



New Hansa and Frugal Four: The Role of Small Creditor States in the Economic and Monetary Union

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Policy Recommendations

1. In order to pursue their interests in the Economic and Monetary Union, smaller creditor states can draw on a variety of strategies that include coalition-building, promoting technical arguments and using influential positions such as presidencies and chairs.
2. The use of small-state strategies requires collective responsibility as it can impede further integration and lead to suboptimal outcomes for all member states. In particular when efficient decision-making is required in times of crisis, gathering behind a Franco-German deal has proven advisable.
3. Conversely, Germany and France should include the preferences of smaller states more explicitly into their bilateral deals. This would also facilitate a speedy agreement on the corona recovery package.

Abstract

The debate on an EU recovery package to fight the corona crisis evokes patterns known from the eurozone crisis, where northern creditor states, among them Austria, were pitted against southern debtor states. Indeed, the frugal four (Austria, the Netherlands, Denmark and Sweden) have already announced opposition against generous spending plans based on grants. This raises questions about the role of smaller creditor states in the Economic and Monetary Union (EMU). Are they just free riders or do they pursue their own agenda? What strategies do they use to realize their preferences, and what does this mean for the corona crisis management? This policy brief argues that despite a common interest in national adjustment (instead of European risk-sharing), preferences on EMU reform diverge among eurozone creditor states. In pursuing their preferences, they make use of diplomatic strate-

gies such as building coalitions or exchanging technical arguments via personal channels. In particular, the emergence of the 'New Hanseatic League' represents an unprecedented phenomenon in EMU politics, which points to an emancipation of smaller creditor states vis-à-vis Germany and other powerful states. At the same time, smaller countries usually refrain from deploying hard bargaining strategies such as veto threats or brinkmanship. Moreover, the level of activeness varies considerably between single countries. In conclusion, the policy brief emphasizes that the use of small-state strategies in EMU should be carefully considered. While a more assertive group of smaller creditor states may increase the input legitimacy of EMU, it is likely to impede future reform. Even where Germany finds a compromise with France, smaller creditor countries may set out to counter-balance an emerging deal.



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Introduction

EU leaders are currently bargaining over the European Commission's €750bn spending plan ('Next Generation EU') to fight the consequences of the corona pandemic. Much of the controversy reminds of the eurozone crisis, where 'creditor states' in the north, among them Austria and the Netherlands, were pitted against southern 'debtor states'. However, while in eurozone crisis management the creditor states were largely represented by Germany, which advocated their common interests in bilateral negotiations with France, this time the Franco-German tandem presented a joint plan that provoked the opposition of the 'frugal four' (Austria, the Netherlands, Denmark and Sweden). With regard to the present Commission proposal, the four countries also expressed scepticism and emphasized that 'Rescue funds will have to be paid back'¹. The frugal four are not the first coalition of smaller creditor states. In the last years, the so-called 'New Hanseatic League' has already promoted fiscally conservative positions with regard to the reform of the Economic and Monetary Union (EMU). This raises questions about the actual role of smaller creditor states in EMU. Are they just free riders in the shadow of Germany or do they pursue their own agenda? What strategies do they use to realize their preferences, and what does this mean for the current corona crisis management?

In order to provide an answer to these questions, this policy brief relies on the findings of a research project (2018-20) that was funded by the Austrian Central Bank's (Oesterreichische National-

bank, OeNB) Anniversary Fund² and conducted at the Centre for European Integration Research (EIF), under the lead of its head Gerda Falkner, at the University of Vienna.³ Among other sources, the project draws on a rich body of 31 elite interviews with high-ranking officials working in the relevant ministries in eurozone member states, EU institutions and Permanent Representations in Brussels.

Smaller Creditor States in EMU: Preferences and Strategies

The eurozone crisis has exposed a deep cleavage dividing EMU into a camp of 'debtor states' in the south of the eurozone, and a camp of mostly northern 'creditor states'. Creditor states, such as Germany, Austria, the Netherlands, Finland and the Baltics, usually have sound fiscal position and run a current account surplus. Therefore, they prefer national adjustment ('austerity') and structural reforms, whereas their southern counterparts advocate European risk-sharing and capacity-building ('solidarity'). However, a closer look at recent issues of EMU governance and reform reveals that the preferences of eurozone creditor states are less homogeneous than usually portrayed.

Diverging preferences

The most salient example of preference divergence among eurozone creditor states was the controversy over a eurozone budget, where the positions of Germany diverged from those of smaller creditor states. When in June 2018 Germany and France proposed in the so-called 'Meseberg

1) <https://www.ft.com/content/7c47fa9d-6d54-4bde-a1da-2c407a52e471?emailId=5ee9a70ddfb6ef0004d5eed&segmentId=488e9a50-190e-700c-cc1c-6a339da99cab> last accessed 2020-06-17.

