JCMS 2022 Volume 60. Number 6. pp. 1645–1662 DOI: 10.1111/jcms.13338

Shocks and Time: The Development of the European Financial Assistance Regime

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Abstract
This paper analyses the impact of economic crises on the development of European financial assistance. It demonstrates that crisis episodes that have taken place over the last five decades have significantly altered the design of European Union emergency support. This paper illustrates how solutions adopted in formative moments – including the 1973 oil shock, the Eurozone crisis, and the Covid-19 pandemic – and their long-term consequences led to the smorgasbord of instruments of the present financial assistance structure. By applying a historical institutionalist approach, combining insights from studies of critical junctures and gradual change, this contribution explains how economic shocks contributed to change in financial assistance, while also highlighting mechanisms that led to the continuation of specific elements of the assistance structure.

Keywords: Covid-19 recovery fund; economic shock; euro area crisis; financial assistance; historical institutionalism

Introduction

Throughout its history, the European Economic Community (EEC) and later the European Union (EU) have tried to resolve economic crises by providing mutual support to its Member States. The role of macroeconomic crises has often been the focus of studies on financial assistance including the euro area (EA) crisis and more recently the Covid-19 pandemic (for example, Verdun, 2015; Ladi and Tsahouras, 2020; Howarth and Quaglia, 2021). Considering that extraordinary financial assistance already existed in the EEC from 1971, and economic difficulties afflicted the Member States repeatedly before the international financial crisis of 2008, a more encompassing historical analysis of financial assistance can contribute to our understanding of how this policy area developed. The main question that this article seeks to answer is how and under what conditions economic shocks contributed to the development of the EU's financial assistance regime. To answer this question, this article uses a historical institutionalist approach to analyse the development of the financial assistance in episodes of economic shock and their long-term effect.

The Historical Institutionalist Focus on Economic Crises

Many historical institutionalist works analyse crisis-induced change and its impact on institutional development through the concept of critical junctures or punctuated change. The explanatory merit of analysing crisis episodes derives from answering when and why an institutional setting is overwhelmed by rapidly unfolding new challenges, underlying the appropriateness of the pre-existing status quo vis-à-vis a potential crisis (see

Mahoney, 2010; Braun, 2015). Recent crises were often associated with critical junctures as they brought about major changes. Critical junctures are defined as 'moments of structural indeterminacy' which allow for an increased role of agency (Capoccia, 2016, p. 101; Mahoney, 2002). While junctures are the opening for potential change, punctuated change is their potential result in the form of actual significant change (Mahoney, 2010). Critical juncture outcomes carry causal weight in the subsequent institutional development, often studied as a sequence of change causally linking the initial outcome of the juncture to later developments (Capoccia, 2015), which can lead to continuity or transformation in equal measure (Mahoney, 2000; Mahoney et al., 2016).

Soifer (2012) defines permissive conditions as necessary parts of a critical juncture. The contextual significance of permissive conditions or critical juncture openings is the opportunity provided via the shift in the institutional environment. Within permissive conditions the constraints on agents are loosened, allowing agency to work as part of the causal chain, adding the interests and interaction of political actors to the explanatory framework (Capoccia and Kelemen, 2007; Capoccia, 2015).

The impact of changing contexts is also emphasized in the literature on incremental change, which uses the following typology of several forms of institutional change (Streeck and Thelen, 2005; Mahoney and Thelen, 2010):

- *Displacement*: removal of existing rules and introduction of new ones.
- *Layering*: introduction of new rules on top of or parallel to existing ones.
- *Drift*: changing impact of existing rules due to shifts in the environment.
- *Conversion*: changed enactment of existing rules due to their strategic redeployment (also called redirection).

Scholars have pointed out that gradual change and path dependence are 'two sides of the same coin' as mechanisms explaining continuity, but also provide insight into how the breakdown of these processes create change (Thelen and Conran, 2016, p. 62). At the same time, scholars point out that forms of gradual change work well within path dependency in order to explain how some elements of the institutional framework experience change and others continuity (Ackrill and Kay, 2006), or how the concept of layering is a useful tool to combine punctuated and incremental change (van der Heijden, 2011). The typology of gradual institutional transformation can be useful in analysing forms of punctuated change (Mahoney, 2010; Verdun, 2015), according to its imminent and long-term impact, thus combining, on the one hand, the processes of punctuated and gradual change and, on the other hand, the mechanism of continuity.

