Embraced in Washington, Ignored In Berlin

The Unexpected Comeback of Hegemonic Stability Theory in a Time of Crisis

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Abstract

The world economy has suffered two major blows since the beginning of the 21st century. Both the 2007-09 global financial crisis and the 2010-12 euro crisis were 'systemic' crises with global repercussions. Led by the U.S., the world dealt with the global financial crisis in a relatively swift and decisive manner: the acute phase of the crisis wound down by the spring of 2009, only about seven months after the cataclysmic bankruptcy of Lehman Brothers. By contrast, it took more than two and a half years before financial markets stopped fearing an imminent and disorderly Eurozone breakup. Due to the lack of decisive intervention by Germany and the EU, which relied instead on a series of temporary fixes, the crisis – though contained by late 2012 after the ECB's pledge to do 'whatever it takes' to save the euro – was still simmering four years after its eruption. Why did policymakers respond so differently?

This paper will explain the differing outcomes – a relatively quick solution and end to the global financial crisis and the lack of a comprehensive solution and much longer duration of the euro crisis – as caused by the United States' role acting as a 'responsible hegemon' for the world economy, and Germany's failure to play a similar role within Europe's regional context. By reviving the original 'leadership' version of hegemonic stability theory and Charles Kindleberger's critique of the United States' actions during the Great Depression, the paper argues that the U.S. *did* and Germany *did not* define its interest as providing the necessary five public goods for the system to recover and sustain itself, including: a market for distress goods, countercyclical long-term lending, a stable exchange rate system, macroeconomic policy coordination, and lending of last resort facilities. The paper will breathe new life into the existing literature on hegemonic stability theory, expand its explanatory reach into the 'regional' context, and causally infer the consequences of the role of leadership (and lack thereof) for understanding the effectiveness in crafting responses to systemic financial crises. The crucial role of ideas in defining the interests of leading states during times of uncertainty will be included as a key independent variable in the theoretical framework.

Key words: leadership, hegemonic stability, regimes, cooperation, ideas, public goods, Germany, United States, institutions, global financial crisis, euro crisis, sovereign debt.

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In these circumstances, the international economic and monetary system needs leadership, a country which is prepared, consciously or unconsciously […] to take on an undue share of the burdens of the system, and in particular take on its support in adversity by accepting redundant commodities, maintaining a flow of investment capital and discounting its paper.

Charles P. Kindleberger[1]

The global financial crisis, with its origins in the United States, and the Eurozone debt crisis, with its origins in the euro's institutional design and missing financial union, took the financial world by surprise and led to the worst real contractions of the advanced economies post-war. While similar in magnitude and potential for conflagration, the outcomes to both crises were nevertheless quite different: the global financial crisis shored up relatively quickly in 2009, while the Eurozone crisis sputtered on for much longer and would come to a questionable halt without clear resolution in 2013. What explains the different policy responses and outcomes? Why was the more complex and less institutionally equipped global system capable of resolving its crisis so fast, while the more highly institutionalized and integrated Eurozone could not?

1. The Puzzle: A Tale of Two Systemic Crises, Public Goods, and Leadership

The global financial crisis of 2007-8 resulted in the world's "Second Great Contraction," in the words of Carmen Reinhart and Kenneth Rogoff, and has been widely recognized as the most serious economic and financial crisis since the Great Depression of the 1930s.[2] With its by-now well-documented origins in the implosion of the American subprime mortgage market that followed the bursting of the U.S. housing bubble in the summer of 2007, the crisis rapidly reached global proportions. An astonishing cascade of unexpected events stunned the financial world in September 2008: from the rescue by way of public ownership of U.S. mortgage lenders Fannie Mae and Freddie Mac, to the bankruptcy of investment bank Lehman Brothers and the federal bailout of American insurance giant AIG.[3] Given the vast exposure and tight links of banks and financial institutions from all over the world to America's financial system, as well as the central role of the U.S. dollar in the world economy, the events of the fall of 2008 sowed widespread panic in global financial markets.[4]

The American economy shrank for two consecutive years, by 0.3 percent in 2008 and by 2.8 percent in 2009. Emerging markets and developing economies saw their annual growth rates slow down to 3.1 percent in 2009 from 8.7 percent in 2007 and 5.9 percent

[1] Charles P. Kindleberger (2013), *The World in Depression: 1929-1939* (Berkeley, CA: University of California Press, 40th anniversary edition), first published in 1973, p. 28
[2] Carmen Reinhart and Kenneth Rogoff (2009), *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press), p. 208
[3] For an excellent review of the causes of the financial crisis, see Andrew W. Lo (2012), "Reading about the Financial Crisis: A 21-Book Review," *Journal of Economic Literature* 50 (1), pp. 151-178
[4] Eric Helleiner (2014), The Status Quo Crisis: Global Financial Governance After the 2008 Financial Meltdown (New York: Oxford University Press), p. 3

in 2008; advanced economies faced an absolute decline in their incomes by 3.4 percent in 2009, after virtually stagnating the year prior. With global output in 2009 falling by 0.4 percent, the first global contraction of the world economy since 1945 was a fact.[5] The rate of unemployment in the U.S. rapidly rose from 4.6 percent in the summer of 2007 to 7.3 percent in December 2008, and peaked at 10 percent in October 2009, with various estimates of 'actual' unemployment rates – which take into account marginally attached or part-time workers for economic reasons – closer to 20 percent.[6] U.S. stock markets took a colossal hit, with the Dow Jones Industrial Average tumbling from an all-time high of just below 14,200 points in October 2007 to a thirteen-year low of just over 6,500 points in March 2009.[7] One month later, in April 2009, the IMF estimated the total cost of all financial write-downs on U.S.-originated assets to be anywhere between $2.7 trillion and $4 trillion, about two-thirds of which would be incurred by banks.[8]

While the sheer depth, massive scale, and absolute strength of the global financial crisis was without postwar precedent, the international policy response to the Great Recession was remarkably swift and decisive. The acute phase of the crisis – from a global point of view – did not last all that long, especially if one compares the response and timeline with that of the Great Depression.[9] The U.S. quickly responded with a wide-ranging financial bailout worth $700 billion (TARP, or the "Troubled Assets Relief Program") in October 2008, aggressive monetary easing by the Federal Reserve, and a fiscal stimulus bill worth $787 billion in early 2009.[10] The U.S. also kept its markets open to world trade, arranged emergency currency swaps with the world's major central banks, and took it upon itself to coordinate the crisis response by launching the G-20 as the main body dealing with international economic issues.

Governments worldwide agreed to bail out their banks, and put into place expansionary measures to stop their economies from sliding further into despair. The U.S. economy bottomed out in the second quarter of 2009 and started growing again in the third quarter. The world economy as a whole bounced back in 2010 and 2011 with annual growth rates of 5.2 percent and 3.9 percent respectively.[11] While U.S. unemployment stayed high for

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[5] IMF (2014), *World Economic Outlook: Recovery Strengthens, Remains Uneven* (Washington, DC: International Monetary Fund), p. 180. Online available at: http://www.imf.org/external/Pubs/ft/weo/2014/01/pdf/text.pdf

[6] The Bureau of Labor Statistics has six measures for unemployment, starting with U-1 (which only includes persons unemployed for fifteen weeks or longer) to the much broader U-6 measure. For more information, see United States Department of Labor (2009), "Bureau of Labor Statistics: Local Area Unemployment Statistics." Online available at: http://www.bls.gov/lau/stalt09q4.htm

[7] Bloomberg (2014), "Markets: Dow Jones Industrial Average," online available at: http://www.bloomberg.com/quote/INDU:IND/chart

[8] IMF (2009), *Global Financial Stability Report April 2009: Responding to the Financial Crisis and Measuring Systemic Risks*. World Economic and Financial Surveys. (Washington, DC: IMF), p. xi. Online available at: http://www.imf.org/External/Pubs/FT/GFSR/2009/01/pdf/summary.pdf

[9] For a more direct comparison of the Great Recession with the Great Depression, see Barry Eichengreen and Kevin O'Rourke (2012), "A Tale of Two Depressions Redux," *VoxEU.org*, March 6. Online available at: http://www.voxeu.org/article/tale-two-depressions-redux

[10] For more detail, see Menzie D. Chinn and Jeffry A. Frieden (2011), *Lost Decades: The Making of America's Crisis and the Long Recovery* (New York: W. W. Norton), chapters 4 and 5

[11] IMF (2014), p. 180

four years, it eventually started falling in 2013, reaching a level of 6.3 percent in April 2014. Even though the world's recovery was rather uneven, with emerging market economies growing much faster than the advanced economies, another Great Depression had clearly been avoided.[12]

In Europe, however, the real crisis would only begin in 2010, one year after the euphoric ten-year anniversary of the introduction of the single currency had led ECB President Jean-Claude Trichet to hail the euro as "a large, solid, and steady ship."[13] International relations scholars see the euro crisis as the most significant aftershock of the global financial crisis.[14] Others have analyzed the euro crisis as the first 'real' crisis of European integration.[15] Either way, what soon became known as the 'European sovereign debt crisis' – a misnomer, since the euro crisis was mainly a banking crisis, which only morphed into a sovereign debt crisis after large public sector bailouts converted private into public debt – shook the very foundations of postwar European integration.[16]

The causes of the euro crisis have also been well documented by now.[17] After an imminent sovereign debt default by Greece in the spring of 2010, the EU – together with the IMF – cobbled together one bailout package after another in order to deal with Greece and the Greek contagion effect, first to Ireland and Portugal that same year, and then to Spain and Italy in 2011. Over twenty European summits were convened over three years, often in haste, in an elusive quest for a comprehensive solution. A myriad of incomplete and eventually unhelpful institutional innovations at the EU level were adopted along the way, such as a new fiscal treaty and a botched imbalances procedure.