2) 'Free Riders, Allies or Veto Players? The Role of Small Creditor States in the Euro Area' (project number 17643).

3) https://eif.univie.ac.at/projects/small_states.php last accessed 2020-06-16.



Declaration⁴ to establish a eurozone budget, the Netherlands, Austria and other small creditor states announced opposition. One year later, eurozone finance ministers agreed on a 'Budgetary Instrument for Convergence and Competitiveness' (BICC).⁵ However, instead of consenting to a genuine eurozone budget, smaller creditor states led by the Dutch succeeded in realizing their own preferences for a conditional reform delivery tool built into the general EU budget, thereby blocking virtually all risk-sharing features of the proposed budget.⁶ The negotiations exposed diverging preferences even among smaller creditor states. Slovakia was in favour of a genuine eurozone budget and Estonia would have agreed to a stabilization function if integrated in the EU budget, whereas the Netherlands and Austria were clearly against any distributional budget. Moreover, when the Netherlands argued that 85% of the funds should flow back to the member states providing them, Finland was against such a floor.⁷ Finally, the idea of a BICC was silently dropped in the context of the corona recovery measures proposed by the European Commission.

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A similar preference constellation has emerged in the case of the European Deposit Insurance System (EDIS). Estonia would support even the original

Commission proposal⁸, and also Austria has cautiously endorsed the idea, provided certain conditions are met, and advanced the debate under its EU Presidency in 2018. The Netherlands are more sceptical, but would be ready to go ahead under strict conditions such as a reduction of government exposure to banks and an asset quality review. Germany, by contrast, has blocked EDIS from the outset and has remained the main veto player despite a more accommodating position expressed by Federal Finance Minister Olaf Scholz in November 2019.⁹

A further example of preference divergence within the camp of creditor states regards the regulatory treatment of sovereign exposures. The Netherlands strongly advocate regulation aimed at reducing the concentration of sovereign debt in national banks, while Austria is clearly against such regulatory disincentives.

In the case of the revised European Stability Mechanism (ESM), the Netherlands preferred the inclusion of the International Monetary Fund (IMF) in the assistance programmes, which was opposed by Finland. Moreover, the Netherlands disapproved the introduction of a precautionary credit line, which was advocated by Germany. In addition, the 85% majority voting rule for emergency decisions, which leaves a veto to Germany but not to smaller states, created a divide in the camp of creditor states.

“In summary, the preferences of EMU creditor states are more heterogeneous than meets the eye.”

With regard to the completion of the Banking Union, finally, the camp of creditor states is divided into so-called 'home countries', where large multinational banks reside (e.g. Austria or the Netherlands), and 'host countries', where the subsidiaries

4) <https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806> last accessed 2020-04-06.

5) <https://www.consilium.europa.eu/de/press/press-releases/2019/06/14/term-sheet-on-the-budgetary-instrument-for-convergence-and-competitiveness/> last accessed 2020-04-06.

6) <https://www.consilium.europa.eu/de/press/press-releases/2019/10/10/term-sheet-on-the-budgetary-instrument-for-convergence-and-competitiveness-bicc/> last accessed 2020-07-08.

7) The final compromise provided for a 70% floor for at least 80% of the funds.

8) <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015PC0586> last accessed 2020-05-22.

9) <https://www.ft.com/content/82624c98-ff14-11e9-a530-16c6c29e70ca> last accessed 2020-05-22.



of these banks are located (e.g. Estonia or Slovakia). While the subsidiaries are often systemically important for the host countries, they may only be of marginal importance for the home country. The conflict line between home and host countries therefore revolves around the question of who will bear the risks if a multinational bank goes bankrupt and the shock spreads to the subsidiaries.

In summary, the preferences of EMU creditor states are more heterogeneous than meets the eye.