The European Financial Assistance Regime and Episodes of Economic Shock

To analyse the impact of economic crises on financial assistance in the EU, the economic context as well as the effectiveness of the (pre-existing) crisis-resolution schemes are relevant factors to include in permissive conditions. Critical junctures are operationalized as a package of two necessary conditions: rapidly unfolding economic difficulties increasing the need for financial assistance, and the inappropriateness of (pre-existing) financial assistance schemes vis-à-vis the respective context (Mahoney et al., 2016). This article uses a regime approach (see Dougherty and Pfaltzgraff, 2001), and defines 'financial assistance regime' as the formal and informal rules, practices and bodies accompanying the provision of extraordinary financial assistance to EU Member States. The regime is operationalized as a composite of three main features: the formal policy elements, including legal eligibility and coverage of assistance; the financing elements, laying out the financing mode and form of the instruments; and, lastly, the procedural elements, including the implementation of assistance and conditions attached to it.

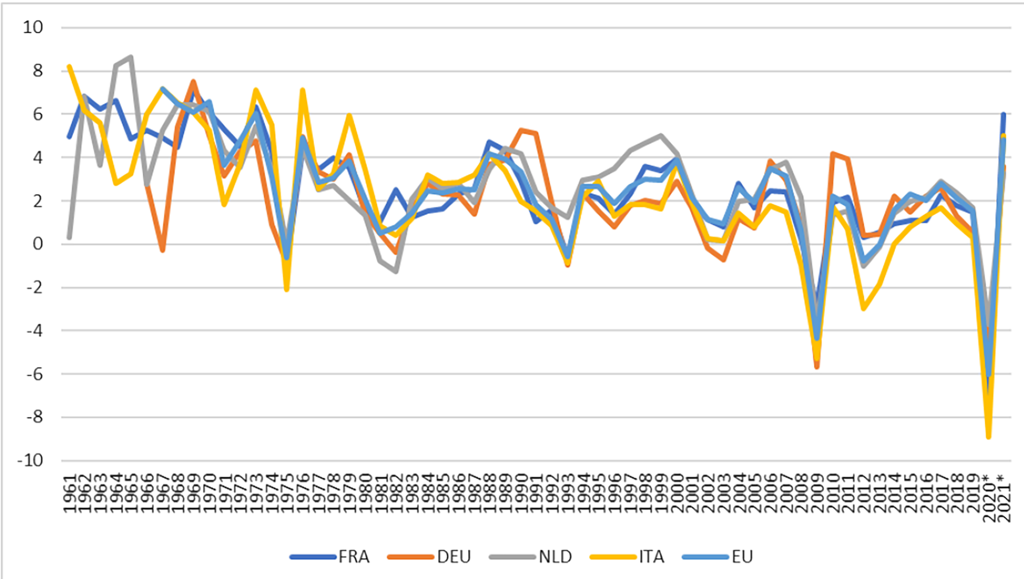
In a first step, this article identifies the contextual marker of economic difficulties, or 'shocks'. Economic shocks are assessed through the overall rapid decline in the growth of GDP in the EU in general, and via the assessment of urgency by political actors. As shown in Figure 1, GDP growth in four EU core countries was largely similar, even though not entirely aligned, allowing to consider the overall economic context as an adequate indicator for the situation in the majority of Member States. In a second step, legal changes are classified and assessed in connection with the economic shocks that provoked them. Episodes of shock, either to the entire EU or only parts of it, impact countries differently due to their varying economic structures and resilience. It is therefore reasonable to focus on these episodes, as they would not only carry the potential to trigger assistance, but test the regime's appropriateness vis-à-vis different economic shocks and contexts.

In order to analyse appropriateness, this article focuses on the resilience and reproduction of the main features in terms of: the availability of assistance instruments; the functionality of the instruments in place vis-à-vis the changing context and symmetry of shocks; and the acceptance of the regime's practice in the provision of assistance. Thus, this article focuses mainly on the functional and legitimation aspects of reproduction (Mahoney, 2000). The working assumption is that path dependent processes can work in parallel to rapid transformation as long as reproductive mechanisms endure vis-à-vis shocks.

Financial assistance in the EEC and later the EU was based predominantly on an intergovernmental form of support, which was decided by and given to Member States' governments. This underlines the relevance of governments' action and their respective interests in episodes of increased agency. In addition, the European Commission is considered a relevant actor given its role in preparing and suggesting policy for common action. Agency is illustrated by governments' actions and preferences in the process of resolving crises. These preferences are based on rational-materialist assumptions, which are influenced by the embeddedness and feedback of the broader EEC/EU institutional configuration, including rules and procedures of monetary co-operation and other EU policies (Büthe, 2016).

Within the last 50 years, this article identifies five episodes of shock in which rapid economic decline co-occurred with legal adjustment: first, the crisis and subsequent collapse of the international monetary system starting in 1968; second, the first oil shock of 1973; third, the second oil shock of 1979; fourth, the international financial and the subsequent euro area crisis starting in 2008; and fifth, the Covid-19 pandemic that began in 2020. The collapse of the international monetary system is included, because monetary instability occurred from 1967 and had a negative economic impact on Community members, and political actors had a sense of urgency to act in light of the expected need for a new monetary system in the future.