While the Eurozone as a whole had contracted by 4.4 percent in 2009, it staged a timid recovery the year after and grew by 2 percent in 2010, but slowed down to 1.6 percent in 2011 and slid back into recession in 2012 and 2013 with negative growth rates of –0.7 and –0.5 percent respectively.[18] These figures masked the stark differences between the Eurozone's core and periphery countries. Germany did quite well for itself, recording remarkable growth rates of 3.9 and 3.5 percent in 2010 and 2011, before slowing down to lower growth rates in 2012 and 2013. Greece, on the other end of the growth spectrum, saw its GDP collapse in absolute terms by a cumulative 25 percent over six years (2008-

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[12] Daniel W. Drezner (2014b), *The System Worked: How the World Stopped Another Great Depression* (New York: Oxford University Press), pp. 15-19

[13] Jean-Claude Trichet (2009), "The euro@10: achievements and responsibilities," *BIS: Central Bankers' Speeches*. Online available at: http://www.bis.org/review/r090119a.pdf

[14] See Miles Kahler and David Lake (eds.) (2013), *Politics in the New Hard Times: The Great Recession in Comparative Perspective* (Ithaca: Cornell University Press), p. 1

[15] See Craig Parsons and Matthias Matthijs (2015), "Chapter 10: European Integration Past, Present and Future: Moving Forward through Crises?" in Matthias Matthijs and Mark Blyth (eds.), *The Future of the Euro* (Oxford University Press, forthcoming)

[16] Mark Blyth (2013), *Austerity: The History of a Dangerous Idea* (New York: Oxford University Press), chapter 3

[17] For an overview of the euro crisis, as well as its major causes, see Matthias Matthijs (2014a), "The eurozone crisis: Growing pains or doomed from the start?" in Manuela Moschella and Catherine Weaver (eds.), *Handbook of Global Economic Governance: Players, Power, and Paradigms* (London: Routledge), pp. 201-217

[18] IMF (2014), p. 180

2013). Its unemployment rate soared to close to 30 percent, levels only observed during the 1930s.[19] Most of peripheral Europe – including Greece, Ireland, Portugal, Spain and Italy – experienced negative growth for successive years, very high and sustained levels of unemployment, devastating levels of youth unemployment, and a steep rise in its overall public debt. Southern Europe was not as lucky as the rest of the world economy. By any standard, they did suffer another great slump, with levels of financial havoc and social devastation redolent of the Great Depression.[20]

This large discrepancy between the post-crisis performance of the global economy on the one hand and the Eurozone economy on the other informs the central puzzle of this paper. Why was the global financial crisis, the most serious crisis to threaten the world economy since the 1930s, resolved so quickly, while the euro crisis remained well short of a comprehensive solution? Why did it take the Europeans so much longer to come to grips with their crisis?[21]

This contrast in both speed and resolve is particularly striking since the Eurozone benefits significantly more than the global economy from strong institutional structures and joint problem solving networks. The world economy as a whole lacks those dense networks powered by regular consultation and sophisticated supranational infrastructure that the European Union has been building since the early 1950s. While the world economy is institutionally integrated in the realm of international trade through the World Trade Organization, this is not the case for international monetary and financial flows, where the International Monetary Fund has a much more narrow mandate and no functioning dispute settlement mechanism. The G-20 only became prominent after the crisis hit, and is not an international organization that has any legal standing. The European Union, on the other hand, encompasses a truly integrated common market, complete with free flows of goods, services, capital, and labor, and is managed by supranational institutions in Brussels. The Eurozone, with 18 member states in 2014, has a common central bank in Frankfurt and legal mechanisms for close fiscal coordination through the Stability and Growth Pact. In short, one would expect the Eurozone crisis to be resolved far more quickly than the global crisis.

The empirical puzzle is important from a theoretical point of view as well, since it clashes with the deductions of Mancur Olson in *The Logic of Collective Action*.[22] Olson theorized that rational actors pursuing their own, narrow, self-interests would be incapable of providing public goods due to the incentive to free ride, and furthermore asserted that group size was inversely related to success in collective action. While larger groups "would fail to provide themselves with any collective good at all," smaller groups would

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[19] Ibid., p. 181

[20] Matthias Matthijs (2014b), "Mediterranean Blues: The Crisis in Southern Europe," *Journal of Democracy* 25 (1), pp. 101-115

[21] At the time of writing, in the spring of 2014, the acute phase of the euro crisis was over, but the Eurozone economy was far from fixed and the institutional infrastructure remained incomplete. See, for example, Peter Spiegel (2014), "The eurozone won the war – now it must win the peace," *Financial Times*, May 17/28, p. 7

[22] Mancur Olsen (1965), The Logic of Collective Action: Public Goods and the Theory of Groups (Cambridge: Harvard University Press)

struggle to deliver the collective good anywhere near the optimal level.[23] In simple terms, the larger the group, the less likely the group would be to promote its common interests. During the past two systemic crises, the larger group – comprised of all the world's national economies – actually proved itself capable of providing the global public goods of financial stability and economic recovery much quicker than the smaller, and more cohesive, European group was able to deliver those same public goods at the regional level just two years later. The question is: why?

This paper will explain the opposing outcomes – a relatively quick solution and end to the global financial crisis versus the lack of a comprehensive response and much longer duration of the euro crisis – in terms of: (i) US willingness to act as a 'responsible hegemon' for the world economy; and (ii) Germany's failure to play a similar leadership role within Europe's regional context. By reviving 'hegemonic stability theory' and Kindleberger's critique of the actions of the United States during the Great Depression, the paper is able to explain two divergent outcomes and renew consideration of what it takes to solve a systemic crisis, including the right kind of leadership and the provision of critical public goods. This paper will show how the U.S. *did* and Germany *did not* define its interest as providing the necessary five public goods.[24] By restoring the central importance of leadership and public goods provision during times of crisis into a novel hegemonic stability approach, this argument contrasts with Robert Keohane's claim that "although hegemony can facilitate cooperation, it is neither a necessary nor a sufficient condition for it."[25]

While for Kindleberger, the main lesson of the 1930s was that the world economy needed to have a stabilizer to be in balance – *one stabilizer* – Keohane argued that though the existence of a hegemon could be tremendously useful in establishing international regimes, a subsequent waning of hegemonic leadership would not necessarily threaten international cooperation.[26] According to Keohane, the conditions for maintaining existing regimes were much less burdensome than those required for setting up new regimes.[27] However, Keohane did not explicitly consider the essential role of a stabilizer in times of international economic crisis: is a stabilizer needed in times of crisis if international cooperative regimes already exist? The goal of this paper is to show that while leadership by the system's most powerful state is a necessary but not a sufficient condition for the system to work in the face of a systemic crisis, the kind of leadership that this state exercises will matter a great deal for the observed outcome.

Both the global financial crisis of 2007-2009 and the euro crisis of 2010-2012 have recently offered us the empirical data that will allow us to test both theories. By breathing new life into the existing literature on hegemonic stability theory, this paper aims to expand the explanatory reach of the influential global theory into the regional context. By

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[23] Ibid., p. 28

[24] Charles P. Kindleberger (1986), *The World in Depression 1929-1939*, Revised and Enlarged Edition (Berkeley: University of California Press), chapter 14, pp. 288-203

[25] Robert O. Keohane (2005), *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press), first published in 1984, p. 12

[26] Kindleberger (1986), p. 304; Keohane (2005), p. 50-51

[27] Keohane (2005), p. 50

doing so it will also causally infer the consequences of the role of leadership (and lack thereof) on the effectiveness of crafting and implementing responses to international financial crises. A key variable that will be integrated in my theoretical framework is the crucial role of economic ideas in determining the interests of the most powerful states during times of uncertainty, including how they perceive and define their leadership role in solving a crisis.

The paper proceeds in six sections. The next section reviews the existing academic literature on hegemonic stability theory and international regimes, situating my argument within the theory's broader evolution. Section three sets out the paper's theoretical framework, re-emphasizing Kindleberger's original insight on the importance of leadership in public goods provision, and adding the independent variable of economic ideas. Section four gives an empirical assessment of U.S. public good provision during the global financial crisis of 2007-9, while section five shows the absence or under provision of such public goods on the part of Germany during (but also prior to) the euro crisis of 2010-12. Section six provides an explanation for why the U.S. felt compelled to act as a 'benevolent' hegemon in the world economy, and felt bound to follow the path set out in Kindleberger's largely 'Keynesian' blueprint. On the other hand, Germany in the context of the Eurozone crisis fundamentally misread Kindleberger's original ideas, and ended up acting as a 'coercive' hegemon based on very different ideas, framing its own leadership role in generally 'ordoliberal' terms. Section seven evaluates the outcome for both the world economy and for Europe, and draws the main empirical and theoretical conclusions of this paper.

2. Explaining International Cooperation (and the Lack Thereof) through Hegemonic Stability or Regime Theory: Brief Review of the Literature

According to Benjamin Cohen, hegemonic stability theory (HST) was the "first genuine theory" in the field of international political economy (IPE).[28] While Robert Keohane invented the term 'HST,' the original thesis was put forward by Charles Kindleberger, an economic historian at the Massachusetts Institute of Technology (MIT), in his 1973 book on the causes of the Great Depression.[29] Going beyond the rather narrow and technical debate between John Maynard Keynes, who emphasized the collapse of demand and the foolish obsession of interwar governments with fiscal rectitude and the gold standard, and Milton Friedman, who stressed the lack of sufficient liquidity and misguided contractions in the money supply, Kindleberger posited that the Great Depression had been caused by an absence of international leadership. In his own words, "the 1929 depression was so wide, so deep, and so long because the international economic system was rendered unstable by British inability and U.S. unwillingness to assume responsibility for stabilizing it."[30] Hegemony, for Kindleberger, who never used the term himself, meant 'leadership' provided by one single country in the system that could fulfill five functions during periods of stress, including: maintaining a market for distress goods, facilitating

[28] Benjamin J. Cohen (2008), *International Political Economy: An Intellectual History* (Princeton: Princeton University Press), p. 67
[29] Ibid., p. 68.; for a complete review of the evolution of HST as a theory, see pages 67-79
[30] Kindleberger (1986), p. 289

countercyclical and long-term lending, policing a stable exchange rate system, coordinating macroeconomic policies, and acting as a lender of last resort by guaranteeing enough liquidity for the overall system.[31]

Kindleberger's thesis was thus based on a rather benign version of leadership, centered on the provision of global public goods. Robert Gilpin subsequently developed Kindleberger's theory in the field of international relations by adding the power and security dimension, reiterating that an open and liberal global economy needed "a power to manage and stabilize the system."[32] He further claimed that the evolution of the international system was primarily driven by powerful and self-interested states that sought to alter the rules of the game in their own interest. Thus, according to Gilpin, global public goods provision by the United States in the postwar world system would last only as long as the benefits for the U.S. outweighed the costs.[33] Or in Cohen's words: "Hegemonic stability will last only so long as there are no challengers waiting in the wings."[34] Reviewing over 150 years of history in international trade relations, Stephen Krasner later provided detailed support for the HST thesis, empirically illustrating a systematic relationship between hegemony on the one hand and relative openness in global commerce on the other.[35] Both Gilpin and Krasner argued that a hegemon was necessary to guarantee an open and stable world economy; overwhelming power by one state was needed to discipline other countries, and to make sure they did not resort to the destructive 'beggar-thy-neighbor' policies of the 1930s. Unsurprisingly, Gilpin and Krasner associated hegemonic decline with systemic instability and the potential reassertion of rival regional blocs.[36]

By the mid-1980s, however, the United States was obsessed with its own relative decline, but the global economic turmoil triggered by the OPEC oil shocks of the mid-1970s had not caused a collapse in the world economy, at least not anywhere near the chaos of the 1930s. Despite declining U.S. hegemonic power, the global "embedded liberal" system the U.S. had created out of the ashes of World War II proved to be robust and enduring.[37] It was thus not obvious that hegemony was a necessary or even sufficient condition for global economic stability. On the other hand, HST began its own decline, especially after being challenged head on by Robert Keohane, who was quickly joined by Duncan Snidal and Barry Eichengreen. In *After Hegemony*, Keohane constructed his own functional theory of international regimes based on realist assumptions of rational state actors and self-help. For Keohane, HST ignored the central role that international institutions play in providing information to states about each other's behavior, reducing the cost of negotiating agreements, and exposing (sometimes even punishing) violations of prior

