetary Fund*. Online. Available as PDF. http://www.imf.org/external/pubs/cat/longres.cfm?sk=24527.0. (Accessed 26 December 2012).

27 Between 2001 and 2009, total consumption in Germany fell from 78.5 percent of GDP to 74.5 percent, while its savings rate increased from less than 19 percent of GDP to almost 26 percent. (December 2012) "GDP per capita, consumption per capita and price level indices." *Eurostat*. The European Commission. Online. Available as HTTP. *http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/GDP_per_capita,_consumption_per_capita_and_price_level_indices#Relative_volumes_of_consumption_per_capita (Accessed 20 December 2012).*

28 Matthijs, M. and Blyth, M. (2011). "Why Only Germany Can Fix the Euro" *Foreign Affairs*, Online. Available as HTTP. *http://www.foreignaffairs.com/articles/136685/matthias-matthijs-and-mark-blyth/why-only-germany-can-fix-the-euro*. (Accessed December 27 2012).

[29] According to a Eurobarometer poll, 42 percent of Poles, 53 percent of Italians, 56 percent of French, 59 percent of Germans, 69 percent of Britons, and 72 percent of Spaniards said they did not trust the EU as an institution.