

The political economy of the euro area's sovereign debt crisis

Introduction to the special issue of the *Review of International Political Economy*

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Abstract

This special issue has two main aims: to examine the contribution of political economy analyses of the sovereign debt crisis and to relate these findings to longstanding debates in the sub-disciplines of comparative political economy, international political economy and European economic governance. This introduction begins by reviewing the comparative political economy literature on national financial systems in order to account for the playing out of the crisis. It then examines the international political economy literature on the International Monetary Fund (IMF) and financial (sovereign debt) markets that played such a key role in the unfolding of the sovereign debt crisis. Finally, it outlines longstanding academic debates on the main 'asymmetries'; in European economic governance, and provides a critical overview of the three main policy and institutional reforms adopted by European Union governments in response to the crisis.

Introduction

The international financial crisis that reached its peak in late 2008 resulted in a fully-fledged economic crisis across much of the European Union (EU) and a sovereign debt crisis in the euro area's periphery. In turn, the sovereign debt crisis risked creating a new banking crisis, threatening the very existence of the euro and menacing the global economy. These developments have prompted an unprecedented degree of policy intervention at the national, EU and international levels designed to prevent a potential domino effect of sovereign debt defaults.

The sovereign debt crisis has profound and far-reaching implications not only for the euro area and European integration but also the international economy and international economic cooperation. At the time of writing -- early 2015, with the election of a new left wing Greek government demanding debt cancellation -- the crisis is far from over. The crisis raises a range of issues that call for a specifically political economy analysis: the dangers of moral hazard in fiscal policy in a single currency area; the difficulties of international cooperation to avoid sovereign debt default and crisis management in the euro area; and the travails of institution-building

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to restore market confidence and stability. This special issue has two main aims: to examine the contribution of political economy analyses of the sovereign debt crisis and to relate these findings to longstanding debates in the sub-disciplines of comparative political economy, international political economy and European economic governance. The contributions to this special issue provide insights into the sovereign debt crisis that unfolded from 2010 -- when Greece's fiscal woes sent shock waves through international financial markets. The articles here also examine issues of concern to all political economists who seek to understand how governments and international bodies respond to economic crises.

This introduction is organised as follows. Section 1 briefly reviews the comparative political economy literature on national financial systems and financial nationalism in order to account for the playing out of, the reaction to, and the aftermath of the international financial crisis across the so-called EU- and / or euro area 'periphery' (Southern, Central and Eastern Europe and Ireland). Section 2 examines the international political economy literature on the International Monetary Fund (IMF) and financial (sovereign debt) markets that played such a key role in the unfolding of the sovereign debt crisis. Section 3 outlines longstanding academic debates in European economic governance, pointing out the asymmetric nature of Economic and Monetary Union (EMU) and the impact of two main asymmetries. Section 4 provides a critical overview of the three main policy and institutional reforms adopted by European Union governments in response to the crisis -- notably, the reinforcement of EU fiscal policy, the creation of support mechanisms for the purchase of sovereign debt and Banking Union which is designed to help stabilise euro periphery banking systems and break the sovereign debt-doom loop. The three reform measures have also been adopted to address the perceived inadequacies of EMU. The objective of this fourth section is to provide background to readers to enable them to better situate the analyses developed in the papers of this special issue. Given limited space, some important issues arising from the sovereign debt crisis are not examined, notably the role of central banks -- here principally the European Central Bank (ECB) -- in tackling the crisis.

1. The comparative political economy of the international financial crisis: national financial systems and financial nationalism

The international financial crisis of 2007-9 directly contributed to the sovereign debt crisis in some European countries, notably Spain and Ireland, where governments with low debt loads moved to recapitalise ailing banks, resulting in a rapidly deteriorating state of public finances. The international crisis also hit Central and Eastern European countries, mainly through the activities of foreign-owned banks which in many cases cut credit provision. In order to understand why and how the crisis played out unevenly across the EU (and the EU periphery in particular) three of the articles in this special issue -- those by Quaglia and Royo (2015); Johnson and Barnes (2015); and Mabbett and Schelkle (2015) -- make reference and contribute to the literature on national financial systems, paying particular attention to bank business models and the activities of foreign owned banks.

Until recently, the comparative political economy work of reference on national financial systems was Zysman's *Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change* (1983), which distinguished between

credit-based and capital market-based financial systems (see also Allen and Gale 2000; Deeg 1999; Deeg 2010). In bank-based financial systems, banks performed the function of financial intermediation between household-savers and firms, providing funding to the real economy. In the capital market-based financial systems, markets were the main source of (rather volatile) credit to the real economy.

Yet, national financial systems have undergone significant changes over the past two decades or so. Hardie and Howarth (2013, see also Hardie *et al.* 2013) developed the concept of ‘market-based banking’ by focusing on banks’ business models, highlighting the fact that over the last decade large European banks have funded themselves, to varying degrees, in the wholesale market (market-based liabilities) and have invested, to varying degrees, in non-traditional banking activities (market-based assets). Consequently, they identify a spectrum of market-based banking on which can be positioned banking systems with more or less market based assets and liabilities. This spectrum can be used to explain the differential impact of the international financial crisis across developed countries because those most affected by the crisis had banks with significant market-based assets and / or liabilities (Hardie and Howarth 2013). Countries, such as Italy and Spain, where banking was moderately market based, coped relatively well with the initial stage of the international financial crisis -- although the collapse of securitisation markets hit Spanish bank lending given significant bank funding on wholesale markets. Hence they confirm the market-based banking thesis on the crisis.

Within two years of the autumn 2008 peak of the international crisis, Spanish saving banks faced major financial difficulties and required government financial support -- a somewhat puzzling development. In this special issue, Quaglia and Royo (2015) contribute to the flourishing literature on national financial systems by engaging in a ‘bank-based’ analysis not only of the banking crisis, but also of the balance of payments crisis, which conflated into the sovereign debt crisis in the euro area periphery. They identify the distinctive features of bank business models and national banking systems that explain the different sovereign debt crisis scenarios in Italy and Spain.