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[31] Ibid.
[32] Robert Gilpin (1975), *U.S. Power and the Multinational Corporation* (New York: Basic Books), p. 40
[33] Robert Gilpin (1981), *War and Change in World Politics* (New York: Cambridge University Press), p. 9
[34] Cohen (2008), p. 73
[35] Stephen Krasner (1976), "State Power and the Structure of Foreign Trade," *World Politics* 28 (3), April, pp. 317-347
[36] Helen V. Milner (1998), "International Political Economy: Beyond Hegemonic Stability," *Foreign Policy* 110, Spring.
[37] John Gerard Ruggie (1982), "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36 (2), Spring, pp. 379-415

agreements by states.[38] Once international regimes are in place, they tend to take on a life of their own. Cooperation continues to take place without hegemony through a coalition of important states. While Keohane admitted that hegemony often played a useful role in establishing those regimes in the first place, he stated in very clear terms, however, that "there [was] little reason to believe that hegemony [was] either a necessary or sufficient condition for the emergence of cooperative relationships."[39]

Snidal extended Keohane's critique of HST, and asserted that collective action could substitute for hegemony in the quest for international cooperation. Snidal identified two strands of HST: the "benevolent strand" where all participants in the international system were made better off by the benign actions of the dominant power, and the "coercive strand" where the benefits of stability accumulate disproportionately or even exclusively to the hegemon, either because systemic equilibrium is not a purely public good or because its costs are thrust upon the smaller states.[40] For Snidal, there were two major limits to HST. First, the public goods hypothesis suffered from the problem that the U.S. liberal order and *Pax Americana* were more like a 'club good' rather than a 'public good.' Second, echoing Keohane, HST was based on the implicit assumption that collective action in the international system was impossible in the absence of a dominant state.[41]

Eichengreen, in his 1989 study of international monetary arrangements – including the classical gold standard, the interwar period, and the Bretton Woods system – found evidence both for and against HST.[42] Eichengreen argued that HST was of some help in understanding the relatively smooth operation of the classical gold standard and early Bretton Woods period. However, much of the empirical evidence was difficult to square with HST, because the market power that both the U.S. and Britain possessed during their respective periods of hegemony could not be causally connected to the stability of the international monetary system. In the same vein as Keohane, Eichengreen thought stability in the international monetary system had long existed "after hegemony," in the sense that more than one dominant power was usually required to insure the provision of public goods and maintain stability. Moreover, Eichengreen believed that the hegemon's willingness to act in a stabilizing capacity at one point in time tended to undermine its ability to continue to do so in the future, leading to recurring patterns of 'overstretch.'[43]

One outspoken and dissenting voice during the 1980s was that of Susan Strange, who argued that it was nothing more than a myth that the U.S. had lost its hegemonic power over the system, and that this was one of the main reasons for the instability and

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[38] Keohane (2005), chapter 6, pp. 85-109
[39] Ibid., p. 31
[40] Duncan Snidal (1985), "The Limits of Hegemonic Stability Theory," *International Organization* 39 (4), Autumn, pp. 585-590
[41] Ibid., pp. 612-614
[42] Cohen (2008), p. 77; Barry Eichengreen (1989), "Hegemonic Stability Theories of the International Monetary System," in Richard N. Cooper, Barry Eichengreen, Gerald Holtham, Robert D. Putnam, and C. Randall Henning, *Can Nations Agree? Issues in International Economic Cooperation* (Washington, DC: Brookings Institution), pp. 255-98
[43] Eichengreen (1989)

aimlessness of the international political economy.[44] Making the distinction between structural power and relational power, Strange showed that U.S. structural power – including the power to provide security, control the production of goods and services, rule over the structure of finance and credit, and have direct influence over knowledge and ideas – on balance, had increased during the 1970s and 1980s.[45] Strange concluded that "a necessary condition […] for greater stability and cooperation lie within the United States, rather than the institutions and mechanisms of international cooperation."[46]

Like Snidal, David Lake also thought it valuable to divide HST into two distinct theories, classifying them as "leadership theory" (which builds upon the theory of public goods and focuses on the production of stability) and "hegemony theory" (which tries to clarify various patterns of international economic openness, based on national trade preferences), roughly corresponding to Snidal's 'public goods' and 'security' versions of HST.[47] For Lake, both public goods theory and Keohane's regime theory implied that a single leader was not a necessary condition for an "adequate international economic infrastructure," since – at least theoretically – leadership could be provided by more than one state.[48] Lake also made the distinction between benevolent and coercive leadership, adding that hegemony theory was necessarily coercive as it was based on the exercise of power: "the hegemon must effectively change the policies of others to satisfy its own goals."[49] Lake thought that HST, despite its prominence in the field of international relations during the 1970s and 1980s, had yet to "put its best possible 'model' into the competition."[50] While progress had been made, Lake believed significant theoretical issues remained. He ended with a call for much more empirical work to be done as then "far more valid assessments of the individual theories could be performed."[51]

By 1998, Helen Milner called for the field of IPE to "move beyond" HST. Milner argued that power was not everything, and that the possession of superior resources by any one state did not automatically translate into either great influence or beneficial outcomes for the world.[52] In addition to Keohane's important role for international institutions, she stressed the power of values and the social construction of state identity, and how those can constrain state choices and propel it towards certain behaviors, referring to the work of Judith Goldstein and Robert Keohane.[53] She also emphasized the impact of domestic politics and domestic political processes in defining a state's purpose, and the renewed

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[44] Susan Strange (1987), "The Persistent Myth of Lost Hegemony," *International Organization* 41 (4), Autumn, pp. 551-574
[45] Ibid., p. 565
[46] Ibid., p. 554
[47] David A. Lake (1993), "Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?" *International Studies Quarterly* 37 (4), pp. 459-460
[48] Ibid., p. 465
[49] Ibid., p. 469
[50] Ibid., p. 462
[51] Ibid., p. 485
[52] Milner (1998), pp. 112
[53] Judith Goldstein and Robert Keohane (eds.), *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change* (Ithaca: Cornell University Press)

interest in the process of globalization and its impact on state power.[54] In his intellectual history of the field of IPE, published in 2008, Benjamin Cohen somberly observed that David Lake's 1993 *ISQ* (*International Studies Quarterly*) article had de facto ended the debate over HST.[55] Milner's call in *Foreign Policy* for IPE scholars to focus on the role of ideas, domestic politics, and globalization was heard loud and clear, and few path-breaking contributions to HST were added to the field. The advent of the global financial crisis and subsequent world recession in 2008-9, as well as the precipitous rise of China in the international system during the 2000s, however, would revive the HST literature.

Michael Mastanduno in 2009 reiterated the view that "[d]ominance in the distribution of international economic capabilities [had] afforded the United States the opportunity to shape the international economic order, the obligation to manage it, and the temptation to take advantage of it."[56] Mastanduno emphasized that the ability of the U.S. to be both "system maker" and "privilege taker" had required the active collaboration of other major powers. While the U.S. maintained relative openness of its large domestic market and provided security benefits to its supporters, the latter absorbed and held U.S. dollars, allowing the U.S. the luxury of maintaining its preferred policy mix of guns and butter. But Mastanduno noted that, after the Cold War, the U.S. quickly became the victim of its own success: the EU and the euro felt confident enough to challenge the role of the U.S. dollar, and China and other Asian states rose quickly by taking advantage of the liberal open economic system defended by the U.S. He doubted whether the current situation could be stable, as the U.S. had become hooked on borrowing and consuming, while Germany, China, and Japan were addicted to lending and exporting. Not only had the size of global macroeconomic balances become seemingly unsustainable as a result, but the growth of domestic markets in Europe and Asia would also make them rely less on exports in the future.[57]

For Harold James, the Great Recession of 2009 had caused a structural break in the international economic and political order, and meant a transformation of power away from the U.S. towards China.[58] James noted that China had actually started to behave more like a Kindleberger hegemon, in that it had a countercyclical strategy in response to the crash, making it an engine for world economic recovery, but also in that Beijing had acted to stabilize financial markets by continuing to hold dollars and by supporting the euro. James saw the main challenge for the management of the new order in China's ability to embrace a universalistic vision that had underpinned previous eras of global stability.[59] Ian Bremmer and Nouriel Roubini argued that after 2008, the U.S. ceased to be the leader of the global economy, as it lacked the resources to continue as the primary

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[54] Beth Simmons (1994), *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years* (Princeton: Princeton University Press); Helen V. Milner (1997), *Interests, Institutions, and Information* (Princeton: Princeton University Press)
[55] Cohen (2008), p. 78
[56] Michael Mastanduno (2009), "System Maker and Privilege Taker: U.S. Power and the International Political Economy," *World Politics* 61 (1), January, p. 153
[57] Ibid., p. 154
[58] Harold James (2011), "International Order After the Financial Crisis," *International Affairs* 87 (3), pp. 525-537
[59] Ibid., p. 536-37

provider of global public goods. With the failure of the G-20 to continue to provide leadership to the world economy after the Toronto summit in June 2010, Bremmer and Roubini observed the arrival of a "G-Zero world," in which "no single country or bloc of countries [had] the political and economic leverage – or the will – to drive a truly international agenda."[60]

G. John Ikenberry responded that the U.S.-based global liberal order would continue after the global financial crisis.[61] The key for America's success in maintaining that liberal order, according to Ikenberry, was that the U.S. as a hegemon had accepted some significant constraints on its own actions through its membership in various international institutions. In doing so, it had not only advanced its own interests, but also the interests of others. Ikenberry claimed that the preservation and expansion of the liberal rule-based order was in the interests of the rising states and would therefore simply endure. Not only was the system easy and beneficial to join, it was also large enough to make it difficult to challenge, let alone for it to be overthrown altogether. As long as the U.S. was careful to accommodate the interests of rising powers and expand their roles and voices in the decision making processes over new rules, Ikenberry did not see any convincing reason for U.S. hegemony to erode any time soon. Charles Kupchan disagreed with Ikenberry, instead predicting the emergence of what he called "no one's world." For him, the global financial crisis had caused a fundamental shift of power away from the West towards "the Rest."[62] Based on careful historical analysis of how the West had become the West, Kupchan did not see modernization resulting in "Westernization" in today's emerging market economies. Instead, he observed alternative forms of governance materialize, such as "paternal autocracy" in Russia, "tribal autocracy" in the Persian Gulf, and "communal autocracy" in China.[63] The outcome would be a world in which no single state is powerful enough to establish global norms, and no coalition of states can reach a sufficient degree of consensus on the rules of the game.