Figure 1: Per cent of GDP growth by geographical unit and year *Estimates for 2020 and 2021. [Colour figure can be viewed at wileyonlinelibrary.com]



Source: World Bank (2021); Statistisches Bundesamt (2002) and European Commission (2020).

This article uses data from the Historical Archives of the European Commission (see Online Appendix) about meetings of the Monetary Committee (1968–89). This data is complemented by official documents from national and European bodies and quality newspaper articles.

The first section deals with economic shocks prior the introduction of the euro, specifically looking at punctuated change in the formal policy and financing elements. The second section treats economic shocks after the introduction of the euro and focuses on the integration of EA countries into the assistance regime, the introduction of grants as well as the shift in the implementation practice of assistance. The last section concludes.

I. Monetary Instability and Community Assistance (1968–2002)

The Origins of the Assistance Regime

The introduction of intra-Community financial assistance in 1971 marked the beginning of the financial assistance regime in parallel to the international system of support mechanisms provided through the International Monetary Fund (IMF) and swap arrangements between central banks. Until 1971 the EEC did not possess instruments for financial assistance, even though the Rome Treaty allowed for mutual support within the Community (Article 108). The opening of a critical juncture came in November 1968, when the permissive conditions of economic difficulties and ineffective support where coupled. Speculative attacks on the French franc to devalue and on the Deutsche mark to revalue led to a multitude of ad-hoc assistance operations outside of the mechanisms of the Bretton Woods monetary system, with credit lines mostly provided to France via central banks and the Bank for International Settlements (BIS) and not the IMF (Appendix Doc. 1; Bundesbank, 1969; De Vries, 1996). These 'violent monetary crises' continued in the following year until the parities of the franc and D-mark were adjusted (Bundesbank, 1970, p. 30). The necessity to keep currencies aligned induced the need for assistance, as the monetary crisis had an asymmetric impact fostering divergence in the EEC. The institutional configuration of the customs union and the common agricultural policy required monetary stability to function properly, and instability, which was not sufficiently tackled by the international monetary system, became a threat to the economic prosperity of EEC countries (Appendix Docs 1 and 2).

In this opening, EEC governments began a process of *layering*, with the Commission proposing a system of monetary support instruments (short- and medium-term credit lines) outside of the existing international assistance framework. The preference in favour of a common system of all six governments converged, considering the institutional configuration and the functional mismatch between assistance needs and the international system. They constituted that the EEC was best situated to act when one of its own required help (Appendix Doc. 3). However, the material considerations of countries with stronger currencies emphasized that structural problems needed to be addressed via economic reforms (Appendix Doc. 2), as they feared an automatism of medium-term support to roll-over short-term credit, which would require their financial involvement and prevent necessary economic adjustment (Appendix Doc. 3). Thus, these countries insisted on policy conditionality, as used by the IMF, for the medium-term financial assistance instrument (MTFA) adopted in 1971 (Appendix Docs 2 and 4), and further mitigated their financial risk by insisting on opt-outs and on repayment clauses (Appendix Doc. 6).

As the monetary crisis was an asymmetric shock, it required adjustment of capital outflows in the form of credit lines to France, even though France still had to devalue and Germany to revalue their currencies in 1969 (De Vries, 1996). Although not its only purpose, the MTFA was intended to balance capital outflows via credit lines from partner countries, that is, act as a balancing mechanism that would prevent unnecessary de- or revaluation. With the MTFA, the Community set in motion an intra-European assistance system via loans with conditionality. Policy-makers marked the origin of the assistance regime with *layering* formal availability of EEC support on top of the international monetary system.

The gradual process of change after the juncture is illustrated by the EEC taking over the IMF system. First, it did not replace but worked alongside the IMF, as shown in the cases where the EEC provided a loan to Italy in parallel with the IMF, or where the IMF provided a loan to the UK in 1976 with potential recourse to additional EEC assistance (Hodson, 2015). However, after 1976 no assistance from the IMF occurred within the EEC and EU for over 32 years. This temporary *displacement* of the formal element of IMF support can be understood as an unintended consequence, as policy-makers emphasized the need to make both systems compatible in the initial discussion on setting up the MTFA. This *displacement* was enabled by the availability of non-conditional private market lending to finance deficits (Appendix Doc. 13), and the availability of Community assistance, which was given precedence over the IMF, shown by the repeated use of EEC support until 1993.

The Oil Shock 1973 – Introducing Community Loans

Only four years after the MTFA was adopted, the EEC introduced a new instrument of Community loans, which was *layered* onto the existing bilateral instrument. This novel financing mode used intermediary borrowing and lending via the EEC and shifted the direct costs of assistance from the Member States to the Community, which allowed a mobilization of support even in episodes of general economic difficulties, and set the standard for all following instruments in the EEC, EU and EA.