Most of the ‘old’ literature on national financial systems (for example, Zysman 1983; and in financial economics, Allen and Gale 2000) as well as the ‘new’ literature (Hardie and Howarth 2013) do not investigate national financial systems in either Southern Europe or Central and Eastern Europe (on varieties on capitalism in Central and Eastern Europe, see Bohle and Greskovits 2012). One of the main distinctive features of Central and Eastern European banking systems is the predominance of foreign-owned institutions -- rising to over 90 per cent of total bank assets held by foreign banks in Estonia, Slovakia and the Czech Republic. Banks’ foreign ownership presented some specific challenges for these countries during the international financial crisis (see Epstein 2014; Spendzharova 2014). First, as in the case of Hungary, foreign banks encouraged domestic loans in foreign currency, which became a major problem when market liquidity evaporated at the peak of the international financial crisis and the national currency devalued. Second, there was a risk that home supervisors would impose regulatory requirements designed to reduce (foreign) bank exposures of their branches and subsidiaries in Central and Eastern Europe (Gabor and Kudrna 2013). Third, home banks in some ‘old’ EU member states were heavily exposed, for example Swedish banks in the Baltics.

In this special issue, Mabbett and Schelkle (2015) compare the unfolding of the crisis in Greece, Hungary and Latvia, noting that the EU was unable to stop the flight of foreign banks out of Greece because of the refusal to intervene by the home country governments of the banks that had invested in Greece. Unlike Swedish banks in the Baltics, which were too exposed to ‘cut and run’ (Epstein 2014), in Greece ‘German banks were not exposed enough: in European banking, Germany is not a hegemonic power, but rather one player among several of similar size’ (Mabbett and Schelkle 2015).

The foreign ownership of large parts of the banking sector also posed the potential risk of national(istic) backlash against foreign banks. Indeed, in Hungary, the Orbán government imposed a temporary ‘crisis tax’ on large businesses, including the many foreign owned banks. In such a context, particularly relevant is the concept of ‘financial nationalism’, defined as the strategy that uses financial policies, including monetary and exchange rate policies, financial regulation and supervision to promote domestic economic and political goals (Johnson and Barnes 2015).² In this special issue, Johnson and Barnes (2015) explain how and why financial nationalism emerged in Hungary, despite (or partly because of) the economic and political pressures exerted by the IMF and EU. As a response, the Orbán government repeatedly defied the IMF and EU, undermined the independence of Hungary’s central bank, and challenged the role of foreign banks in Hungary. “‘Orbánomics’ aimed to achieve the orthodox goals of governmental deficit and debt reduction through unorthodox, anti-austerity financial nationalist policies’ (Johnson and Barnes 2015). Bond markets, which played such an important role in the crisis, as explained below, failed to impose ‘orthodox’ economic policies in Hungary.

2. The international political economy of the sovereign debt crisis: the IMF and financial markets

The international financial and sovereign debt crises mark a noteworthy shift in the role of the IMF. In the past, the IMF had provided financial assistance mainly to developing countries with relatively few exceptions -- most notably, the UK and Italy during the stagflation of the 1970s. During the international financial crisis of 2007-9, the IMF provided financial support to Hungary, Latvia and Romania. Subsequently, in response to the euro area sovereign debt crisis, the IMF provided about one third of the total financial assistance to Greece, Ireland, Portugal and Spain. The IMF also provided some financial assistance to Cyprus. What is particularly interesting is that the IMF not only imposed conditions and monitored loan provision and repayment; it was also involved by the EU in monitoring the conditions attached to European loans. From 2010, the Fund became part of the so-called ‘Troika’, together with the European Commission and the European Central Bank (ECB), which negotiated

² The theme of ‘economic patriotism’ was examined in a special issue of the *Journal of European Public Policy* (2012); see also Helleiner and Pickel (2005). Clift and Woll (2012: 308) define ‘economic patriotism as economic choices which seek to discriminate in favour of particular social groups, firms or sectors understood by the decision-makers as insiders because of their territorial status. Economic patriotism entails a form of economic partiality: a desire to shape market outcomes to privilege the position of certain actors.

programmes and closely monitored their implementation. How and why did the IMF become involved in European responses to the international financial crisis?

The international political economy literature on the IMF is extensive (for example, Broome 2012; Moschella 2010, 2011; Rogers 2012). With reference to the IMF and the EU prior to the crisis, only limited attention was paid to the influence (or the lack of it) of the EU and/or the euro area in the IMF (some of the few studies are McNamara and Meunier 2002; Bini Smaghi 2004). However, with the crisis there has followed greater academic interest in the role of the IMF in crisis management in Europe.

Adopting an openly Marxist approach, Rogers (2012) explains the joint EU-IMF lending programme during the crisis as a way for the EU to ‘repackage’ and ‘sell’ its preferences for fiscal austerity through the IMF. Hence, the EU turned to the IMF to lend credibility to, and deflect blame for, policies designed to shift the burden of economic adjustment from capital to labour. Unlike Rogers (2012), Lütz and Kranke (2013) find the IMF to have been less supportive than the EU of fiscal austerity. They argue that as a result of policy learning from past mistakes, the IMF had become sceptical of pro-cyclical austerity policies (on learning by the IMF, see also Moschella 2011). Moreover, the EU lacked both sufficient experience and funding (at least at the beginning of the crisis) to lend on a large scale, as explained in the following section. By contrast, the IMF had funding readily available and had a consolidated experience in relation to surveillance (Moschella 2010).

In this special issue, Hodson (2015) argues that during the crisis, the IMF emerged as a de facto ‘decision-making body of the EU’ because EU member states delegated monitoring powers to both the Fund and European Commission.³ By using a ‘multiple supervisors’ variation of the classic principal-agent approach, Hodson argues that EU member states lacked confidence in the Commission’s ability in crisis management and turned to the IMF ‘not for reasons of fiscal austerity or financial necessity but in search of more credible monitoring mechanisms’.