Miles Kahler, countering Kupchan, concluded that the rising powers had proven they were "conservatives" rather than rebels after the global financial crisis and during the Great Recession. They ended up defending the status quo in the international economic order, driven by domestic stakeholders and based on their national economic interests. Kahler did, however, warn that another large shock in the future could make regional options more attractive.[64] Finally, Daniel Drezner, in his analysis of the global response to the Great Recession and the surprising resilience of global governance thereafter, argued that "the system worked."[65] While the initial shocks were more severe than the Great Depression, both national policy elites and multilateral economic institutions responded with remarkable speed and vigor. Drezner noted that the global economy has

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[60] Ian Bremmer and Nouriel Roubini (2011), "A G-Zero World," *Foreign Affairs* 90 (2), p. 2
[61] G. John Ikenberry (2011), *Liberal Leviathan* (Princeton: Princeton University Press)
[62] Charles Kupchan (2012), *No One's World: The West, the Rising Rest, and the Coming Global Turn* (New York: Oxford University Press)
[63] Ibid., chapter 5
[64] Miles Kahler (2013), "Rising Powers and Global Governance: Negotiating Change in a Resilient Status Quo," *International Affairs* 89 (3), pp. 711-729
[65] Daniel W. Drezner (2014a), "The System Worked: Global Economic Governance during the Great Recession," *World Politics* 66 (1), January, pp. 123-164; and Drezner (2014b)

rebounded much better and much faster than it did during the 1930s. His reasoning was threefold. First, U.S. power and leadership were more robust than expected. Second, the institutional environment proved to be much entrenched with status-quo policies focused on promoting economic openness. Third, the ideational consensus around Keynesian stimulus proved to be the best way to resuscitate the economy.

However, while Drezner argued that Kindleberger's five global public goods were all provided during the Great Recession, he stops short of explicitly giving credit to the U.S. for providing them, or for it having been a necessary condition for the system to work in the first place. I now turn to why this is so.

3. Theoretical Framework: Hegemonic Stability, Leadership, and Ideas during Moments of Crisis

A Theory of Leadership: Benevolence vs. Coercion

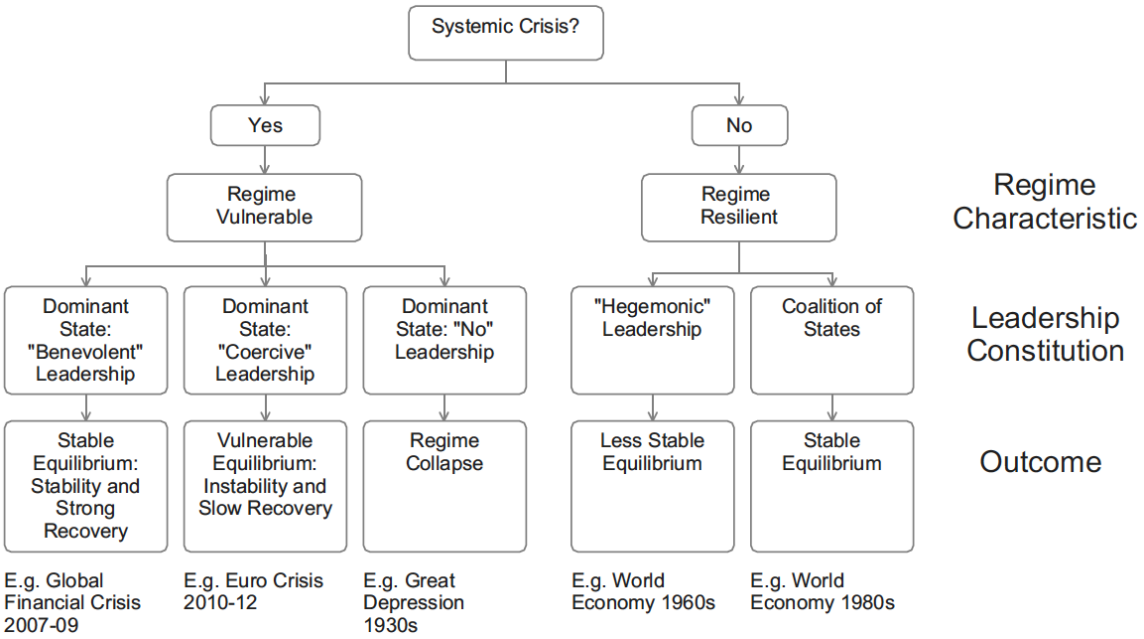
The main theoretical argument that follows is squarely placed within the 'leadership' tradition or 'public goods' version of hegemonic stability theory and is schematically summarized in figure 1. The starting point is that over the natural life course of different international economic systems or regimes – be it for example the global economic system built by the U.S. at Bretton Woods, or regional international regimes such as the EU, the Eurozone, NAFTA or ASEAN – there are two possible situations within which a regime can find itself. Either the international regime is grappling with a systemic crisis rife with uncertainty over the potential outcome, or alternatively, and most of the time, the regime will only have to cope with day-to-day and mostly computable risks. In the first case the regime will be most vulnerable and may be teetering on the brink of collapse, while in the second case the regime will be generally resilient and can therefore rely on standard operating procedures for its continued smooth functioning.

In the absence of any systemic crisis, for the regime to maintain its resilience, leadership of the system is still necessary. Keohane himself re-emphasized this point in 2012: "we know that in the absence of leadership, world politics suffers from collective action problems as each state tries to shift the burdens of adjustment to change onto others."[66] Of course, leadership can either be provided jointly, by a 'coalition of states' (like the world economy during the 1980s, which was governed by a coalition of the U.S., Japan, West Germany, Great Britain, and France), or through 'hegemonic' leadership (like the U.S. and the world economy in the 1960s). Leadership by a coalition of states – a la Keohane – will prove less troublesome for the regime than hegemonic leadership, since the burden of public goods provision is shared more evenly among the main stakeholders of the regime, creating a much more stable and balanced equilibrium. Hegemonic leadership – a la Gilpin – will sow the seeds and gradually create the conditions for the hegemon's own decline, since the hegemon will begin to suffer from bearing an uneven and disproportionate burden of public goods provision. This lack of burden sharing will undermine the hegemon's capacity to continue to provide hegemonic leadership in the future, as it eventually falls into the trap of what Paul Kennedy famously called 'imperial

[66] Robert O. Keohane (2012), "Hegemony and After," *Foreign Affairs* 91 (4)

overstretch.'[67] In the case of hegemonic leadership, the regime will be broadly resilient but will be operating under a progressively less stable equilibrium, as there is no real balance between the regime's major stakeholders.

Figure 1: International Economic Regimes: Systemic Crisis, Leadership, Outcomes



In times of systemic crisis, the regime will be vulnerable, and for it to survive, leadership by the dominant state is a necessary but not a sufficient condition. The pre-existence of a working international regime or supranational institution is not enough to guarantee that the system will continue to work: its most powerful state needs to step up during such a crisis, and agree to bear a disproportionate share of the financial burden.

My argument is based on the belief that the regime will suffer from Olson's collective action problem due to the panic that tends to break out in the midst of systemic uncertainty, and will therefore underprovide the necessary public good of economic and financial stability. The leading state, which stands to gain the most from the regime's survival, will need to coordinate and deliver the system's public goods itself. Under this scenario of systemic crisis, the key question is whether the dominant state provides leadership that is 'benevolent' (in the liberal institutionalist tradition), 'coercive' (in the realist tradition), or 'non existent.'[68] In the words of David Lake: "When benevolent, the leader provides the international economic infrastructure unilaterally, or at least bears a disproportionate cost of providing the public good, and thereby gains relatively less than others. When coercive, the leader forces other, smaller states to contribute to the

[67] See Paul Kennedy (1987), *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (New York: Random House)
[68] Beth V. Yarbrough and Robert M. Yarbrough (1992), *Cooperation and Governance in International Trade: The Strategic Organizational Approach* (Princeton: Princeton University Press)

international economic infrastructure and, at an extreme, to bear the entire burden."[69] In the third possible scenario, where there is an absence of dominant state leadership, the regime will most likely collapse and die, as indeed the gold standard and liberal trade regime did during the Great Depression of the 1930s.

Under the scenario of 'benevolent leadership,' Kindleberger's original argument holds. Benign leadership manifests itself when the state in question can to some degree provide all five of Kindleberger's public functions, including: keeping its domestic market open for the purchase of distress goods; facilitating countercyclical, stable, and long-term lending; ensuring a relatively stable system of exchange rates; managing the coordination of macroeconomic policies; and acting as a lender of last resort by providing liquidity to countries and systemic financial institutions in need.[70] This is the only realistic scenario in the event of a systemic crisis that will produce a stable equilibrium of the regime. Stability will return relatively quickly and the recovery will be robust. As I will show in section four, this is the scenario that played out during the global financial crisis, with the United States avoiding the mistakes of the 1930s, having memorized the lessons from the Great Depression, and providing benevolent leadership for the overall system.

Under the scenario of 'coercive leadership,' the dominant state will try to push the main burden of adjustment onto the weaker states, and shirk its responsibilities as a 'stabilizer.' Rather than providing Kindleberger's five public functions, the dominant state will refuse to coordinate macroeconomic policies, serve as a consumer of last resort, or provide liquidity and countercyclical lending. It will use its position of power to dictate the rules of adjustment for the other states of the regime, which may serve its own short-term interests, but will do much to weaken the regime over the longer term. This outcome will result in a much more vulnerable equilibrium: system instability will remain endemic and recovery will be anemic. In section five, I will show that this scenario occurred during the euro crisis of 2010-12, with 'surplus' Germany – the Eurozone's indispensable economic power – refusing to allow the ECB to act as lender of last resort. Furthermore, by imposing deflationary policies of austerity and structural reform on the countries that were hit most severely by the crisis, Germany ended up pushing the main burden of adjustment onto those 'deficit' countries, which prolonged the economic pain of the crisis. Only when the ECB decided to step in during the summer of 2012 as the de facto lender of last resort, did market fears recede. While imminent collapse of the currency union was avoided, the Eurozone's equilibrium nevertheless remained vulnerable.

In sum, while regimes and institutions enhance predictability, they occasionally fail. In that case, the regime needs leadership and freedom of action.[71] The rules of the game may need to be changed altogether. The existence of hegemonic leadership is necessary for the regime to survive a systemic crisis, but it needs to be practiced in a 'benevolent' rather than a 'coercive' way for the system to return to some sort of stable equilibrium. And the choice of benevolence or coercion is where the role of ideas during times of uncertainty comes in as our key explanatory variable. It is no coincidence that

[69] Lake (1993), p. 467
[70] Kindleberger (1986), p. 289
[71] Erik Jones (2009), "Elusive Power, Essential Leadership," *Survival* 51 (3), pp. 243-252

Kindleberger, an economic historian in the Keynesian tradition of MIT, wanted the system's leading state to provide five *specific* public goods. Three of those five goods – serving as a *consumer* of last resort ("market for distress goods"), *investor* of last resort ("countercyclical" and "long-term lending"), and *lender* of last resort ("providing liquidity in financial crisis") – are all three unmistakably "Keynesian:" their goal is to stimulate aggregate demand in the system. The two other public goods – policing a relatively stable system of exchange rates and managing the coordination of macroeconomic policies – still leave significant room for interpretation. A stable system of exchange rates is primarily aimed at avoiding competitive devaluations that resulted in the disastrous beggar-thy-neighbor policies of the 1930s, while coordinating macroeconomic policies can be interpreted either as joint stimulus, joint austerity, or stimulus for the 'surplus' countries combined with austerity for the 'deficit' countries.

