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for the German delegation. For the IMF to become an effective institution, it also needs more legitimacy, and this cannot be achieved without giving the emerging economies a greater voice, foremost a greater representation on the IMF's executive board. In an interview to the *Süddeutsche Zeitung* on the eve of the summit, Merkel appeared increasingly open minded (Bundeskanzleramt 2008a). However, IMF reform is likely to remain difficult.

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Bank or the founding of new financial institutions such as the Financial Stability Forum (FSF) and the G20. In the current crisis, however, Germany has left the field to Britain and France. Sarkozy was particularly eager for Europe to play a more vocal role on the international stage. He believed that the financial crisis, weakening the U.S., has provided the EU with an opportunity to boost its influence. Germany was critical of his approach. "Europe can only make the most of its influence if all 27 member states present a common front," Merkel agreed with Sarkozy in Brussels in early November (Bundesregierung 2008). However, she did not want to put off Germany's partners by overly detailed plans, and wanted to leave enough space for compromises. The chancellor wanted the global financial summit to set out a concrete roadmap with a clear time schedule. But she did not support the strict timeline proposed by France, particularly in the light of leadership change in the United States.

With the next federal elections in Germany slated for September 2009, the chancellor is anything but in an easy position. She faces two challenges: the dissatisfaction of Germans with the social market economy and the related possible shift of public opinion toward the left. Polls by the German banking association say that one in two Germans is unhappy with the social market economy. If the economy continues to deteriorate, the CDU's political opponents, the Social Democratic Party and the Left (*die Linke*), will remind voters of the stance of the CDU — and of its desired coalition partner, the market-oriented Free Democratic Party — and build on the wide dissatisfaction with current economic policy making. Once citizens start to feel the economy downturn, the CDU will be threatened by the loss of votes. Angela Merkel is thus walking a thin line — and much more international leadership can thus not be expected.

An Important Step in the Right Direction

Merkel went to Washington hoping that the recent financial crisis would force the U.S. to give up its opposition to tighter regulation of markets but expecting difficult negotiations. Knowing that President Bush, who remained averse to too much government intervention in markets, would be difficult to get commitment, she viewed the G20 summit as an important but only first step in the right direction (Bundeskanzleramt 2008c). Unfortunately, the timing was not the best. While the G20 leaders wanted to set a reform process quickly into motion, the event received relatively little attention by the public and media in the U.S. as President-Elect Barack Obama sent representatives but chose not to attend himself.

Nonetheless, many focal points of Merkel's wish list made it on the agenda. The summit started a six-month process of consultations. The G20 planned to circulate a detailed proposal by March 31, 2009, with the next summit planned to take place before April 30. The G20 countries also agreed on more oversight of credit-rating agencies and stronger regulation of hedge funds — both two important points on Merkel's agenda. They also proposed clearer accounting standards and affirmed the importance of free trade, agreeing to refrain from raising new barriers to investment and trade in goods and services for the next 12 months.

But — not entirely surprisingly — no immediate action was taken. Concrete steps will have to wait until Obama takes office. What must still be negotiated is the future role of the IMF in supervising and regulating the global financial system — a disappointment

and head of the Euro-group of finance ministers. Even the European Parliament has challenged the EU member states, in a resolution in March 2006, to speak with one voice in the IMF.

But contrary to the supranational level, most EU members, including Germany, regard a single seat in the IMF as premature. A stronger delegation of authority to the European level would be necessary: the council, the commission and parliament would have to be more deeply involved in the decision-making process, and far-reaching changes to the EU Treaty would be necessary. At present this is not politically viable — despite the financial crisis. There is still little appetite in Europe for a common foreign financial policy. As German national bank president Axel Weber stated, “We believe a common EU external representation at the IMF is premature. For this, Europe should be much more strongly politically integrated” (Beunderman 2006).

Although many experts argue that the negotiating power of Europe, whether through the EU or the EMU, would grow with a single seat, Germany fears a loss of power. Not entirely unwarranted, it believes that consensus building would prove almost impossible within a collective representation due to diverging interests. The consequence would be a dilution of the EU voice rather than a strengthening. In addition, the EU would ultimately have to agree on the reduction of its own voting rights as other IMF members would hardly accept an EU power block in its current size. Steinbrück correspondingly underlined that as the world’s third largest economy after the U.S. and Japan, Germany needed to keep its influence in the IMF (“Germany Opposes Single Voice for Euro Countries at IMF” 2006).