By contrast, Schwarzer (2015) uses the concepts of instrumental and social learning under severe external pressure and time constraints in order to explain the decision to involve the IMF in the response to the euro area sovereign debt crisis. In her article for this special issue, Schwarzer highlights learning in three areas: in the field of lending and program implementation, in the understanding of the nature of the crisis and in the evolving acknowledgement of the incompleteness of the euro area’s governance framework.

Financial (to be precise sovereign debt) markets played an important role in the unfolding of the sovereign debt crisis: some commentators pointed out the inability of market dealers to distinguish between ‘good’ and ‘bad’ sovereign debt prior to the crisis, as well as the overreaction of the financial markets once the crisis started. In order to explain the behaviour of financial markets before and during the crisis it is

³ For a study of the functioning of the combined IMF-euro area lending programmes see Pisani-Ferry, Sapir and Wolf (2013).

useful to make reference to the international political economy literature that gained prominence over the last decade not only because of EMU, but also because of international financial developments, such as capital liberalisation, financialisation and complex financial instruments (Rommerskirchen 2016). Two main views on the ability of bond markets to impose fiscal discipline have been articulated in the literature (Malkiel 2003, Heinemann and Winschel 2001), to which the article by Chang and Leblond (2015) in this special issue contributes.

According to the market discipline hypothesis, financial markets exert disciplining effects on national fiscal policies through the yields (interest rates) that they require to finance government debt (e.g. Afonso and Strauch 2004; Bernard and Leblang 2006; Bernoth and Wolff 2008; de Haan and Sturm 2000). If bond-market investors question government policies and capital flows out of the country, the national government does not have the funds available to support its policies, regardless of domestic support. Thus, in the euro area, prior to the sovereign debt crisis, there should have been different ‘pricing’ of national government bonds, with higher financing costs imposed on member states with less sound fundamentals. Some authors, for example, Rommerskirchen (2016), argue that this is in fact what happened between 1996 and 2012. Other scholars have also observed that investors priced credit (or default) risk in the yields they demanded for financing the sovereign debt of euro area member states (Bernoth and Erdogan 2012; Bernoth *et al.* 2012).

A now widespread argument is that market discipline was insufficient prior to the crisis and, if anything, EMU weakened it (see, for example, De Grauwe and Ji 2013, 2012). The single currency eliminated the currency risk for euro area members; while inflation risk was also substantially reduced because of the stability mandate and independence of the ECB. Only default risk remained; yet financial markets paid less attention to it because they were not fully convinced of the credibility of the no-bail-out rule inserted in the Maastricht Treaty. The spread on interest rates paid on public debt converged to a large extent in the run up to the final stage of EMU. Afterwards, some spread differentials remained between German bunds and bonds of euro area periphery countries, but bond yields did not fully reflect the different national economic fundamentals (for an overview of fiscal policy in EMU prior to the crisis, see Hallerberg *et al.* 2009). Why did investors not discriminate in their pricing of euro area sovereign bonds before the crisis? Why did market sentiments change rather abruptly in late 2009 and early 2010?

Some scholars working on the political economy of currency crises and debt crises argue that in order to understand the divergence between a country’s economic fundamentals and the pricing of its currency or sovereign debt, it is necessary to take into account political as well as economic factors during crises periods (Bernhard and Leblang 2006; Leblang and Satyanath 2006). Building on and contributing to this literature, Chang and Leblond (2015) argue that macroeconomic indicators, such as the levels of debt and deficit provide only a partial explanation for differences in bond yields. For example, certain countries with high debt levels, like Belgium, did not suffer from market speculation to the same extent as the euro periphery countries. With regard to Greece, Ireland, Portugal, Spain and Italy, investors were concerned that these countries might eventually leave the euro area (and possibly the EU) and reintroduce their own national currencies. This move would be accompanied by currency devaluations and, potentially, debt defaults in those countries. The delayed

and piecemeal response of the EU to the sovereign debt crisis led financial markets to question whether the EU had the will and capability to do whatever it took to save the euro.⁴

Outside the euro area, the case of Hungary challenged the market discipline hypothesis. In his study of emerging markets, Iain Hardie (2011) argues that countries (like Hungary) with relatively highly financialised government bond markets would be charged higher interest rates in a crisis situation because international investors were less forbearing of unorthodox policies (see also Mosley 2004). Nonetheless, despite criticisms from the IMF and the main rating agencies, the threatened punishment from bond markets never fully materialised in the Hungarian case. During its time in office, the Orbán government held dozens of successful bond auctions, although some of them were occasionally cancelled due to insufficient participation by foreign investors. The spreads between Hungarian government bonds and Greek, Portuguese and Irish bonds were negative (Johnson and Barnes 2015).

3. European economic governance and the political economy of Economic and Monetary Union and the sovereign debt crisis

Last but not least, the third body of literature that is relevant for this special issue concerns European economic governance and the political economy of EMU, to which several of the articles contribute. Three ‘original sins’ of EMU deserve attention: the asymmetry created through a full monetary union without a full economic (fiscal) union; the asymmetry created through monetary integration without financial (especially banking) supervision which mostly remained at the national level; and the lack of a (benevolent) hegemon in the euro area.

When EMU was agreed in 1992, and even more when the third and final stage of EMU began, several authors pointed out the asymmetric nature of EMU, whereby monetary union was not coupled by a full economic (fiscal) union (Dyson 2000, Verdun 1996). During the negotiations leading to the Maastricht Treaty (Dyson and Featherstone 1999), when the blueprint for EMU was agreed, some member states, first and foremost Germany, opposed fiscal (or transfer) union for political and economic reasons. Politically, it was seen as a step too far, impinging upon a core area of national sovereignty. Economically, member states with sound fiscal positions, led by Germany, were concerned by the potential moral hazard that a fiscal union would bring about, and that they would end up financing countries that lacked sufficient fiscal discipline (for an overview of this debate, see Dyson and Quaglia 2010).