The kind of leadership provided by the most powerful state in the system – be it either benevolent or coercive – will thus heavily depend on the economic ideas policymakers hold about how to get out of the crisis. If the government of the dominant state is broadly pragmatic and Keynesian in its economic orientation, it will more than likely follow Kindleberger's recommendations, and act or continue to act as a consumer, investor, and lender of last resort. Coordinating macroeconomic policies in that case will mean coordinating fiscal and monetary stimulus in the short term to stop any further slide into recession (with the risk of inflation), and a rebalancing of demand between deficit and surplus countries in the medium term, when recovery is already well under way. If the government of the dominant state is more neoclassical, financially conservative and economically orthodox in its conduct of economic policy – in the tradition of former U.S. Treasury Secretary Andrew W. Mellon – it will largely act upon those economic ideas, and stress the need to balance budgets, cut spending, bring down overall sovereign debt burdens, maintain low inflation, and "purge the rottenness out of the system."[72] Coordinating macroeconomic policies in this case will mean exercising monetary and fiscal restraint, relying on market forces for prices to adjust, with the risk of deflation and stagnation in the short term. This will prolong the crisis, foster further instability in the regime, and thwart any quick recovery of the system, in the hope that the regime will return to a more stable equilibrium over the medium to longer term.

Two New Empirical Cases

As early as 1993, David Lake complained that both "leadership and hegemony theory remain poorly articulated."[73] He encouraged future scholarship come up with more causal propositions, add missing variables, and conduct more empirical tests, but to avoid under specification and over extension.[74] The next three sections of this paper respond to Lake's call and are an effort to add more empirical flesh to the theoretical bones of the above framework. As is often the case in the social sciences, there are many more theories than there are cases, and actual natural experiments rarely supply themselves. Over the past

[72] As quoted in Barry Eichengreen (1992), *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (New York: Oxford University Press), p. 251
[73] Lake (1993), p. 485
[74] Ibid.

decade, both the global financial crisis and the euro crisis have provided the researcher with two new case studies, in which multiple data points lend themselves to this kind of testing. Both crises were systemic in nature, and the central role of the United States and Germany respectively in bringing about a solution to those crises has been widely debated, both in academia and the popular press.

Both the global financial crisis and the euro crisis have been analyzed extensively through various lenses, primarily focused on narrow theoretical explanations.[75] However, the crises warrant a more systemic account. Both were too serious and the consequences too severe to remain within the narrow confines of discussions focused on technical fixes and political bargaining, or the broad parameters of general observation. We need a much more systemic, theoretically informed, and empirically sound understanding of the crisis response.

As we will see in the next section, the global financial crisis was a direct challenge to the decline of the leadership version of hegemonic stability in IPE. The global economy as a system has a relatively weak institutional framework, especially compared to the European Union. But with 22 percent of total world GDP in 2007, the United States was the only national player in the world economic system that proved able and willing to provide global public goods, which had a positive transmission impact on the world's emerging markets. Because of its decisive actions, a second Great Depression could be avoided.[76] As a *deus ex machina*, hegemonic stability theory saved the day.

The euro crisis proved to be very different. First, the Eurozone is a regional economic regime with its own currency and monetary policy, but with different national fiscal policies, and no political union or supranational economic government. Because of the lack of any central government in Europe, the logic of collective action applies. While the theory of hegemonic stability has traditionally been tested for the global system, there should be no reason why it could not apply to the European subsystem. After all, prior to World War I, the international system was basically equal to the European state system. The Eurozone as a whole today is also a relatively closed and self-sustaining economic regime, with only about 11 percent of its overall GDP accounting for extra-Eurozone imports in 2009, while it is broadly in balance with the rest of the world. The euro crisis would be the first major test of the resilience of the European currency regime and its institutions. Secondly, Germany, with close to 28 percent of overall Eurozone GDP, was the only country capable of providing leadership.[77] The 'coercive' leadership style and selfish economic norms Germany adopted over the course of the euro crisis would prove decisive for the Eurozone's lackluster economic performance by imposing pro-cyclical economic policies on Europe's currency union.

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[75] See Matthijs (2014a)
[76] IMF (2014), *World Economic Outlook Database*, April and own calculations. Online available at: http://www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx
[77] Ibid.; European Commission (2014), *Ameco Database*.

4. America's 'Benevolent' Leadership in the Global Financial Crisis (2007-09)

This section will assess the United States' response to the global financial crisis through the lens of Kindleberger's five public goods, and conclude that the U.S. provided the international economic regime with abundant and generous benevolent leadership during the most acute phases of the crisis. This display of leadership by the Americans explains the world economy's relatively quick reversal from the 2008-09 Great Recession into a robust and sustained recovery in 2010. The actions of the U.S. government, both fiscal and monetary authorities, during the late 2000s stand in stark contrast to U.S. inaction in the late 1920s and early 1930s, when a 1929 stock market crash on Wall Street led to a global systemic collapse and the long slump of the 1930s. The full extent of public goods provision by the United States during the Great Depression – when it was able but unwilling to lead – and the Great Recession – when it was able *and* willing to lead – are directly compared in table 1.

Table 1: United States Leadership: Great Depression (1930s) vs. Great Recession (2008-09)

Kindlebeger's Public Goods	**Great Depression, 1930s**	**Great Recession, 2008-09**
U.S. Consumer of Last Resort (Distress Goods)?	✗ *(Smoot Hawley Tariff, 1930)*	✔ *(Resisted Protectionist Temptation)*
U.S. Countercyclical, Long-Term Lending?	✗ *(K Flow Reversal, Lower Lending)*	✔ *(K Flow Reversal + Fast Recovery)*
U.S. Policing Stable Exchange Rate System?	✗ *(Competitive Devaluations)*	✔ *(Initial US dollar strengthening)*
U.S. Coordination of Macroeconomic Policies?	✗ *(London Economic Conference)*	✔ *(G-20 Summits in 2008 and 2009)*
U.S. Lender of Last Resort (LoLR)?	✗ *(Fed only LoLR for U.S. economy)*	✔ *(Fed Swaps w/other Central Banks)*

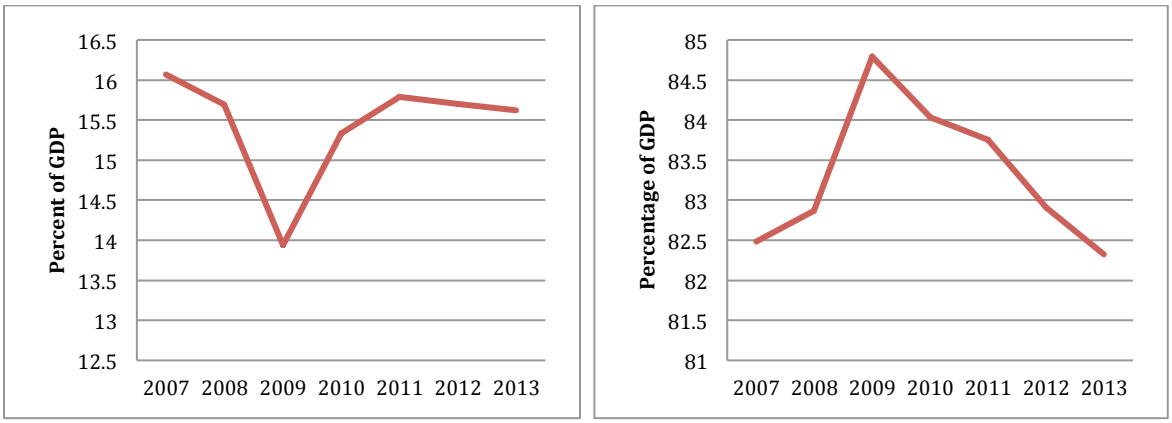
First, while the United States responded to the Great Crash of 1929 by unilaterally imposing the infamous 1930 Smoot-Hawley tariff on the rest of the world – increasing the price of all imported goods by an average of 40 percent – it managed to resist the many protectionist temptations after the credit crunch of 2008. Many analysts agree that the lack of any real upsurge in protectionist measures was one of the more extraordinary aspects of the Great Recession, and give the WTO and the multilateral trading system, including its binding dispute settlement mechanism, much of the credit for it.[78] While this is undoubtedly correct, few have pointed out explicitly that the United States played a major role in this. It was the U.S. under President Bush after all that convened the inaugural G-20 summit for heads of state in Washington, DC in November 2008. In the communiqué of that summit, their joint commitment to free trade was stated in no uncertain terms: "We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing … (WTO) inconsistent

[78] For an overview of those accounts, see Drezner (2014b), pp. 39-42

measures to stimulate exports."[79] These pledges were repeated during the G-20 summits of London in April and Pittsburgh in November 2009.[80] Protectionism did not return.

While the share of U.S. imports to its GDP fell from 16 percent in 2007 to 14 percent in 2009, it surged back to 15.3 percent in 2010 and close to 16 percent in 2011. U.S. consumption increased from an already high percentage of 82.5 percent in 2007 to an absolute peak of 84.8 percent of its GDP in 2009, before gradually returning to around 82 percent by 2013 (figure 2). This last point underscores the United States' role as consumer of last resort: it delivered on public good #1 and, despite the deep recession it found itself in, continued to serve as the world's market for distress goods.

Figure 2: Evolution U.S. Imports (% of GDP) (a) and Total Consumption (% of GDP) (b), 2007-2013[81]



Next, we look at public good #2 ("countercyclical long-term lending") together with #5 ("lender of last resort"), as they are closely related. The U.S. central bank, the Federal Reserve, played a major role in providing liquidity, but so did U.S. private investors, who took their money abroad in massive amounts in 2009 in search of higher yields. Also, the U.S. government used its strong voting power in the IMF and leadership role in the G-20 to advocate for a tripling of IMF lending capacity to $750 billion. Figure 3 neatly shows the evolution of U.S. financial flows during the crisis years. While U.S. private financial outflows (in blue) virtually come to an end in the third and fourth quarters of 2008, when one can observe massive private inflows into the U.S. from abroad as part of the 'flight to safety' into the U.S. dollar, these flows went into reverse during the first two quarters of 2009. But while private financial outflows suddenly stopped in the second half of 2008, they were replaced by U.S. government flows (in purple) during that time period, also known as Federal Reserve Swaps. By early 2009, the (purple) U.S. government flows already started going into reverse as foreign central banks honored their commitments to the Fed by paying back those loans.