With regard to the IMF’s functions, Steinbrück (2007) stated that surveillance was its key task. Renewing the foundation of bilateral surveillance and strengthening its implementation was a key objective of the IMF, according to the minister. This opinion is shared by other EU members such as the United Kingdom and France. Highlighted in this context is specifically the need to analyze the implications of financial market turbulences on the real economy. An important step in this direction would be the deeper integration of the financial sector assessment program, an instrument created in 1999 to identify risks and vulnerabilities in the financial sector of member countries, into the Article IV consultations. Furthermore, the German government generally views credit conditionality as an important instrument for implementing IMF reform recommendations. While it has been, without doubt, important to tailor programs to country realities, Germany believes that the IMF should continue to stick to its core policy guidelines: reducing imbalances in a country’s current account and reintroducing sound fiscal policies. Germany thus stresses the importance of the concept of uniformity of treatment contrary to more specified conditionality.

(Re-)Assuming Leadership?

Germany has long lobbied for more transparency within the international system. Most recently, as president of the G8 in 2007, it placed transparency of hedge funds at the top of the agenda of the G7 finance ministers in order to reduce potential systemic and operational risks, while at the same time promoting freedom of investment. As one of the world’s leading economic powers, Germany has a strong interest in a stable and well-functioning international financial system and has thus repeatedly played an important role in the reform of the international financial architecture, be it the IMF and the World

Merkel's personal representative (sherpa) for the G8 summit, emphasized likewise: The issue is integrating large, emerging markets, without letting anyone feel unwelcome in the international economic order, particularly China, India, Brazil, Mexico and South Africa. But Pfaffenbach stressed that Germany was not seeking to enlarge the G8 to a G9 or G13, or that the G20 is a prospective substitute for the G8. Accordingly, it offered no proposals for formalizing or politically strengthening the G20.

Without doubt, the G20 has the legitimacy the G8 lacks: Apart from the G8 members, it includes many members of the Organisation for Economic Co-operation and Development (OECD) and the Asia-Pacific Economic Co-operation (APEC) forum, as well as the big emerging economies. It accounts for more than 90% of global gross domestic product (GDP), 80% of global trade and two thirds of the world's population. However, many critics warn that a group as big as the G20 could hardly be expected to reach meaningful consensus or even agree on binding commitments. The November 2008 summit in Washington was indeed a positive sign that the G20 is capable of taking rapid action. It was the first time that the G20 heads of state and government came together, not just their finance ministers and central bank governors. But one should not forget that the financial summit of industrial and emerging economies delivered a rather broad and general closing statement with few concrete decisions. The operationalization of the summit declaration will come in the subsequent months. Whether the G20 will be able to forge compromises on concrete steps thus still remains to be seen.

Germany on the International Monetary Fund: Revitalizing the IMF

Germany has been a strong proponent of IMF reform. In the past years, the IMF has lost influence in the governance of the international financial system. Reform of both its structure and its functions is necessary to restore the IMF to its former position as a highly respected international institution. Aligning members' quotas and voting shares with their relative weight and role in the world economy has been the first step in a difficult reform process. Those quotas determine the voting power of IMF members as well as their responsibilities within the IMF system.

Germany was critical of some of the earlier reform steps of the IMF's so called Medium-Term Strategy, initiated by former managing director Rodrigo de Rato in 2005. After the ad hoc quota increase in 2006, Germany demanded that "the new quota formula should be as simple and transparent as possible. It should be based on verifiable and clear economic criteria to reflect the relative economic position of each member country in the world economy. In this respect, GDP and openness (both in trade and in financial terms) should play an important role in the new formula" (Steinbrück 2006). Germany was thus pleased when the IMF's Executive Board approved a comprehensive reform proposal end of March 2008 (Steinbrück 2008). In addition, Germany agreed to forego part of the quota increase it would have been eligible for according to the newly adopted quota formula — albeit still being one of the biggest IMF members.