Many economists recognised that EMU was not an optimum currency area (OCA) (the theory of OCA was formulated by Mundell 1961 and McKinnon 1963) and therefore a sort of federal budget was required for stabilisation purposes. These economists argued that in EMU the exchange rate as instrument of adjustment was no

⁴ This refers to a famous sentence used by ECB president Mario Draghi on 26 July 2012 to describe the ECB’s new programme of ‘Outright Monetary Transactions’ -- amounting to the potentially unlimited purchase of sovereign debt on secondary and primary markets -- designed to bring down euro periphery government bond yields.

longer available but different developments in prices and productivity remained.⁵ Political economists, such as Hall (2012) and Scharpf (2013), argued that Southern European economies needed (somewhat inflationary) fiscal stimuli and lacked the institutions to restrain wage increases in line with productivity growth. Hence, Southern European countries needed exchange rate adjustments vis-à-vis the more competitive core economies, first and foremost Germany. In the absence of devaluation, over time, eventually some form of fiscal transfer would be needed to keep these economies afloat.

Yet, the dangers related to the building up of macroeconomic imbalances due to different national competitiveness (Frankel and Rose 1997) and the possibility of asymmetric shocks (Bayoumi and Eichengreen 1992) were left unaddressed. Partly, this oversight owes to the fiscal concerns noted above. Partly, the dangers created by imbalances were downplayed because there was excessive confidence in the disciplining action of financial markets (see Section 2), whereas markets contributed to the imbalances that led to the crisis. Indeed, the Maastricht Treaty limited the use of balance of payments loans that had been set up to deal with the balance of payments crises in the 1970s to non-euro area member states because balance of payments problems were no longer expected to occur in EMU (Mabbett and Schelkle 2015; see Section 4). For this reason, Greece, which joined the single currency in 2001, was not eligible for the emergency financing offered to Hungary, Latvia and Romania.

All the countries hit by the sovereign debt crisis had suffered major macroeconomic imbalances since joining EMU: the sovereign debt crisis was first and foremost a balance of payments crisis (Gros 2012a). In EMU, macroeconomic imbalances had not faded away: they were automatically financed only in so far as capital flew from countries with current account surpluses to countries with current account deficits, mostly through the intermediation of the banking system. Once these capital flows came to a halt (and, even worst, reversed) and the banking system in the EMU became balkanised, a de facto balance of payments crisis erupted.

The second asymmetry brought into relief by the crisis was the imbalance that existed between a single monetary policy -- conducted by the ECB for the euro area -- and financial supervision and crisis management, conducted almost entirely by individual member states. In the negotiations on EMU, member states discussed but could not agree upon whether the ECB should be assigned supervisory responsibilities (Dyson and Featherstone 1998). These intergovernmental discussions tied into a broader debate in the economic literature on whether or not the monetary policy function of a central bank should be separated from prudential supervision (see, for example, Goodhart 1995, 2000). There were also ongoing debates as to which authorities should be responsible for macro-stability (that is, the stability of the system) and crisis management, micro-stability (that is, the solvency of individual financial entities) and consumer protection -- matters of concern highlighted in several reports issued in the

⁵ A survey of the literature suggests that US academic economists were generally very sceptical of EMU, basing their arguments on OCA theory: see http://ec.europa.eu/economy_finance/publications/publication16345_en.pdf. The US economist Martin Feldstein (1997) went as far as to argue that EMU would increase ‘conflicts within Europe and between Europe and the United States’.

wake of the financial crisis, including the De Larosiere report (2009) and a Group of Thirty report (2009). The proposals on Banking Union, discussed below, were meant by many to address this second asymmetry.

The sovereign debt crisis also offers an opportunity to reflect on international and European monetary regimes and the role of hegemon therein. When the international monetary regime of Bretton Woods collapsed, Kindleberger (1973) argued that the international system needed a (benevolent) hegemon to provide the public good of stability, a role played in the past by the US. Eichengreen (1987) revisited Kindleberger's account and argued that cooperation, rather than hegemonic leadership, provided a better basis for stabilisation.

With regard to the EU / euro area, some commentators argued that Germany should take on the role of hegemon (Paterson 2011). Yet, Mabbett and Schelkle (2015) point out that Germany has been reluctant to assume the role of hegemon. This reluctance reflects the country's (limited) domestic capacities, domestic political constraints, as well as a long-standing concern for moral hazard. In the absence of a benevolent hegemon, David Marsh (2013) claims that the euro has become a currency for which no one is responsible. Indeed, the delayed and piecemeal response of the EU / euro area to the sovereign debt crisis highlighted both the lack of political leadership and the revival of national interests (Marsh 2013).

Finally, this special issue contributes to the literature on sovereign debt crises mainly by dispelling the 'myth' of the euro area sovereign debt crisis as, above all, a fiscal crisis -- apart from Greece and, potentially, Italy. For most euro periphery member states, the crisis was mainly a balance of payments crisis, due to the building up of persistent macroeconomic imbalances from the launch of the single currency in 1999. The creation of the Macro-economic Imbalances Procedure (MIP) in 2010 gave the European Commission only the bluntest of instruments to prod member states with large deficits or surpluses to modify their policies.⁶ For some countries, such as Ireland and Spain, the crisis also confirms the finding that a banking crisis often precedes a sovereign debt crisis (Reinhart and Rogoff 2009) and accompanies a balance of payments crisis (Kaminsky and Reinhart 1999). For other countries, such as Greece and potentially Italy, the sovereign debt crisis risked turning into a banking crisis because domestic banks held large amounts of depreciating government bonds (Quaglia and Pagoulatos 2013). If the sovereign debt crisis is not to be seen as principally a fiscal crisis, then it can be argued that the EU's response based on austerity policies and politics cannot be an effective solution. Austerity can actually worsen the crisis, with painful recessionary effects. (For a sustained criticism of austerity politics and policies, see Blyth 2013; for a somewhat different view see Bini Smaghi 2013.)