Small-State Strategies, the New Hanseatic League, and varying activeness

In order to realize their preferences, smaller creditor states can draw on a variety of diplomatic strategies. The most important of these small-state strategies is to build or join coalitions. In the realm of EMU, we could observe the emergence of the 'New Hanseatic League' by the end of 2017 as a group of eight smaller EU countries: the Netherlands, Denmark, Sweden, Finland, Ireland, Estonia, Latvia and Lithuania. The Irish first called for a meeting of like-minded states on the side-lines of a Eurogroup meeting. In this context, Dutch Finance Minister Wopke Hoekstra saw the chance of forming a coalition to counter-balance proposals for more risk-sharing in EMU, thereby building on the pre-existing 'NB6' cooperation among the three Scandinavian and the Baltic states. Thus, the Netherlands coordinated the first position paper of the New Hansa, which promoted fiscal prudence and risk-reduction at the national level.¹⁰ Further activities of the New Hansa include opposition to Franco-German plans for a Eurozone Budget, a position paper supporting

Capital Markets Union (CMU)¹¹ and a paper demanding a reinforced role for the ESM in monitoring conditionality agreements¹². Occasionally, the New Hansa has been joined by other small states such as the Czech Republic and Slovakia. The finance ministers of the New Hansa states have usually met for dinner every two months around the Economic and Financial Affairs Council (ECOFIN) or Eurogroup meetings, and there have been monthly meetings at Financial Counsellor level in Brussels.

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A coalition like the New Hansa is unprecedented in eurozone politics. On the one hand, this regards the public visibility of the New Hansa, which pro-actively publicizes its joint papers instead of working behind the closed doors of Committees and Eurogroup meetings. On the other hand, the group's novelty lies in its potential to disrupt conventional practices in the EMU decision-making process. Whereas in former times, smaller states usually waited for Germany and France to strike a compromise that was acceptable to everyone, the New Hansa countries made their voices heard early on and thus opened another front.

The emergence of the New Hansa must be seen against the background of Brexit and a possible Franco-German compromise in favour of more risk-sharing in the eurozone. With Brexit smaller liberal states such as the Netherlands lost an important ally. The result is a (perceived) shift of power towards Germany and France. At the same time, domestic changes in Germany since 2017, the EU's 'polycry-

10) <https://vm.fi/documents/10623/6305483/Position+EMU+Denmark+Estonia+Finland+Ireland+Latvia+Lithuania+the+Netherlands+and+Sweden.pdf/99e70c41-6348-4c06-8ff8-ed2965d16700/Position+EMU+Denmark+Estonia+Finland+Ireland+Latvia+Lithuania+the+Netherlands+and+Sweden.pdf.pdf> last accessed 2019-04-01.

11) <https://www.government.se/statements/2018/07/shared-views-of-the-finance-ministers-from-denmark-estonia-finland-ireland-latvia-lithuania-sweden-and-the-netherlands-about-capital-markets-union/> last accessed 2020-07-08.

12) <https://www.government.se/statements/2018/11/shared-views-of-the-finance-ministers-from-the-czech-republic-denmark-estonia-finland-ireland-latvia-lithuania-the-netherlands-sweden-and-slovakia-on-the-esm-reform/> last accessed 2020-07-08.



sis', and global developments (such as the retreat of the United States as a reliable partner for Europe) make German concessions towards France more likely. In the case of EMU, such concessions would arguably be to the (short-term) disadvantage of creditor countries as they would increase risk-sharing at the European level.

“The emergence of the New Hansa must be seen against the background of Brexit and a possible Franco-German compromise in favour of more risk-sharing in the eurozone.”

Another important small-state strategy is to use personal relationships between government representatives to share ideas at their Brussels meetings or mutual bilateral visits. Such an exchange takes place at different levels from civil servants through to ministers. The arguments concern either technical issues or normative ideas, but in both cases they serve to promote the own position. In addition, smaller states may seek to exert influence through national representatives in the position of presidencies or chairs. In particular, positions at the higher political level, such as the President of the Eurogroup, can be used to influence decisions by emphasizing certain issues and neglecting others. However, while this strategy works well for middle-sized states such as the Netherlands, very small states often lack expertise and human resources to make strategic use of influential positions.

Arguably for the same reason, smaller creditor states rarely set the agenda. Only the Netherlands have sometimes acted as a successful agenda-setter in recent EMU governance and reform. Among the more recent proposals for EMU reform, the Netherlands advocated single-limb collective action clauses (CACs)¹³ and a public debt-sustainability

analysis for the revised ESM treaty. In the context of its 2018 EU Presidency, also Austria put some EMU issues on the agenda, which, however, have not materialized so far. These proposals include a 'hybrid model'¹⁴ of EDIS and a harmonized European insolvency law as a condition for the Capital Markets Union (CMU). Hence, if smaller eurozone states set the agenda, they do so by making detailed technical proposals rather than promoting big political visions.

At the same time, smaller creditor states usually refrain from deploying hard bargaining strategies such as veto threats or brinkmanship. Smaller member states are well aware that they need other member states in future decisions or different policies and therefore search for constructive solutions or even accept second-best outcomes. One notable exception are the Netherlands, which, for example, made it clear that they would veto any stabilization instrument outside the EU budget. This veto threat is in line with the more recent perception of the Netherlands as the most 'hawkish' member state in EMU governance.