Germany is less compromising when it comes to its seat on the Executive Board. Pressure on the Europeans to form a single seat for the countries of the EU, or at least of the European Monetary Union, in order to create space for developing countries has grown continuously. Institutions such as the European Commission and the European Central Bank (ECB) tend to support such proposals. The plan has the backing of both Jean-Claude Trichet, ECB president, and Jean-Claude Juncker, president of Luxembourg

2008). Steinbrück has proposed, among other things, a higher equity ratio for financial institutions as well as limiting the influence of ratings agencies and making executives personally more responsible for their company's investment decisions. Merkel wanted to abolish "blind spots" in international financial markets, including the hedge fund industry, which has so far been largely free from oversight. She also proposed greater control in the area of derivatives trading. A paper prepared for the chancellery by a group of six experts, headed by Ottmar Issing, the former chief economist of the European Central Bank, proposed the establishment of a world map of risk that would include all major financial institutions and financial products. The paper also proposed establishing an international credit register to record all transactions over a particular limit as well as new rules for credit-rating agencies. It also underlined the necessity for reform of the system for compensating bank executives as the current system has been oriented to short-term profits, leading many managers to take greater risks. Lastly, the paper reaffirmed Sarkozy's proposal to transform the IMF into the prime regulator of the global financial markets, strengthening its co-operation with the Bank for International Settlement and the Financial Stability Forum (Bundeskanzleramt 2008b).

With regard to the G20 summit, two issues merit particular attention: Germany's position on the G20 vis-á-vis the G8 and its position on the future of the IMF.

Germany on the G20: An Important Supplement to the G8

The G20 leaders summit has fuelled once again the debate about the limitations of the G8. Even if G8 countries still hold the world's top positions in economic terms, others are quickly catching up. "As the newly industrializing countries are not represented in the G7, the mandate of this group is restricted, especially in issues that concern developments of the international economic and financial system," the German Ministry of Finance acknowledges (Bundesfinanzministerium 2003). Global economic problems need global solutions. Without doubt, most global challenges in key economic areas such as global trade and investment rules, as well as climate change and energy, cannot be tackled without the co-operation of the big emerging economies. Under its G8 presidency in 2007, Germany therefore launched the Heiligendamm Process, a two-year process to open up dialogue between the member states of the G8 and the important emerging economies of Brazil, China, India, Mexico and South Africa — the so-called Outreach Five (O5) — on a more structured and long-term basis.

While the inclusion of the O5 into the G8 process is largely supported by the German government, the strengthening of the G20 at the expense of the G8 or the institutionalization of an L20 is met with scepticism among most German politicians. Steinbrück's 2006 call for a radical transformation of the G8 was not met with strong support, neither within his own party nor within his own ministry.[1] As host of the G8 in 2007, Germany (2007) said that "the German G8 Presidency aims to develop procedures that will generate a common understanding on the part of the G8 states and the major emerging economies in terms of how to tackle the major global challenges of our times. The objective is not to enlarge the G8 to make it a G13, but to build new cooperation with the emerging economies in the form of a topic-oriented dialogue." Bernd Pfaffenbach, secretary of state in the German Ministry of Economics and Labour and

[1] See *Frankfurter Allgemeine Zeitung*, November 20, 2006.

market, the property lender was on the verge of collapse in September (Csaba 2008). Early in October the government stitched together a state-led €35 billion rescue program not only to keep the company afloat but also to prevent a collapse of Germany's banking sector.

But in addition to the crisis in the banking sector, by then the turmoil in the financial markets had reached the country's real economy. Germany was on the brink of a recession. Instead of the previously forecasted 1.2% growth, the economy was expected to stagnate or even contract next year. German business confidence had plunged to its lowest level in more than five years, and consumer confidence was falling amid worries about a deep recession. It thus came as little surprise that the government changed its course. While Germany initially planned to help banks on a case-by-case basis, on October 17 parliament overwhelmingly approved a €500 billion sector-wide rescue package to restore confidence, thus creating Soffin, a financial market stabilization fund.