4. Completing EMU: reinforcing EU fiscal policy, creating support mechanisms and constructing Banking Union.

6

See http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_scoreboard/

Euro area member states have responded to the sovereign debt crisis by promoting three main policy and institutional reforms designed to tackle the two asymmetries of EMU discussed above. First, spearheaded by the German government, a range of reforms has been adopted to address the asymmetry between monetary and fiscal policies in EMU and, specifically, reinforce EU fiscal policy. Second, the Commission, the French and euro periphery member state governments sought keenly to create European support mechanisms designed to purchase government debt in order to bring down national bond yields and ensure sustainable government borrowing, and potentially rescue banks. Third, in their Banking Union proposals, euro area member state governments moved to adopt a range of measures designed to break the sovereign debt-bank doom loop. They agreed to supranationalise banking supervision and resolution and create a European fiscal backstop to support struggling banks that were deemed by the ECB (specifically, its Single Supervisory Board (SSB)) to be solvent. In the three sub-sections below we provide a critical overview of each set of policy and institutional reforms.

Fiscal policy reforms reflected the position that responsibility for resolving the sovereign debt crisis ultimately rested with the individual member states themselves and the achievement of sustainable fiscal policies. German governments were the leading proponents of this ‘own house in order’ approach which reflected longstanding German insistence upon necessary macroeconomic policy convergence (low inflation and low public sector debt loads) in order to ensure a stable EMU (Howarth and Rommerskirchen 2013). (For a recent and unequivocal defense of this position from a (former) senior German and ECB policymaker see Stark 2015.) The emphasis placed upon the reinforcement of fiscal policy rules and procedures is the direct descendent of the ‘economist’ position defended by Germany in the Werner Committee of the early 1970s that explored the possible move to EMU by 1980 (Tsoukalis 1977; Ludlow 1982).

In opposition to this emphasis on fiscal policy reinforcement, the French and euro periphery governments called for the creation and expansion of European support mechanisms which -- it was argued -- in addition to being a manifestation of much needed European solidarity, would help to calm financial markets. This position stemmed from longstanding views dating to the 1950s, that market integration and then monetary integration should be accompanied by support mechanisms that shared the burden of adjustment between surplus and deficit / strong currency and weak currency member states.

Banking Union was proposed in June 2012 to tackle the sovereign debt-bank doom loop that arose in the context of the sovereign debt crisis because of the flight of foreign investors from euro periphery member states. Banks headquartered in these countries came to hold an increasing amount of debt issued by their home government -- measured both as a percentage of total debt issued and as a percentage of total bank assets. The threat of default on this debt undermined confidence in the solvency of a number of euro periphery banks, including some that had escaped the crisis largely unscathed. Confidence in the solvency of euro periphery governments, already facing a heavy and rising debt burden, was further undermined at the prospect of further bank bail-outs. Yet German government reluctance, owing to a fear of moral hazard

created for both sovereigns and banks, undermined efforts to supranationalise banking supervision, fiscal support for banks and resolution funds.

Fiscal rules, market confidence and fiscal consolidation

The range of fiscal policy measures adopted at the EU level since 2010 – the Six Pack, the Two Pack and the Treaty on Stability, Coordination and Governance (TSCG, also known as the Fiscal Compact) – has given rise to claims of a significant reinforcement of fiscal policy constraint (Hughes Hallett and Jensen 2012) and even the rise of an 'Expenditure State' (Begg 2013). However, the impact of these measures upon actual fiscal consolidation remains to be seen and may be difficult to prove. There are good reasons to be sceptical of their efficacy. The measures correspond largely to previous agreements on fiscal policy at the EU level in the sense that they continue to allow member state governments considerable margin of manoeuvre. They provide at best a questionable reinforcement of pre-existing EU and national fiscal rules.

Clearly, EU rules alone are not enough: the impact of the EU's Stability and Growth Pact (SGP) both in its original (1996) and revised (2005) versions upon fiscal consolidation has been more widely challenged (see for example, Buti 2006; Hallerberg *et al.* 2007). While the Maastricht Treaty and SGP may have encouraged fiscal consolidation in the lead up to EMU entry, post-entry it is likely that EU-level rules had no effect on consolidation whatsoever. In 2011, Marneffe *et al.* concluded that the SGP (even in its post-2005 reformed version) provided no added value in terms of fiscal consolidation but that some domestic fiscal rules were more effective. They note that 'it could be considered that the domestic rules are a means to achieve a more prudent fiscal policy given the shortcomings of the pact' (p. 21).

There is a large literature on the impact of fiscal institutions (rules) on fiscal performance (see, for example, Poterba and von Hagen 1999; Nerlich and Reuter 2013; Bergman *et al.* 2013). Scholars have also questioned the efficacy of fiscal rules in the context of economic crisis. Poterba (1993: 5) argues that fiscal rules may have less 'impact on the way states respond to fiscal stress'. Empirical findings indicate that neither domestic nor EU-level fiscal rules had an impact on the fiscal policy responses in the aftermath of the international financial crisis that broke out in 2007 (see Rommerskirchen 2014). The impact of fiscal rules on sovereign bond yields is also the subject of debate in the literature (see for example, Iara and Wolff 2011; Kumar *et al.* 2009; Hatchondo *et al.* 2012; Manganelli *et al.* 2009).

From 2009, the adoption of new EU fiscal rules, including the TSCG and its transposition into national legislation, came at German insistence, with the debt rule of the Fiscal Compact a marginally more flexible version of the German variant, the *Schuldenbremse*. The German Grand Coalition (CDU-SPD) government revised the Basic Law in June 2009 to include new fiscal rules defining structural budget balance targets for both the federal and Land governments and monitored by an independent Stability Council. The Austrian and Slovakian governments were the only two EU member state governments to adopt unilaterally a similar debt brake and independent fiscal councils (the Austrian Internal Stability Pact and the Slovakian Fiscal Responsibility Act) thus closely emulating the *Schuldenbremse*.