The oil shock in 1973 posed a serious challenge for governments in the EEC, which run large deficits to stabilize their economies. Due to the different abilities to cope with the shock's rapid impact, EEC countries' balance-of-payments disequilibria increased significantly, forcing some countries to introduce unilateral measures to restrict imports to safeguard their economies, impairing the proper functioning of the common market (Appendix Doc. 7).

The permissive conditions of this shock were composed of the increased need for financing deficits in the balance-of-payments and the inappropriateness of the financing design of the MTFA in this context. First, the oil shock was symmetric, putting all countries under economic distress, which shifted the focus from monetary alignment to general balance-of-payments difficulties. Second, the MTFA's small amount was not sufficient to support several Member States in parallel (Appendix Doc. 5; Appendix Figure S1). Third, it worked through bilateral loans raised among the Member States, which in some cases had to include bilateral assistance as expenditure on their balance sheets. As all Member States faced economic difficulties, the opt-out clause of the MTFA posed an obstacle to mobilize its funds and made prospective application uncertain. When Italy had to roll over its short-term monetary loans with the MTFA in 1974, only parts of the intended assistance could be mobilized, as the UK opted out, and the funds from the MTFA had to be topped up by IMF and bilateral German loans (European Communities, 1975). Thus, the functional deficiencies of the MTFA were also linked to its financing design to balance monetary crisis within the EEC and not to mitigate episodes of common European deficits. The permissive conditions created an opening for a critical juncture in June 1974 when the Commission called for urgent measures to ensure assistance within the EEC.

The French government and a group of experts designated by the Council proposed several possibilities of a 'dispositif de solidarité communautaire' for borrowing capital with the purpose of on-lending these funds to EEC countries in difficulties (Appendix Docs 7 and 8). Notably, options included the use of the European Investment Bank (EIB) and the European Monetary Co-operation Fund (pre-predecessor of the ECB). Preferences converged on borrowing via the Community, as this required no additional capital subscriptions and Member States would not incur direct costs on their balance sheets, which was seen as the key for effective assistance (Appendix Doc. 14). However, it took several months to hammer out an agreement on Community loans, because the German government insisted on several safeguards and repayment provisions (similar to the MTFA), and especially concessions from deficit countries to reduce their expenditures (Bundestag, 1974; Sénat, 1975). In 1975 the Council adopted the community loan mechanism (CLM) with a lending amount of $3 billion, using the same lending procedure via loans with conditionality as introduced with the MTFA (Appendix Doc. 9).

After the introduction of assistance in 1971, this was an almost immediate punctuated change in the financing design of the assistance regime, using the Community as borrower and lender for funds instead of relying on direct bilateral contributions from the Member States. This financing mode overcame the functional issue of reduced availability of funds in episodes of more symmetric shocks causing general economic difficulties, as Member States only had to bear direct costs in case of default by the receiving state, which, even in severe economic distress, was seen as unlikely. The advantage of Community borrowing and lending was that the Community's own resources posed substantial collateral to achieve favourable market rates for loans.

This financing mode had the advantage of being able to allocate and transfer assistance in episodes of European-wide difficulties, as brought about by the symmetric nature of the first oil shock. The positive feedback is shown in subsequent episodes of economic shock, such as the second oil shock in 1979. This shock was contextually very similar to the first oil shock, which led the EEC to simply revive the previously temporary CLM, as the advantage of an intermediary assistance format still outmatched cumbersome bilateral assistance (Appendix Doc. 13; Appendix Table S1). Thus, in this case the economic difficulties were not coupled with inappropriateness in the institutional structure, given that a feasible option was already designed. Streeck and Thelen (2005) called this dynamic 'survival and return', which has a functional mechanism of reproduction vis-à-vis its context. This case demonstrates that the lack of the second permissive condition, the inappropriateness of assistance, did not allow for a critical juncture to open. In parallel governments increasingly relied on the rapidly growing private (Eurodollar) market to finance their deficits, resulting in a reduced need for assistance and a non-negligible accumulation of public debt after the first oil shock (Landsberg, 1976).