[79] New York Times (2008), "Statement from G-20 Summit," November 14. Online available at: http://www.nytimes.com/2008/11/16/washington/summit-text.html?pagewanted=all&_r=0
[80] IMF (2009), "G-20 Communiqué, London, April 2," points 23-25. Online available at: http://www.imf.org/external/np/sec/pr/2009/pdf/g20_040209.pdf; and G-20 (2009), "Leaders' statement," September, multiple points, especially point 48. Online available at: http://www.g20dwg.org/static/2009_G20_Framework_for_Strong_Sustainable_and_Balanced_Growth.pdf)
[81] European Commission (2014*), Ameco Database*

Figure 3: U.S. Net Financial Flows (1991-2012)[82]

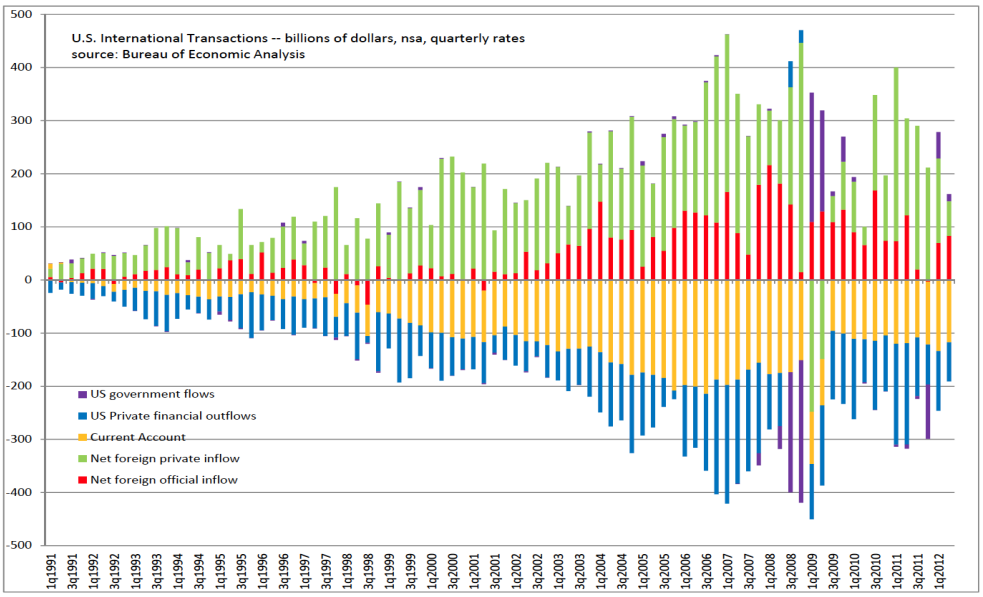


Figure four shows the liquidity activities of the Federal Reserve in a bit more detail. Not only did the Fed aggressively cut interest rates in response to the market panic that broke out after the bankruptcy of Lehman Brothers, it also expanded its balance sheet through multiple rounds of quantitative easing (QE), as illustrated on figure 4 (a). While the Fed's total liabilities were around $800 billion in early September 2008, those had grown to more than $2 trillion by the end of 2009. By buying up all kinds of agency debt and mortgage backed securities (MBS) from distressed financial institutions, many of which with substantial business and investments overseas, the Federal Reserve not only restored confidence in the global financial system, but also enabled its banks to start the painful process of deleveraging.

Furthermore, the Fed was literally the only institution in the world capable of functioning as a global lender of last resort. Between December 2007 and February 2010, the Fed made liquidity swap lines available to the European Central Bank, Bank of Canada, Bank of England, Bank of Japan, and the central banks of Australia, Brazil, Denmark, Korea, Mexico, New Zealand, Norway, Singapore, Sweden, and Switzerland.[83] By the end of November 2008, the total amount of outstanding Fed credit lines to the world amounted to a whopping $600 billion, almost as high as the Fed's own entire balance sheet prior to the crisis.[84] On top of the swaps, Helleiner added that "the Fed provided liquidity directly to troubled foreign financial institutions by allowing their US branches and subsidiaries access to its discount window and enormous emergency facilities during the crisis."[85]

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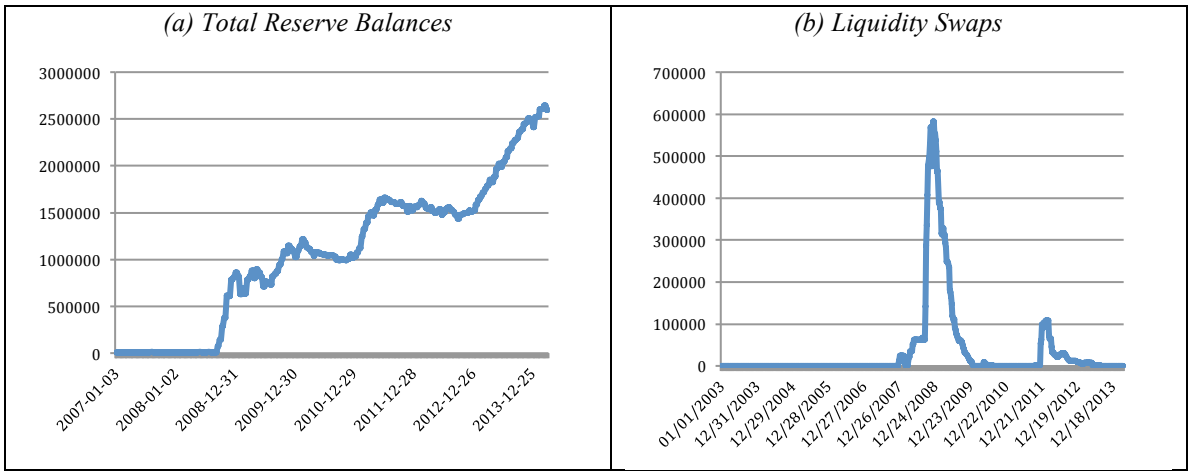
[82] Jaime Marquez (2014), "International Monetary Theory" course at Johns Hopkins University, SAIS. Data from *Bureau of Economic Analysis* (BEA), design is from Charles Thomas at the Federal Reserve.
[83] For a more detailed analysis, see Helleiner (2014), pp. 38-45
[84] Federal Reserve Bank of New York (2014), "Central Bank Liquidity Swaps Arrangements Archive," online available at: http://www.newyorkfed.org/markets/liquidity_swap_archive.html
[85] Helleiner (2014), p. 41

Figure 4: Federal Reserve: Lender of Last Resort (2007-2009)[86]



Kindleberger identified public good #3 as overseeing a relatively stable regime of exchange rates, and here the U.S. also delivered. Figure 5 shows the evolution of the United States' real effective exchange rate – or the weighted average of the U.S. dollar relative to an index consisting of the currencies of its major trading partners – from 2007 to 2013. While one can observe an initial dollar strengthening in late 2008 and early 2009 due to the effects of the 'flight to safety' during the most acute phase and panic of the crisis, the dollar returned to its natural medium-term value, fluctuating around the value it had during the summer of 2007 between 2009 and 2013. As Eric Helleiner has noted, one of the more surprising things about the global financial crisis has been the absence of a dollar crisis. Both private and foreign official support for the U.S. dollar remained the order of the day, and despite Chinese and French murmurings about the instability of the dollar-led international monetary system and the need for an alternative reserve currency, there was broad continuity in foreign official preferences.[87]

Figure 5: U.S. Real Effective Exchange Rate, 2007-2013 (2010 = 100)[88]

[86] Board of Governors of the Federal Reserve System (2014), "Total Reserve Balances Maintained" (a), and "Central Bank Liquidity Swaps held by the Federal Reserve: All Maturities" (b). Millions of dollars.
[87] Helleiner (2014), chapter 3, pp. 54-91
[88] Bank for International Settlements (2014)

Finally, public good #4, the coordination of macroeconomic policies globally, was most successful in 2008 and 2009 under the auspices of the G-20. As Dan Drezner has pointed out, "[t]he combined G20 stimulus in 2008 and 2009 amounted to approximately $2 trillion – or 1.4 percent of global economic output," which gave a substantial boost to global growth, estimated around 2 percent.[89] But again, the important point here is not so much that the system as a whole worked, but that the system could not have worked without the United States. Of the impressive $2 trillion in extra global fiscal spending, close to $800 billion was directly committed by the U.S. federal government, which adds up to almost 40 percent of the world's total stimulus. For an economy, which in nominal terms was just over 20 percent of the world's GDP at the time, the U.S. share of the stimulus was indispensable to the global regime's success. It is hard to imagine the world economy having recovered as fast without it. Also, as Helleiner has argued, most national stimulus plans were enacted because of domestic political reasons rather than any desire to abide by the international regime of the G-20, making the large U.S. share all the more important for the speed of the recovery.[90] On the monetary side, the Federal Reserve had already done most of the coordinating of interest rate cuts before the G-20 had even met.

In sum, without any doubt, the U.S. public goods performance and display of benevolent leadership during the global financial crisis of 2008-9 would have received MIT's highest grade of *summa cum laude* and the U.S. government would have been invited to join Kindleberger's *Phi Beta Kappa* society. As we will see in the next section, Germany's scorecard during the euro crisis would look rather different.

5. Germany's 'Coercive' Leadership during the Eurozone Crisis (2010-13)

The parallels with the United States' role during the Great Recession and Germany's role during the European sovereign debt crisis are mostly striking because of their absence. If we apply Kindleberger's five public goods criteria for benevolent leadership to Germany, we can but conclude that Berlin royally failed the test, as summarized in table 2.[91]

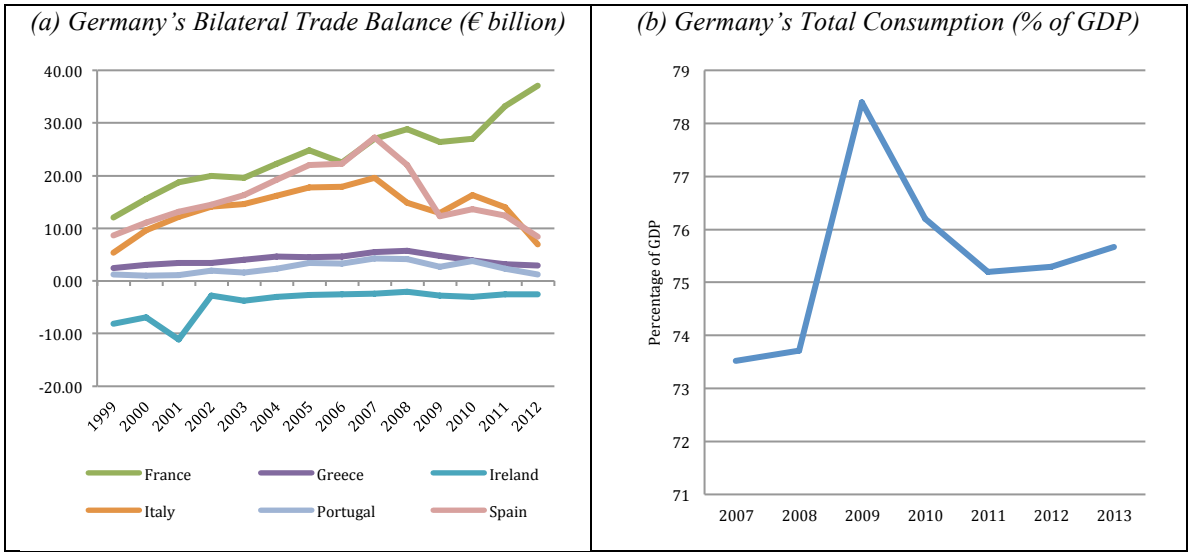
Table 2: German Public Goods Provision during the Euro Crisis (2010-13)

Kindleberger's Public Goods	Euro Crisis (2010-2013)
Germany: Consumer of Last Resort (Market for Distress Goods)?	✗ *(Persistent Current Account Surplus, High Savings)*
German Counter-Cyclical, Long-Term Lending?	✗ *(K Flow Reversal post Crisis, Pro-Cyclical Lending)*
German Policing of Stable Exchange Rate System?	✗ *(Deflationary Impact of Austerity in Euro Periphery)*
German Coordination of Macroeconomic Policies?	✗ *(No Stimulus, but Austerity for All)*
Germany/ECB Lender of Last Resort, liquidity provision?	✗ *(ECB Conditionality – even after OMT in Sept 2012)*

[89] Drezner (2014b), p. 45
[90] Helleiner (2014), p. 30
[91] The main argument in this section has been earlier developed, and heavily borrows from, Matthias Matthijs and Mark Blyth (2011), "Why Only Germany Can Fix the Euro," *Foreign Affairs*, November 17

First, rather than providing the Eurozone's peripheral countries in distress with a market for their distress goods, Germany continued enthusiastically to sell its manufactured goods to that periphery, a process which had started already in the late 1990s. According to Eurostat, while Germany's trade surplus with the rest of the EU was €46.4 billion in 2000, it had grown to €126.5 billion in 2007.[92] Looking at the evolution of Germany's bilateral trade surpluses with the Mediterranean countries, between 2000 and 2007 Greece's annual deficit with Germany grew from €3 billion to €5.5 billion, Spain's almost tripled from €11 billion to €27.2 billion, Italy's doubled from €9.6 billion to €19.6 billion, and Portugal's quadrupled from €1 billion to €4.2 billion. All those surpluses started falling after the crisis, but mainly due to a collapse in German exports to the periphery rather than a pick-up in German imports from the Mediterranean. All four countries remained in deficit with Germany in 2012. France's bilateral deficit with Germany steadily rose from €12 billion in 1999 to €37 billion in 2012 (figure 6a).