The Italian government modified the constitution to introduce a balanced budget rule for central and subnational governments in the Italian Constitution (parliamentary adoption on 20 April 2012), while the Spanish government amended the constitution to impose a balanced budget rule to come into effect by 2020 and strict debt limits (parliamentary adoption 27 March 2012). Most of the other EU member state governments restricted national legislative changes to the transposition of new EU legislation (the Six Pack and the Two Pack) and to the national ratification of the intergovernmental Fiscal Compact which in some cases (for example, Slovenia) was combined with additional reforms to fiscal rules not specifically required by the TSCG.

The Six Pack and Two Pack were two packages of legislative measures (proposed respectively by the Commission in 2010 and 2011 and agreed by the Council in 2011 and 2013). They were designed ostensibly to reinforce the Commission's fiscal policy surveillance. While marginally more restrictive of national policy making (for example, the introduction of the European semester into national budgetary cycles involving earlier Commission intervention), most academic observers have queried the extent to which these measures restrict national fiscal policy margin of manoeuvre (see, for example, Marzinotto and Sapir 2012) and the extent to which a more hierarchical top-down Community method has replaced the open method of coordination (Armstrong 2013).

The actual impact of the intergovernmental TSCG was likely to be limited and amounted to only modest modifications of the existing SGP and the measures already agreed in the Six and Two Pack reforms (Commission 2012, Gros 2012b). From day one, the application of new TSCG rules was undermined, thus sending a clear signal to financial markets as to their unlikely efficacy. All 23 EU Member States with an ongoing Excessive Deficit Procedure (EDP) in November 2011 were granted a 3-year exemption to comply with the SGP deficit rule. Furthermore, exceptions in the case of very low growth would continue. The principal effect of the new treaty was to bring about significant harmonisation in national fiscal frameworks along the lines of the reformed SGP of 2005 and the *Schuldenbremse*. The TSCG required all governments to adopt national legislation introducing a rule that general government budgets were to be in 'balance' or in surplus. A fine could be imposed on member states that failed to do so. National laws were to contain supposedly 'automatic' correction mechanisms but governments could determine the trigger to these mechanisms as long as the existing guidelines of the Six Pack provisions were respected. As in the reformed SGP, exceptional circumstances could still be considered by the Council to block temporarily the EDP mechanism – thus undermining its automaticity.

Creating mechanisms for financial support

The creation of the European Financial Stability Facility (EFSF) in May 2010 has been presented as an ad hoc crisis measure that emerged in an 'atmosphere of confusion, panic, and desperation' (Godaj and Meunier 2013). However, the creation of support mechanisms -- notably the temporary EFSF and the permanent European Stability Mechanism (ESM) -- should also be seen in light of long-standing debates among EU member states and with and within the Commission on macro-economic policy support for member states dating back to the earliest years of European

integration in the 1950s. The provision of potential balance of payments support to European countries by the IMF in the Bretton Woods monetary system undermined the need to create a specifically European support mechanism. The opposing camps pitted German governments -- opposed to European Community support mechanisms on the grounds that they created a potential moral hazard that undermined national reform efforts -- against French governments that were fearful of the implications of market integration for the national economy and concerned as to the asymmetric costs of macro-economic adjustment.

In 1957, Robert Triffin, the Belgian professor of economics known widely for having first outlined the 'dilemma' undermining the stability of the Bretton Woods system, launched a proposal on a European current account fund, inspired explicitly by the views of John Maynard Keynes, and a European clearing house (Triffin 1957). The aim was to help countries that suffered from large current account deficits and speculative pressure against their currencies. Triffin believed that generous support should be offered to governments of these countries on the grounds that this would ensure the progress of European market, and eventually monetary, integration.

For Triffin, like Keynes, balance of payments disequilibria and exchange rate instability were a problem for both deficit and surplus / weak and strong currency countries. Surplus countries should be expected to assume the responsibility of helping deficit countries, on the grounds that they gained disproportionately from trade liberalisation. In the context of European market integration, it was above all Germany that should assume this responsibility given its constant -- and normally very large -- current account surplus. In the autumn of 1957, Triffin spelled out the details of a European Reserve Fund (Maes and Buyst 2002). In 1969, the Council adopted a regulation explicitly inspired by Triffin, 'Establishing a facility providing medium-term financial assistance for Member States' balances of payments' (1969/88). However, this facility had a limited loan ceiling and involved EC loans financed exclusively with funds raised on capital markets and not from member states.

In the context of EMU, balance of payments support became -- many argued -- less essential on the grounds that sharing the same currency eliminated the potential for balance of payments problems. In the Delors Committee -- the group consisting principally of central bank governors that discussed and agreed the blueprint for the move to EMU in 1988-89 -- the Governor of the Banque de France, Jacques de Larosière raised the issue of balance of payments problems in EMU and the need for a fund (Dyson and Quaglia 2010; Regling interview 8 April 2013). However, the German vision on the need for macroeconomic convergence in order to ensure the stability of EMU dominated the thinking on the committee. The EU member states recognised the potential need for on-going balance of payments support only for non-euro area member states. In 2002, they adopted a regulation (332/2002) to replace the 1969 regulation to clarify that EU support would apply only to non-euro area member states and to lower the loan ceiling from 16 billion euros to 12 billion (2002 value). This support was later provided to Hungary, Latvia and Romania (Mabbett and Schelkle 2015).