The gradual process of change initiated by punctuated *layering* is illustrated by the *displacement* of the MTFA through the repeated use of the CLM in the following years, even though the latter was less capitalized than the former. The reason the Community put more work into the MTFA was linked to closer monetary co-operation and the legal interpretation of assistance within the Community and the expected temporary nature of the economic difficulties. Before the second oil shock, the dominant understanding was that assistance according to Art. 108 was limited to bilateral loans (Appendix Doc. 10). Therefore, the Community used the flexibility clause (Art. 235 of the Rome Treaty) for the CLM. However, the legal interpretation was reconsidered after the second oil shock, as in practice Community loans were much more feasible and had been used repeatedly since 1975 for assistance to Italy, Ireland, Greece and France. Community financing prevailed due to the persistent nature of the shocks, which started from monetary instability within the EEC and shifted to symmetric economic shocks to the entire Community (see Figure 1). As several common shocks occurred after 1975, the application of this financing mode solidified and bilateral assistance was sidelined due to its functional drawbacks in these contexts. Finally, bilateral and Community assistance were merged under the same legal basis into a single facility for medium-term financial assistance in 1988 (Appendix Doc. 15). Even though legally the bilateral arm of assistance existed until 2002, the advantage of the *layered* CLM undermined the bilateral financing mode only three years after its adoption. This shows that the intended punctuated change by policy-makers in critical junctures created non-intentional gradual change in the form of *displacement* of elements in the long term, even though policy-makers kept adjusting the MTFA.

II. Two Decades, Two Crises (2008–2021)

The Euro Area Crisis and Euro Area Assistance

When the CLM was adapted to the post-euro framework, the resulting assistance instrument (BoP) was only available for non-euro countries. The euro-linked exclusion is explained through gradual *displacement* of the formal coverage emanating from the institutional configuration of developments of Economic and Monetary Union (EMU). This notion is captured by what Slater and Simmons (2010, p. 887) called 'critical antecedent' conditions, which 'shape the choices and changes that emerge during critical juncture in causally significant ways'. Here the introduction of the euro, and its resulting interdependence of EA countries and their exclusion from assistance, is such a critical antecedent condition not present before 1999.

The gradual *displacement*, which is cultivated through alternative institutional forms, here the euro, is illustrated by the process before the introduction of the euro. Policy-makers considered the assistance between EA countries unnecessary because balance-of-payments disequilibria appeared no longer important and only the common imbalance towards the exterior was relevant (Marzinotto et al., 2010). This view coincided with expectations from governments and the markets that the euro would bring stability, which contributed to a downward trend of nominal interest rates and rapid growth of external demand in the 1990s (Stieber, 2015). This made the need for assistance after 1993 unnecessary and backed the legitimation that assistance will no longer be required. However, the same trend also resulted in EA governments being less stringent with their fiscal policies (Chang, 2016). In 2010 the regime expanded assistance eligibility for EA countries via a process of punctuated *layering* to the formal regime element (Appendix Table S2).

The international financial crisis brought with it a major recession in the EU and sovereign debt skyrocketed due to attempts by countries to stabilize their economies. Until 2010, the situation was principally managed at the national level with countries running high deficits financed on the private market to counter the socio-economic impact of the shock, and with three loans provided to non-euro countries through the IMF with EU participation via the BoP. Except for two increases in the amount of the BoP, the assistance regime appeared appropriate. However, the impact of the crisis brought Greece to the brink of sovereign default in 2010, and other EA countries started to face similar fiscal difficulties as the access to market financing, a necessary provider to finance deficits, was severely impeded (Kelton, 2015). For EA countries, the interdependence resulting from the euro posed a severe threat, as a Greek disorderly default would have had a devastating effect on the country and carried systemic risk for financial stability (Ardagna and Caselli, 2014; Colasanti, 2016).

The permissive conditions were formed by the necessity to support Greece and potentially other EA countries to avoid default, to maintain market trust, and by the lack of a formal EA assistance instrument in place to do so. The inappropriateness of the regime was thus linked to the formal lack of availability of support, coupled with a broader understanding that assistance between EA countries was neither necessary nor legitimate. A critical juncture opened in March 2010 when Greece requested financial support and the European Council designated a task force to reflect on measures to improve the crisis resolution framework (European Commission, 2010). Due to the pressing circumstances, the first response was a voluntary ad-hoc loan construct of bilateral support for Greece channelled via the EU as no official EU or EA instrument existed for this purpose.

In the process of adjusting the eligibility, government positions did not converge, and the inclusion of EA support was contested within the institutional configuration of EMU, explicitly excluding mutual fiscal liability. Therefore, in the process of legitimizing support, EA countries first resorted to prescribing economic policy reform to Greece before realizing that assistance was unavoidable. After the use of the BoP, policy-makers were aware of the advantage of Community financing in a situation of a more symmetric and common economic shock. Legally, Art. 122 TFEU did allow for EU assistance regardless of currency affiliation. This is reflected in the Commission's initial proposal, which tried to include EA support into the EU framework by establishing an instrument similar to the BoP (European Stability Mechanism, 2019). However, given that the EU did not have enough budgetary margin to guarantee a large assistance instrument needed for EA support, the Commission asked Member States to guarantee the rest. This option was opposed by the German government due to the budgetary and moral hazard risks associated with national guarantees, while having less control over its use (Howarth and Schild, 2021). The German government was also particularly wary of its constitutional court's possibility to overturn the agreement if its parliament was not sufficiently involved or legal barriers would make EA support within the EU unlawful (Barber, 2010). The UK was against EA support based on EU guarantees altogether (Barber, 2010). The disagreement was thus not linked to the financing elements, but to the legal structure and the legitimation aspect of EA support within the EU.