Apart from short-term approaches, the German government is keen on a restructuring of the international financial architecture. Merkel has endorsed the British call for a new Bretton Woods conference and a fundamental review of global economic governance. The International Monetary Fund (IMF) should act as a global policing body for national financial regulators, the British prime minister Gordon Brown proposed: "Around us we must build a new Bretton Woods — a new financial architecture for the years ahead" (Naughton 2008). Brown continued that a focal point needed to be transparency, with an immediate adoption of internationally agreed accounting standards. He also underlined the need for enhanced global cooperation to monitor and supervise financial flows. German president and former IMF head Horst Koehler and French president Sarkozy both made similar demands. German finance minister Steinbrück likewise underlined: "I'm absolutely in agreement that we need more regulation in the financial markets" (Kirschbaum 2008). Merkel argued that "we must now together, as an international community, draw the right consequences. In my view, this includes strengthening the International Monetary Fund's role in the supervision of financial institutions" ("Germany Adopts" 2008). Merkel was thus not interested in a radical restructuring of oversight mechanisms. Moreover, she wanted to strengthen already existing institutions and instruments — still a very ambitious task.

European leaders, following an invitation from Sarkozy, met again in Brussels on November 6, to prepare for the upcoming G20 leaders' summit scheduled for November 14–15 in Washington. The 27 member states agreed on "common principles … to build a new international financial system," including adopting principles to ensure the convergence of accounting standards, to submit rating agencies to registration and surveillance, and to establish codes of conduct to avoid excessive risk taking in the financial sector ("EU Agrees Joint Line on Global Financial Reform." 2008). The EU wants to give the IMF the initial responsibility and resources for "recommending the measures to restore confidence and stability" (Council of the European Union 2008). The EU hopes that the G20 leaders summit would deliver real decisions swiftly. Measures agreed in Washington should be implemented within 100 days starting on November 15 — a tight schedule considering that this would leave U.S. president-elect Barack Obama hardly any time to formulate his own input.

After the EU summit in November, Merkel emphasized that more transparency is needed in the financial markets, as are stronger institutions that can act globally (Heller

Chapter 11
(Re-)Taking the Lead?
Germany and the Reform of the International Financial Architecture

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As recently as late in the summer of 2008, the German economy was regarded crisis-proof, with a stable banking sector and solid export performance. Insisting its banks were safe, the coalition government rejected the French proposal for a common European bailout fund along the lines of the United States plan. At the invitation of Nicolas Sarkozy, president of France, which held the presidency of the European Union, EU leaders met in Paris on October 4 to find a common response to the financial crisis.

But despite similar financial turmoil in their banking sectors, the EU's four biggest economies — Germany, Britain, France and Italy — could not agree on a common approach, let alone on Sarkozy's proposed €300 billion European banking fund. Arguing it could not trust how its money would be spend, Germany refused to give what Chancellor Angela Merkel called "a blank cheque to all banks" (Taylor 2008). It set up its own deposit guarantees without consulting its partners — a move harshly criticized by its European peers. On October 6, the government stepped in to avoid the collapse of Germany's second largest mortgage lender, Hypo Real Estate (HRE). In an attempt to prevent a subsequent run on banks, the government announced it would guarantee all personal bank deposits in the country. With regard to a concerted European rescue plan, the German government believed that "each must endeavor to solve the problem with the means and methods available to them" (Kole 2008). German finance minister Peer Steinbrück defended the government's original approach: "In some judgments we may have been wrong and our timing was perhaps not perfect, but you can only make a judgment based on the information you have at the time … And I maintain that the scope of this financial market crisis was not clear until deep into August or September" ("German Parliament Approves 500b Euro Financial Bailout" 2008).

Indeed, the picture has changed dramatically. IKB, the German bank that lends to small and medium-sized enterprises, together with several regional banks (*Landesbanken*) had diversified into risky international investments, in particular collateralized debt obligations that included subprime securities. The fallout from the credit crisis led German state-owned banks to write off more than €11 billion from their investments by spring. BayernLB, Germany's second largest state bank, revealed in March that the subprime crisis had costs the bank €4.3 billion. While the German government thought to have contained the problem by injecting capital into IKB, one of the first European banks to seek state aid, the company continued to struggle alongside the worsening financial crisis in the United States. The government had to step in again with a €9 billion rescue package, clearing the way for the bank's sale to Lone Star in August.

Another high-profile casualty of the global financial markets crisis was HRE. While it had claimed not to expect any negative effects from the crisis of the U.S. subprime loan