In May 2010, euro area member state governments agreed to create the European Financial Stability Facility (EFSF) to provide funds specifically to euro area member states shut out from international bond markets and subject to EU adjustment programmes and additional conditionality -- notably, Greece, Ireland and Portugal. The EFSF was limited to 440 billion euros. To the Facility was added a Commission fund of up to 60 billion (the European Financial Support Mechanism (EFSM)) and IMF support of up to 250 billion euros for a total of potentially 750 billion. The EFSM was an emergency funding programme for all EU member states in economic difficulty, subject to conditionality. Funds were raised on the financial markets by the European Commission and guaranteed by the EU budget. The EFSM essentially reproduced for the 27 EU member states the mechanics of the existing Balance of Payments Regulation for non-euro area member states.⁷

The German government set the parameters of the EFSF: it was to be a purely intergovernmental body with decisions reached by consensus and a temporary mechanism to be liquidated in 2013. Member state contributions came in the form of credit guarantees for funds raised through the issue of bonds by a Luxembourg-based private limited company. The use of an intergovernmental agreement to create the EFSF allowed the member states to rely on a simplified domestic ratification process and to avoid having to guarantee EU operations on the financial markets (Louis 2010). Anything resembling fiscal transfers or a fiscal union in the euro area would have been met with domestic opposition in Germany at the level of political elites and public opinion alike -- and only in part because of moral hazard concerns (see Dyson 2014). Furthermore, the German government had to be constantly sensitive to the possibility of a legal challenge, given the past judgments of the German constitutional court as well as the cases pending before the court (De Witte 2011; Louis 2010).

Most observers agreed that the Facility was inadequate and failed to provide the kind of 'shock and awe' to calm financial markets (Gros and Meyer 2011; Godaj and Meunier 2013). There were soon widespread calls for EFSF reform to expand its capacity and lower its lending rates -- not only from a range of member states but also from the ECB, the Commission and the IMF. On 21 July 2011, in the context of another Greek bail-out, the German government agreed to allow the EFSF to intervene on secondary markets and to recapitalise Greek banks (European Council 2011).

Following a bilateral Franco-German agreement, in October 2010, the EU member state governments agreed to create the permanent European Stability Mechanism (ESM) which was to replace the EFSF when the temporary mechanism was wound down. The decision to adopt an ESM treaty among only euro area member states helped avoid a contradiction of the no-bail-out clauses in the EU treaties. The ESM was given authorised capital of 700 billion euros (but with only 80 billion in paid-in capital by the member states and the remainder to be lent through the issuance of bonds as under the EFSF) and a maximum lending capacity of 500 billion. Unlike the original EFSF, the ESM was given the power to recapitalise banks directly. Conditions would be attached, but unlike the stability support within a macro-

⁷ http://ec.europa.eu/economy_finance/eu_borrower/efsm/

economic adjustment programme, the conditionality would focus only on the financial sector of the country in question (De Witte 2011; Louis 2010).

The creation of ‘euro bonds’ was presented by many as the quickest route to calming financial markets and bringing down bond yields (see, for example, several articles by Wolfgang Münchau, including *Financial Times* 13 November 2011). In November 2011, the European Commission produced a green paper on the creation of ‘stability bonds’.⁸ Supporters argued that euro bonds would enable the euro area as a whole to borrow on the market at a better rate than the rates paid by periphery countries and hence the funds collected with euro bonds could then be invested in those countries. However, the proposal met with strong German opposition -- stemming from a fear of moral hazard created for periphery countries -- and was set aside by the Commission (*Financial Times*, 20 November 2011).⁹

The Road to Banking Union

In June 2012, the President of the European Council, the President of the Eurogroup, the President of the Commission and the President of the ECB, presented an interim report titled ‘Towards a Genuine Economic and Monetary Union’. The Van Rompuy (2012) report, which was also known as the Four Presidents Report, proposed what later became known as Banking Union, namely ‘an integrated financial framework to ensure financial stability in particular in the euro area and minimise the cost of bank failures to European citizens. Such a framework elevates responsibility for supervision to the European level, and provides for common mechanisms to resolve banks and guarantee customer deposits’. The project of BU was subsequently endorsed by the European Council and euro area summit in June 2012 (Council 2012).

The main objective of Banking Union was to break the ‘vicious circle’ between ailing banks and struggling sovereigns by providing financial assistance to countries and banks hit by the crisis. The instruments to do this were to shift banking supervision and resolution to the Banking Union level, and to introduce new EU rules for the resolution of ailing banks and the protection of depositors (this component of Banking Union was subsequently set aside, as explained below). Banking Union was to include all the countries in the euro area as well as the countries that decided and were permitted to opt-in (on Banking Union and differentiated integration see Schimmelfennig 2015).

Banking Union was intended to address the so-called ‘inconsistent quartet’ created by financial stability, cross border banking, national financial policies for supervision and resolution and the single currency (for further discussion of the concept of the inconsistent quartet, see Howarth and Quaglia forthcoming). The quartet adds a fourth element, namely the single currency, to the ‘financial trilemma’ identified by Dirk Schoenmaker (2013). The single currency not only increased cross-border banking in the euro area, it also undermined national financial policies, because the function of

⁸ http://ec.europa.eu/economy_finance/articles/governance/2011-11-23-green-paper-stability-bonds_en.htm

⁹ http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2012/120269/LDM_BRI%282012%29120269_REV1_EN.pdf

lender of last resort can no longer be performed by national authorities. Furthermore, national resolution powers are limited by fiscal rules in the euro area. Consequently, the safeguard of financial stability can only be achieved at the euro area level.

In the quartet, any three of the four objectives can be combined but not all them: one has to give. For these reasons, euro area member state governments agreed (in some cases with great reluctance) to set up Banking Union, which shifts policies for supervision and resolution from the national level to the Banking Union level. The UK, which was not part of the single currency and had a very internationalised rather than 'Europeanised' banking system, lacked an incentive to join Banking Union. Central and Eastern European member states of the EU that had banking systems dominated by foreign (mostly euro area) owned banks had an incentive to join Banking Union because they were not in a position to safeguard financial stability domestically (Spendzharova 2014). The euro area countries that faced the quartet had however different preferences on the various elements of Banking Union, depending on the concern of national policy makers for moral hazard and the configuration of their national financial systems. Hence, the negotiations of certain components of Banking Union were time consuming (see Donnelly 2014) and a 'light' version of Banking Union was agreed in the end, as explained below.