Member States resolved this disagreement by splitting the assistance into two instruments. The first instrument, the European financial stabilization mechanism (EFSM) with €60 billion, was an EU instrument using Art. 122 TFEU, similar to the BoP. The second instrument, the European financial stability facility (EFSF) with €440 billion, was an exclusive EA instrument and the first that was not embedded in the EU legal framework and therefore not covered by the EU budget, but by explicit national guarantees from EA countries. A similar idea was brought forward in the debate about the first CLM. At the time, a construct outside the Community was considered to have the least 'esprit communautaire' (Appendix Doc. 8). Both instruments used intermediary financing via the Community or an explicit EA vehicle. Through the separation of financing elements from formal legal elements, the survival and return dynamic of this financing mode becomes clear and helps us understand that the establishment of new legal instruments can only partially be considered an institutional novelty, as the functional mechanism of reproduction preserved the financing mode.

The establishment of EA support outside of the EU via the EFSF was a novel element in terms of legal cohesion in the assistance regime (see Verdun, 2015; Rehm, 2021), and paved the way for the establishment of the EFSF's successor, the European Stability Mechanism (ESM), as an intergovernmental institution outside of the EU legal framework in 2012. The punctuated change is, however, not the innovative legal construct of the new instrument, but the legitimation of EA assistance. In fact, the legal distinction between the EFSM and the EFSF/ESM is less relevant for the use of assistance, as is shown in the cases of Ireland and Portugal in 2010 and 2011, which combined funds from both sources in their assistance programmes, and in the case of a bridge loan from the EFSM to Greece in 2015, which was later absorbed by the ESM. EA support allowed a quick response in the following public health crisis in a similar fashion to 2010. Especially the first response of April 2020 relied on the positive feedback of legitimation of EA assistance, activating the ESM and an instrument with the same legal basis as the EFSM.

Credibility and Strict Conditionality

In the context of the international financial and the subsequent EA crisis, the implementation practice of the assistance regime shifted noticeably with the IMF entering support programmes for EU and EA countries, and with the application of loan conditionality in a much stricter fashion than before. Both elements (IMF participation and strict conditionality) were relevant changes, as they altered the procedural elements by *redirecting* the application of conditionality, and by *layering* IMF support onto the European assistance regime.

Between 1971 and 2008 the IMF and the EU constituted two parallel assistance regimes, which merged for a short while for European assistance in 2008–2015, first for assistance to non-euro countries, then also for EA support. Indeed, IMF assistance was not a novel element, given that all EU countries were IMF members, and especially considering that many central and eastern European countries received the Fund's assistance in the 1990s before joining the EU a decade later. Even though the IMF participated in and, for the most part, led the financial assistance to EU countries in 2008 and 2009, its role remained unclear in terms of EA support.

When in 2010 the permissive conditions opened a juncture to reform the assistance regime, public opinion in surplus countries, in particular Germany, considered the Greek problems as homegrown due to fiscal irresponsibility (Pisani-Ferry, 2014), and feared that the rather poor track record of the Commission to ensure compliance with the Stability and Growth Pact undermined its credibility as crisis-solver or enforcer of necessary structural reform in an EU-led response (Hodson, 2015). In their eyes, the laissez-faire conditionality that had been practised up to that point posed an inappropriate aspect of the procedural element of assistance. The idea of having another body in charge to ensure credibility is illustrated by the call for a European monetary fund by the German finance minister at the time (Brunnermeier et al., 2016). However, at that moment the only and certainly most reputable alternative in solving a full-blown debt crisis was the IMF.