Figure 6: Germany's Trade Balance and Total Consumption[93]



Germany saw its final consumption increase from 73.7 percent of GDP in 2007 to 78.4 percent in 2009 after the global financial crisis. After the Great Recession of 2009, however, consumption fell back to just above 75 percent in 2011, during the midst of the euro storm, and barely budged since then, staying somewhere in between 75 and 76 percent in 2012 an 2013 (figure 6b). Germany's gross savings rate increased from just above 20 percent of GDP in 2001 to almost 26.8% in 2007, after which it fell to a low of 22.5 percent during the fiscal stimulus year of 2009. But again, German savings started going up during the euro crisis, hovering around 24 percent between 2010 and 2012. Germany's current account deficit also persistently remained above 6 percent between 2007 and 2013, with the exception of 2009 when it stood at 5.9 percent. The German economy remained Europe's (and by some measures also the world's) export champion,

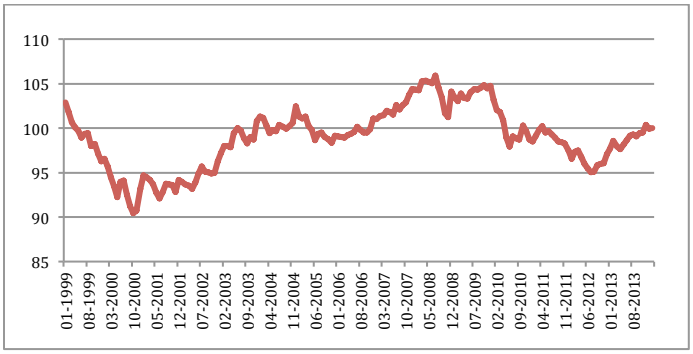
[92] Eurostat, *External and intra-EU trade – Statistical Yearbook (Data 1958-2009)*, Brussels: European Commission, 2010, p. 145

[93] European Commission (2014), *Ameco Database*, "German Trade Surplus" and "German Total Consumption"

with high savings and relatively low consumption, as far away from the necessary consumer of last resort as it could be.

Second, instead of providing the Eurozone with countercyclical long-term lending, German lending was largely pro-cyclical after the introduction of the euro. During the boom of 2003-2008, German banks extended credit on a massive scale to the periphery countries of the Eurozone, a trend that abruptly went into reverse as the euro crisis began to gather steam in late 2009. A 2010 IMF working paper on "European Financial Linkages" revealed Germany to be one of the two biggest net creditors within the Eurozone in 2008 (after France) with intra-Euro Zone net investment positions of +€735 (compared to France with +€764 billion), which was the exact mirror image of Portugal (–€136 billion), Greece (–€199 billion), Italy (–€334 billion) and Spain (–€794 billion).[94] Since the beginning of 2010, when the European periphery needed long-term loans and cheap credit more than ever, Germany's enthusiasm for credit extension – both from the private and the public sector – quickly faded away as German investors lost their appetite and started fluctuating between caution and active hostility. The credit that was extended through the ESM and the bailout programs for Greece, Ireland, and Portugal, limited Germany's share to its percentage of EU GDP, and were primarily aimed at directly helping governments finance their deficits, and were subject to strict conditionality.

Figure 7: Germany's Real Effective Exchange Rate, 1999-2013 (2010 = 100)[95]



Third, when it came to policing a relatively stable system of exchange rates, Germany had less of a direct role to play, and its own actions actually encouraged others to defect. By definition, the euro gave the countries that chose to join it a common external float, the credibility from doing business in a potential global reserve asset, and the credit rating of its strongest member. At the core of the Eurozone construction lay the belief that, if countries adhered to a set of rules about how much debt, deficits, and inflation they can have, their economies will converge, and the same exchange rate would work for all members. This was obviously true only in theory, and only so long as all countries obeyed the rules. It is well known that Germany – together with France – in 2003 broke its own fiscal rules written in the Stability and Growth Pact (SGP). When it violated that pact itself, it sent the signal to smaller countries that fiscal profligacy would go

[94] C. Waysand, K. Ross, and J. de Guzman, "European Financial Linkages: A New Look at Imbalances," *IMF Working Paper*, WP/10/205, Washington, DC: December 2010
[95] Bank for International Settlements (2014)

unpunished. But looking at figure 7, showing Germany's real effective exchange rate since 1999, one can see its rate strengthening until late 2009, but weakening after. This was the wrong trend if Germany wanted to allow the European periphery to become more competitive vis-à-vis itself.

Fourth, in the domain of coordinating macroeconomic policy, Germany failed the most spectacularly, especially during the first half of the crisis in 2010 and 2011. Ignoring long-established economic laws like the Keynesian "paradox of thrift" or the "fallacy of composition," Germany advocated a serious dose of austerity in the European periphery without trying to offset the negative economic effects with either fiscal stimulus or inflationary policies at home.[96] The result was an increase in the debt-to-GDP ratios in the affected countries, thereby exacerbating the problem the deflationary medicine was trying to solve.[97] It was always going to be impossible for the rest of Europe to become more like Germany, as Berlin's elites prescribed. Germany extolled the virtues of austerity, while in effect benefiting from the fact that others did *not* follow austerity. German pre-crisis growth was partially fueled by buoyant demand in Southern Europe made possible by excess German savings. By the iron logic of the balance of payments, one country's exports are another country's imports, and one country's capital inflows are another's capital outflows. The Eurozone could never as a whole become more like Germany, since Germany could only be Germany because the others were not.

Finally, the only public good where you could argue that Germany and the Eurozone have had some success was with the lender of last resort function, though with a serious caveat. The ECB, which had been dominated by Germany and German ideas since its inception, was initially not allowed to act as a real lender of last resort by discounting or providing liquidity during financial crisis. Germany insisted on IMF conditionality for the bailout countries and severe austerity measures in 2010 and 2011. German obstinacy when it came to letting the ECB play the same "bazooka" role as the Federal Reserve, which demonstrated its effectiveness in turning the financial tide in 2008 and 2009 in the United States, was striking. Jens Weidmann, the president of Germany's Bundesbank, rebuffed global demands, including by U.S. President Obama, for more decisive intervention in Europe's bond markets by the ECB to combat the crisis. Weidmann flat out rejected the idea of using the ECB as "lender of last resort" for governments, warning that such steps "would add to instability by violating European law."[98] Weidmann would never give up his opposition to the idea, but over the summer of 2012, Germany's Chancellor Angela Merkel would be forced to change her mind and let go of her objections.[99]

The change of heart started with the replacement of Jean-Claude Trichet by Mario Draghi at the helm of the European Central Bank. While Draghi managed to temporarily calm

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[96] Henry Farrell and John Quiggin (2012), "Consensus, Dissensus and Economic Ideas: The Rise and Fall of Keynesianism During the Economic Crisis," *Center for the Study of Development Strategies*, March 9
[97] Blyth (2013), chapter 3
[98] As quoted in Matthijs and Blyth (2011)
[99] Peter Spiegel (2014), "How the Euro Was Saved, Part 3: 'If the Euro Falls, Europe Falls'," *Financial Times*, Friday May 6, p. 5

down the markets in late 2011 and early 2012 by instituting Long-Term Refinancing Operations (LTROs) to put liquidity back into the currency union's ailing banks, the real turnaround for the Eurozone would come when he announced in the summer of 2012 that he would do "whatever it takes" within his mandate to save the euro. The follow up announcement of Outright Monetary Transactions (OMTs) in September 2012, opposed by Weidmann but quietly supported by Merkel, calmed down the markets. Even though the program has never been tested at the time of writing, it was not clear whether OMT would actually work as it still had a strong element of conditionality to it. But it seemed to be enough of an assurance to investors and financial market participants, and the tail risk of a euro break up disappeared over the course of 2013.

In sum, when one looks at the German record in public goods provision during the euro crisis, it is clear that rather than a 'benevolent' hegemon – in the Kindleberger fashion – Germany used its power in a 'coercive' way by transferring the main burden of adjustment of the sovereign debt crisis onto the periphery countries.[100] The tragedy is that Wolfgang Schäuble, Germany's all-powerful finance minister at the time, had actually read Kindleberger's *World in Depression*, and strongly believed that its "central message [was] more important in 2010 than ever before."[101] Schäuble fundamentally misread and misinterpreted Kindleberger, however. In a speech at the Sorbonne in Paris in November 2011, he proclaimed: "A stable world economy does not materialize 'by itself.' It is a public good, that must be provided in the face of national self-interest. For the world economy to be stable, it requires a leading nation, a benign hegemon or 'stabilizer.'"[102] Schäuble continued to explain that he thought France and Germany once again needed to take up the leadership mantle in Europe, and "lead by example." By that, however, he did not mean provide the five public goods Kindleberger had in mind. What he had in mind was for Germany and France to live by the letter of the EU's Stability and Growth Pact, abide by the rules, and implement their self-imposed (German) role model at home.[103]

How was it possible for someone as intelligent as Schäuble to completely misinterpret Kindleberger's original teachings? And why is it that most of America's economics establishment – including Ben Bernanke, Larry Summers, and Christina Romer – had a completely different understanding on how the U.S. government should behave during a similar systemic crisis? The importance of ideas cannot be overstated. As the next section will show, the reason why the U.S. and Germany understood their roles so differently can be traced back to the ideas their governing elites – including bureaucrats and politicians – held about the proper conduct of economic policy.

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[100] See also Federico Fubini (2013), "Europe in Depression?" *Project Syndicate*, World Affairs, April 22. Online available at: http://www.project-syndicate.org/commentary/restoring-growth-and-external-balances-in-the-eurozone-by-federico-fubini

[101] Hans Kundnani (2012), "What Hegemon? Germany's self-centeredness and short-term thinking disqualify it as a hegemon," *DGAP* (German Council on Foreign Relations), May 4. Online available at: https://ip-journal.dgap.org/en/ip-journal/topics/what-hegemon

[102] Wolfgang Schäuble (2010), "Rede des Bundesministers der Finanzen Dr. Wolfgang Schäuble an der Unitversité Paris-Sorbonne," *Bundesministerium der Finanzen*, November 2. Online available (in German) at: http://www.bundesfinanzministerium.de/Content/DE/Reden/2010/2010-11-02-sorbonne.html?view=renderPrint

[103] Ibid.