The main supporters of Banking Union were the French, Italian and Spanish governments, which stressed the need to move quickly (Howarth and Quaglia 2013, 2014). By contrast, the German authorities argued that speed was not the essence but that it was instead important to get the right institutional arrangements in place (*Financial Times*, 6 December 2012) (Donnelly 2014). The UK by and large supported the Banking Union project, but declared at the outset that it would not be part of it. The British authorities were however concerned about the 'side effects' of Banking Union, such as the potential formation of a euro area majority shaping EU financial regulation (*Financial Times*, 8 November 2012, 13 December 2012). The financial industry broadly supported Banking Union, although there were some important disagreements on the specific components (see BBA 2012, BDB 2013, FBF 2012).

One after the other, the main components of Banking Union were put in place, with the exception of the Common Deposit Guarantee Scheme (DGS). The Single Supervisory Mechanism (SSM) was agreed at the December 2012 European Council which assigned to the ECB responsibility 'for the overall effective functioning of the SSM' and 'direct oversight of the euro area banks' (European Council, 2012, p.2). Supervision, however, would be 'differentiated' and the ECB, through the Single Supervisory Board (SSB), would carry it out in 'close cooperation with national supervisory authorities' (*ibid.*). The regulation establishing the SSM also permitted the ECB to step in, if necessary, and supervise any of the 6,000 banks in the euro area to bring about the eventual restructuring or closure of ailing institutions.

In March 2014, an agreement was reached on the establishment of the Single Resolution Mechanism (SRM). The ECB was to be responsible for deciding whether or not a bank should be resolved, but the newly created SRM Board could take this decision should the ECB decline to do so. Composed mainly of national authorities, the SRM Board was assigned the main decision-making power on the application of resolution tools, and the responsibility for the planning and resolution phases of

systemically important cross-border banks and those directly supervised by the ECB and the use of the Single Resolution Fund (SRF). Opposed to supranational interference with regard to semi-public savings banks and cooperative banks, the German government insisted that national resolution authorities continue to be responsible for all other banks. The SRF, financed by bank levies raised at national level, would initially consist of national compartments that would be gradually merged over a period of eight years (Howarth and Quaglia 2014).

The missing component of Banking Union was the Common DGS. In June 2012, the interim Van Rompuy (Four Presidents) report mentioned the need to set up a common DGS. However, the final Van Rompuy report issued in December 2012 only made reference to the ‘Agreement on the harmonisation of national resolution and deposit guarantee frameworks, ensuring appropriate funding from the financial industry’ (Van Rompuy 2012, p. 4). By December 2012, any reference to the setting up of a ‘common’ DGS had disappeared from the agenda for Banking Union, mainly because of German opposition (*Financial Times*, 13 September 2012; House of Lords 2012, p. 37). Yet again, the German government insisted upon the problem of the moral hazard that could arise for both banks and governments if national deposit guarantee funds could be replenished by funds from other euro area member states or by a supranational fund (*Financial Times* 13 September 2012). By contrast, France and other periphery countries supported a common DGS. However, they focused their efforts on the SRM, rather than lobbying for a common DGS, which was seen as a lost battle. The ECB regarded the common DGS as an important component of Banking Union but one that could be implemented later (Constati 2014).¹⁰ Furthermore, the different design of existing national DGS -- which in large part reflected the different configuration of national banking systems -- would have made full harmonisation extremely complex.

To sum up, the Banking Union that was eventually agreed and subsequently put in place between late 2012 and mid 2014, was a ‘lighter’ version of the original June 2012 project in two main respects. First, member state governments retained their vetoes on the mutualisation of national resolution funds and an important say on the use of funds in the SRM. A rather ‘complex’ compromise was reached on triggering the resolution process. Second, the creation of a Common DGS was shelved for the time being. The Banking Union ‘light’, eventually agreed, reflected German government preferences (Donnelly 2014) and its concern to avoid moral hazard -- that is, in this context, incentives for ‘risky’ behaviour by both sovereigns and banks. Germany was the largest economy in the euro area, it had a massive current account surplus and a comparatively sound fiscal position. Thus, it would be the main net contributor to the support and resolution mechanisms of Banking Union. Germany enjoyed a kind of veto power in the construction of Banking Union (Bulmer 2014), although one constrained by the threat of sovereign debt default in the euro periphery, contagion and euro area disintegration.

Conclusion

This special issue examines the causes of and the responses to the euro area sovereign debt crisis at the national, EU and international levels. Although the crisis is far from

¹⁰ <http://www.ecb.europa.eu/press/key/date/2014/html/sp140512.en.html>

over, it offers the opportunity to reflect on important topics in comparative and international political economy, as well as European economic governance. Four main political economy themes are highlighted in different ways by the contributors to this special issue, which also suggest directions for further research. First, the contributors examine how the configuration of national financial (especially banking) systems -- notably the degree of foreign ownership and of market-based banking -- shaped the playing out of not only the financial crisis but also the sovereign debt crisis by fuelling unsustainable macroeconomic imbalances. Further research could expand the bank-based analysis of the sovereign debt crisis to other countries in the EU but also to other sovereign debt crises. Second, the crisis demonstrates the limited ability of both governments and financial markets to monitor and even less to enforce fiscal discipline. Further research is needed to explore under what conditions financial markets are more (or less) effective in monitoring the fiscal behavior of states. Third, the role of the IMF has changed as a result of its involvement in the management of the sovereign debt crisis in the euro area (potentially as an 'agent' of the EU), and so arguably has its 'thinking', as a result of policy learning. One wonders whether a similar process of learning has taken place at the national or EU level and why or why not. Fourth, the reactive and arguably belated institutional reforms implemented by the EU as a result of the crisis were mainly designed to address the initial asymmetries that undermined the foundations of the EMU project. Some of these reforms (for example, Banking Union) have only recently been implemented, so further research is warranted as to both design and efficacy. Only time will tell whether or not these reforms have served their purpose and future crises can be avoided or, more realistically, diminished in their intensity.

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