In the negotiations on how to resolve the stand-off, between pro- and anti-IMF-involvement, surplus countries, with Germany as the largest contributor to any rescue scheme, strong-armed its partners to agree to include the IMF, and to ensure far-reaching structural reform (strict conditionality) in assisted countries in order to regain market trust (EU Council, 2010b). With strict conditionality for EA countries, the conditions become much more elaborate and far-reaching. While conditionality was a formal part of the assistance regime from the MTFA in 1971, it only gradually evolved into a defining element of the assistance regime. In the 1980s, the implementation of conditions was seen as 'altogether unsatisfactory' (Appendix Docs 11 and 12), leading to the disbursement of assistance through instalments in order to enforce reforms. Until 1993 (the last use of assistance before the introduction of the euro), conditionality was linked to macro-economic aspects, including monetary and fiscal targets, rarely including more than seven points. The changed enactment of conditionality illustrates a case of punctuated *conversion* in the implementation practice. Even though conditionality tended to be strengthened over the years, austerity measures in 2010, including extensive detailed reform demands and close monitoring of compliance, were a leap in the procedural element of assistance. The practice of strict conditionality became a key element for EA assistance in 2010 and similar fiscal rigour was introduced in reforms of the institutional configuration of EMU including the six pack, two pack and fiscal compact (Ioannou et al., 2015). Strict conditionality was included in the EFSF framework agreement, the Treaty of the ESM, and in the EFSM regulation. In the eyes of surplus countries, structural reforms were necessary to ensure the credibility of EA support, legitimizing the repeated use of strict conditions in assistance to Ireland, Portugal, Spain, Cyprus and again Greece in the following years. However, the emphasis on credibility did not hold in the new context of the Covid-19 pandemic (see below).

The laws were not explicit nor binding on IMF involvement. It was rather expected that the IMF provides 'at least half as much through its usual facilities' as the EU mobilized through the EFSM and EFSF together (EU Council, 2010a, p. 7). Notwithstanding, the punctuated *layering* of IMF assistance was followed by a process of gradual *displacement* of IMF involvement. After several joint programmes, co-operation between the EU and the IMF tapered off over disagreement on details in structural reforms (Blustein, 2015; Chang, 2016). After the IMF refused to participate in the third Greek programme in 2015, the *displacement* became apparent through a cascade of early repayments of costlier IMF loans by EU and EA countries, effectively putting an end to most IMF involvement in the EU. This gradual reversal is, on the one hand, explained through its informal basis, which could easily be changed and, on the other hand, by the increasing role of the ESM as replacement for a non-Commission institution in the hands of EA governments to ensure credibility.

The Covid-19 Pandemic – A New Trend in Assistance

In order to counter the impact of the economic shock resulting from Covid-19, two crucial changes occurred to the assistance regime. First, a new form of non-repayable support was *layered* onto the financing design of instruments and, second, conditionality was anew *redirected* from austerity to expansionary conditionality (see Appendix Table S2).

When the health crisis hit Europe, parts of the economy were shut down and EU Member States introduced recovery programmes for their economies. The economic recession as forecasted by the Commission in May 2020 pointed to a larger GDP decrease for the EU than in the international financial crisis (see Figure 1). However, despite having assistance mechanisms of over €450 billion in place for the EU and the EA, countries were not yet queuing for any sort of support, which was intended to be available only if market financing was impaired.

Even though the financing needs of countries increased, they were still able and willing to turn to the market to cover their immediate short-term financing needs. Market access was ensured through low refinancing costs for governments, which even after a slight increase in March 2020, remained at similar levels as in 2019. Arguably this was linked to the ECB's increased balance sheet stretch by more than €2 trillion from €4.6 trillion in 2019 to almost €7 trillion in 2020, including ultra-cheap refinancing operations that encouraged banks to purchase short-term government bonds, thus ensuring the availability of market financing (Arnold and Stubbington, 2020; European Central Bank, 2021).

However, this fuelled the reduced ability of several countries to take on more debt through assistance via loans. The permissive condition of increased need for assistance came with the short-term risks of fiscal sustainability for several major EU countries in this period due to increased deficit financing (European Commission, 2021a).

The second permissive condition of an inappropriate assistance design had several elements. First, the legitimation of austerity, which some countries fought very hard for a decade earlier, broke down in this new context as it discouraged countries from requesting assistance in a situation where fiscal discipline was not the central problem. As the economic impact of Covid-19 originated from a world-wide health crisis, countries did not consider previous conditionality practice expedient (EU Council, 2020a). Second, ESM support had a potential crowding out effect on market financing, which EA countries were particularly in need of, as private creditors would fear a junior position vis-à-vis ESM debt. Lastly, the EFSM was almost depleted after assistance to Portugal and Ireland and next to the BoP for non-EA countries, the ESM was the only source of assistance for the EA.

A critical juncture opened in March 2020 when the European Council requested the Eurogroup to present proposals for economic recovery (EU Council, 2020b). In an immediate first response, the preferences of countries converged in significantly easing conditionality for loans, which *redirected* the procedural element of conditionality from austerity to expansionary ex-ante conditions related to increased Covid-19 expenditure (Appendix Table S2; Rehm, 2021). For the EA, the ESM was to provide €240 billion in loans. However, the issue with the senior creditor status remained. For the EU altogether a €100 billion loan instrument (SURE) was introduced, which allowed for intermediary support via the EU (EU Council, 2020b). Support to mitigate Unemployment Risks in an Emergency (SURE) followed the dynamic of survival and return of the financing mode and the legal inclusion of EA countries via Article 122, as the mechanism of reproduction linked to functionality of assistance prevailed. However, these measures were only partially helpful as the issue at hand was not only linked to impeded market access. The problem was that countries faced sustainability problems with the increased issue of debt, making an assistance regime based on loans less effective. French President Macron went so far as to call assistance via loan instruments 'fake money' (Khan and Brunsden, 2020).