6. An Explanation of Washington's Acceptance and Berlin's Rejection of Kindleberger's Teachings

Eric Hobsbawm summed up the U.S. government's management of the Great Depression during the 1930s as follows: "Never did a ship founder with a captain and a crew more ignorant of the reasons for its misfortune or more impotent to do anything about it."[104] Kindleberger lamented that "[t]he World Economic conference of 1933 did not lack ideas […]. But the one country capable of leadership [the U.S.] was bemused by *domestic concerns* and stood aside." (Emphasis added).[105] One cannot help but think of Germany's behavior during the first two years of the euro crisis when reading these quotes, while at the same time observing that the United States did not make the same mistakes in 2008 as it had made during the late 1920s and early 1930s. One could argue that there was never any doubt about the fact that the global financial crisis was caused in the U.S., hence it should be no surprise to anyone that the U.S. ended up shouldering a disproportionate share of the financial burden. The conventional narrative in Germany about the euro crisis was very different, with the 'sovereign debt crisis' caused by profligate spending in the Eurozone periphery, whose countries therefore needed to pay. This line of thinking, however, fundamentally misses the point of leadership during systemic crises.

Yet, it would be erroneous to say that Germany did not provide any leadership at all during the euro crisis. By all means, it did. There was no doubt in anyone's mind that Germany was the Eurozone's indispensable member state, just as much as the U.S. held that position in the world economy in 2008. Yet, the 'coercive' leadership it provided in Europe, based on legal rules and ordoliberal dogma, was qualitatively opposite to the 'benevolent' leadership the United States offered the world economy two years earlier, which was grounded in discretion rather than rules, flexibility and Keynesian pragmatism. Different ideas held by the national elites in both countries explain the very different outcomes in dealing with relatively similar systemic crises.[106]

The tension between rules and discretion has always existed in international politics, but much more so in times of systemic crisis and relative regime 'disorder' than during normal times of institutional 'order.' When the regime functions, the rules of the game provide stability and path dependence. When the regime ceases to function, however, and totters on the brink of systemic breakdown, it needs leadership and discretion, as the rules of the game no longer work. In the words of Erik Jones: "[T]he usefulness of the law is itself a function of its acceptance. More importantly, the law by itself cannot tell us how to reform existing structures once that acceptance breaks down. When the law ceases to

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[104] Eric Hobsbawm (1999), *Industry and Empire: The Birth of the Industrial Revolution* (New York: The New Press, W.W. Norton), first published in 1968, p. 190

[105] Kindleberger (1986), p. 298

[106] See, for example, Sheri Berman (1998), *The Social Democratic Moment: Ideas and Politics in the Making of Interwar Europe* (Cambridge: Harvard University Press), Mark Blyth (2002), *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press), and Matthias Matthijs (2010), *Ideas and Economic Crises in Britain from Attlee to Blair* (1945-2005) (London: Routledge)

function, it is leadership that matters."[107] This is the tricky predicament Theodore Lowi encountered in *The Politics of Disorder*, in which he saw leadership in a rather negative light, and as diametrically opposed to the rule of law, even though he recognized that leadership was needed in times of disorder to change the rules of the game.[108] As Jones sums it up: "The challenge … is to find some balance in the relationship between leadership and the law."[109]

The United States' response to the global financial crisis was to resuscitate a global system in cardiac arrest through a combination of a large fiscal stimulus, monetary easing, countercyclical lending, and the full use of the Federal Reserve's firepower as a global lender of last resort. While it could have blamed a global savings glut and Chinese currency manipulation for the cause of the global financial crisis, it realized that the rest of the world's lack of spending was met equally with America's overspending, and excess savings abroad was balanced by excess investment in the U.S. housing market. Rather than trying to push the burden of adjustment onto the rest of the world, the U.S. government refused to play the blame game once the crisis hit in 2008, and instead kept its markets open, and agreed to bear a disproportionate share of the global adjustment cost. Through its discretionary actions, the U.S. established new norms for the world economy, emphasizing that systemic crises need benevolent leadership, based on freedom of action and flexibility to respond in pragmatic Keynesian, rather than dogmatic and orthodox, ways.

Germany's management of the euro crisis was almost entirely the opposite of the U.S. response to the global financial crisis. The German response to the pending Greek default in 2010, and to the contagion to other periphery countries later that year and in 2011 was a moralizing one, dividing up the Eurozone in fiscal sinners and budgetary saints. Rather than choosing to analyze the crisis as a lack of solidarity between North and South, the German government preferred to warn against the risk of moral hazard if the Northern core countries were too generous with the periphery countries.[110] German finance minister Schäuble, in a 2012 editorial in the Wall Street Journal, summed up his government's view: "Moral hazard is not benign. Setting the wrong incentives would mean stabbing reformist governments in the back. By suggesting that uncompetitive economic structures can endure, we would buoy the populists, scapegoat-seekers and illusion-peddlers who lurk at the fringes of our political landscapes. By discouraging reform, we would not solve Europe's imbalances but make them permanent."[111]

It is more than ironic that German savings made periphery overspending possible, and that periphery overspending fueled German growth and gave it the moral high ground

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[107] Jones (2009), p. 249

[108] Theodore J. Lowi (1971), *The Politics of Disorder* (New York: Basic Books), prologue and chapter 8. I want to thank Erik Jones for bringing this book to my attention.

[109] Jones (2009), p. 249

[110] See Abraham Newman (2015), "Chapter 6: Germany's Euro Experience and the Long Shadow of Reunification," in Matthias Matthijs and Mark Blyth (eds.), *The Future of the Euro* (Oxford University Press, forthcoming)

[111] Wolfgang Schäuble (2012), "Building a Sturdier Euro," *Wall Street Journal*, December 12. Online available at: http://online.wsj.com/news/articles/SB10001424127887323981504578174812451337722

and position of European hegemon. Overspending, too little saving and too much borrowing by the Greeks was the flip side of the coin of under spending, too high savings, and too much lending on the part of the Germans. There is no truth in arguing that the 'sinful' periphery was solely at fault, while the 'virtuous' core was blameless. Yet the German response initially shifted the whole burden of adjustment onto the 'deficit' countries of Ireland and the Mediterranean, by imposing austerity measures and structural reforms onto the countries that needed a financial rescue from the Troika. Furthermore, through the course of the crisis, the German government emphasized the importance of rules and laws over the arbitrariness of discretion. Institutional innovations at the EU level, like the Fiscal Pact and the European Semester, only further cemented the importance of fiscal and financial rules over political discretion in the Eurozone. More rules, however, do not guarantee any future solutions once the politics of disorder come back to haunt the currency union. Germany acted as the 'anti-Keynesian' hegemon, furthering a pro-cyclical fiscal regime, and insisting that the crisis had national rather than systemic and international solutions.

It is fair to assume that both policy elites in the U.S. and Germany have read or heard of Kindleberger's teachings. Yet, they have internalized very different interpretations. Both the U.S. as well as Germany acted within their interests during the systemic crises they faced as most powerful country within the regimes they built, in 1944 at Bretton Woods and in 1991 at Maastricht respectively.[112] While U.S. elites in Washington defined their national interests as acting as a benevolent hegemon for the world economy during the Great Recession, German elites in Berlin defined their national interests as acting as a coercive hegemon for the Eurozone, and a guardian of its sacred institutional rules. The result was the relatively quick return to stability of the global economy in 2009, and a robust recovery in 2010; while the Eurozone fared much worse in that instability seemed to become institutionalized over the course of 2011 and 2012, and recovery was first non-existent before it was feeble.

What has the outcome been for both hegemons? In the short term, Germany gained in importance within the Eurozone. Its superior growth performance over the course of both crises, made it increase its share of nominal GDP within the Eurozone from 26.7 percent in 2007 to 28.5 percent in 2013. The United States' share in the world economy, on the other hand, fell from 22 percent of the world's nominal GDP in 2007 to 19.3 percent in 2013.[113] Germany gained more than the rest of the Eurozone due to its own actions in the short term, but it left the regime in the Eurozone vulnerable and instable in the longer term. The global economy gained relatively more from U.S. actions and leadership in the short term than the U.S. itself, but the system was saved and put back on a more solid footing, benefiting the Americans in the long term.

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[112] There is, of course, a qualitative difference. While the U.S. built the new liberal economic order at Bretton Woods in 1944 primarily out of its own initiative and largely by its own design, the Germans only reluctantly agreed to Economic and Monetary Union (EMU) at Maastricht in 1991. While EMU largely tailored to German preferences, Germany never fully accepted its 'leadership' role in EMU: fiscal and inflation rules would replace the need for leadership, was the logic in Germany at the time.
[113] IMF (2014), *World Economic Outlook Database*.

7. Conclusion: Crisis, Power, Leadership, and Ideas

Hegemonic stability is alive and well in the 21st century. This paper presented a new model of hegemonic stability theory, testing longstanding and opposing theories – that of Kindleberger and that of Keohane – with new empirics made possible by two recent cases, the Great Recession of the world economy in 2008-9 and the so-called European sovereign debt crisis of 2010-12. The theoretical framework makes a crucial distinction in times of systemic crisis between different types of leadership. The dominant state can either act as a 'benevolent' hegemon or a 'coercive' hegemon, determined by whether or not the system leader bore a disproportionate amount of the costs of stabilization by providing the public goods necessary for economic recovery.

This paper has shown empirically how the U.S., acting as a benevolent hegemon, was able to resolve the global financial crisis relatively quickly, while Germany, acting much more as a coercive hegemon, delayed the resolution of the euro crisis by not refusing to provide the necessary public goods, thereby exacerbating the consequences of the crisis, especially in the European periphery.

Moreover, this paper has added a critical variable to explain why a dominant state will choose to act as either a benevolent or coercive hegemon: the power of ideas, and in particular, the role economic ideas play in defining states' interests. The U.S. acted the way it did because of the Keynesian economic ideas it held, no doubt influenced by its catastrophic performance during the Great Depression. Germany also acted consistently with its ideas, propounding an ordoliberal approach of fiscal rules and national austerity in a crisis that instead demanded largely 'systemic' solutions.

It is the ultimate irony that Germany's finance minister during the crisis expressed a belief in the importance of leadership and hegemonic stability, yet fundamentally misinterpreted Kindleberger's vision, and acted almost in opposite fashion to what the MIT economist had in mind. Rather than providing the public goods necessary to resolve the crisis, Germany induced the hard-hit Eurozone countries to adopt German-style austerity policies. The different ideas held by national policymakers in the United States and Germany would lead to very different perceptions of their national interests and fundamentally opposing definitions of leadership during a crisis. This divergence of views explains why, in the beginning of the 21st century, Kindleberger's leadership version of hegemonic stability theory was fully embraced in Washington, but largely ignored or misunderstood in Berlin.

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