“A coalition such as the New Hanseatic League constitutes a 'win-win situation' for smaller member states.”

Finally, the activeness of smaller creditor states varies considerably. On the one side of the continuum, we find the Netherlands as the most active creditor state, followed by Finland and, depending on the issue at stake, sometimes Austria. On the other side, we find very small countries that lack the bureaucratic resources to engage actively in EMU decision-making, such as the Baltics or Slovenia. As an official of a Baltic country stated: 'There are not more than half of the questions where we actually define the national interest. We rather follow the general thinking'. As a consequence, very small eurozone countries often have no other choice than to free-ride on the diplomatic efforts of other countries. A coalition such as the New Hanseatic League

13) For a short introduction, see <https://www.esm.europa.eu/content/revised-esm-treaty-envisages-introduction-single-limb-collective-action-clauses-cacs-what> and <https://www.esm.europa.eu/content/revised-esm-treaty-envisages-introduction-single-limb-collective-action-clauses-cacs-what> last accessed 2020-07-08.

14) For details, see <http://data.consilium.europa.eu/doc/document/ST-14452-2018-INIT/en/pdf> last accessed 2020-07-08.



therefore constitutes a 'win-win situation' for smaller member states. Single states such as the Netherlands can strengthen their own position by gathering smaller states behind them, while the smallest states can free-ride on the efforts of the coalition leaders even if these do not represent their preferences in each single aspect.

Conclusions and Policy Recommendations

In the aftermath of the eurozone crisis, the preferences of smaller creditor states have become more differentiated. In order to pursue their interests, these states can rely on a variety of small-state strategies including coalition-building, promoting technical arguments via personal channels and making use of influential positions such as presidencies and chairs. As the smallest eurozone states often lack the resources to apply such strategies, they can join policy-specific coalitions such as the 'New Hanseatic League'. Indeed, whereas in times of eurozone crisis management, smaller creditor states saw their preferences represented by Germany and thus subordinated their short-term preferences to a Franco-German compromise for the sake of maintaining the single currency, they now seem more ready to open a 'new front' whenever they do not see their preferences sufficiently taken into account.

“Paradoxically, the corona crisis can therefore be a chance for correcting some of the eurozone ‘design failures’ despite diverging interests in the camp of creditor states.”

However, while a more assertive group of smaller creditor states may increase the input legitimacy of EMU governance, it is likely to result in a dilemma for future reform steps. Even if Germany makes the necessary concessions to France in order to find a viable compromise, the more hawkish creditor countries may now set out to counter-balance an emerging deal. This was the case with the prevention of a genuine eurozone budget, for example. A similar pattern can be observed in the case of the 'frugal four', which announced opposition against

a Franco-German recovery plan in the corona crisis. At the same time, a reignited crisis increases the need for efficient decision-making: as the eurozone crisis has shown, economic shocks that endanger the entire monetary union may lead to a rapid regrouping of smaller member states behind a Franco-German compromise. Paradoxically, the corona crisis can therefore be a chance for correcting some of the eurozone 'design failures'¹⁵ despite diverging interests in the camp of creditor states.

This implies that the use of small-state strategies in EMU requires a degree of collective responsibility that only the large countries would otherwise have. The active pursuit of particular interests may impede necessary reform steps and thus lead to suboptimal outcomes for all member states. Hence, the use of the strategies described in this policy brief should be carefully considered. This applies all the more since the small export-oriented countries in the north of the eurozone have so far greatly benefited from an EMU that is based on Franco-German deals. Conversely, Germany and France should include the preferences of smaller states more explicitly into their bilateral compromises. With a view to the negotiations of a corona recovery package, finally, an agreement based on loans rather than grants, as demanded by the 'frugal four', may do little to find a sustainable solution to the design failures of EMU and the resulting debt and legitimacy problems. In terms of process, however, a viable solution is most likely to emerge if it is based on a revised Franco-German compromise that makes explicit how the preferences of the 'frugal four' and other smaller states have been taken on board.

15) See De Grauwe, P., & Ji, Y. (2015): Correcting for the Eurozone Design Failures: The Role of the ECB. *Journal of European Integration*, 37(7), 739-754; Jabko, N. (2015): The Elusive Economic Governance and the Forgotten Fiscal Union. In M. Matthijs & M. Blyth (Eds.), *The Future of the Euro* (pp. 70-89). Oxford University Press.



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Economic and Monetary Union, eurozone reform, creditor states, small-state strategies, New Hanseatic League, Frugal Four

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