In May 2020, the German government joined France, with the support of many EA countries, to propose a grant-based recovery fund for the EU, showing that one of the strongest advocates of assistance via loans and strict conditionality had realized that the current financing design was functionally impeded in the changing context, and that the interests of safeguarding economic prosperity was also dependent on the economic stability of partners (Howarth and Schild, 2021). Governments of the so-called frugal countries opposed grants, but after four days of negotiations about the loan/grant ratio, the amount and the apportionment of assistance, they accepted a solution for the recovery and resilience facility (RRF) (Rehm, 2021). The RRF was equipped with €360 billion in loans and €312.5 billion in grants. While RRF loans followed in line with SURE, the grant element of the RRF *layered* a new financing mode on top of loan-based assistance.

The pandemic represented a critical juncture for the formal element of loan-based assistance, which had remained the go-to solution for 45 years. Formally, the gold standard of EU assistance in the form of loans with conditionality, used for almost five decades,

Table 1: Origin of the main elements of today's financial assistance regime

Year	*1968–1971*	*1973–1975*	*2008–2015*		*2020*	
Context	Int. monetary crisis –asymmetric shock	First oil shock – symmetric shock	Int. financial crisis/euro area crisis – symmetric shock		Covid-19 pandemic – symmetric shock:	
Inappropriate element	No formal instrument	Countries reluctant to provide bilateral loans in a recession	No formal instrument	Lack of credible implementation of conditions in euro area	Countries not accepting strict conditionality	Debt sustainability at risk through loans
Main adjustment	*Formal policy elements*: Introduction of mutual EEC support in parallel to IMF	*Financing elements*: Introduction of Community loans	*Formal policy elements*: Inclusion of euro area countries in assistance	*Procedural elements*: Inclusion of IMF in assistance and strict conditionality	*Procedural elements*: Introduction of expansionary conditionality	*Financing elements*: Introduction of non-repayable assistance
Applies to today's Instruments	ESM, BoP, EFSM, SURE, RRF (partially)	ESM, BoP, EFSM, SURE, RRF (partially)	ESM, EFSM, SURE, RRF	ESM, EFSM;	SURE, ESM (partially), RRF	RRF (partially)

was sidelined by an additional form of non-repayable assistance to governments paid by EU resources and by the general use of limited, mostly expansionary, policy conditionality for all assistance instruments (see European Commission, 2021b).

Through *layering* in the financing mode, the regime became a hybrid of the previous Community financing mode through re-purposing the ESM and establishing the SURE and the RRF loan instrument, while introducing a novel element through non-repayable assistance. While since its establishment the ESM gradually assumed a more active role in EA assistance, this process was interrupted by the introduction of new common EU instruments, which absorbed all new assistance activities via loans (see Appendix Figure S2), and left the ESM untouched. This could be an indicator for the beginning of the erosion of the ESM due to its discouraging design in the recent crisis.

Legally, the RRF was embedded in the EU budget similarly to structural funds. However, it was not intended to be a permanent instrument. Arguably, EU loans under SURE and the RRF can provide better interest rates for several countries, easing their debt burden. Given that EU instruments do not have a crowding out effect for market financing in comparison to the ESM, their use is much more likely than ESM assistance (see Appendix Figure S2). However, without the additional grant-based support, some debt-ridden countries would have had trouble maintaining fiscal sustainability during this episode. The introduction of grants illustrates that assistance shifted from a market access approach to debt sustainability and therefore to the loan absorption capacity of Member States, which can be an obstacle for effective recovery in a loan-based assistance regime.

Conclusion

This article applies a historical institutionalist approach to analyse how the European financial assistance regime has developed in the last 50 years. Of the sequence of five cases assessed, four exhibited critical junctures. Through the separation of the main composing features of assistance, a more detailed picture is provided, illustrating that critical junctures occurred in most cases separately for each feature and never for all at once. This allows us to emphasize the path dependence of changes introduced in critical junctures, as their resilience in subsequent shocks provided positive feedbacks and ensured their continuity. For the financing mode in particular, the reproduction of functionality of the instrument vis-à-vis the nature of the shock was crucial for appropriateness, while formal policy and procedural elements were built on reproduction of legitimation of the eligibility and the conditions of assistance. The sequence of shocks analysed here – including junctures and positive feedback – explains why the present regime is almost exclusively based on Community financing and a hybrid of loans and grants, but at the same time is composed of a variety of instruments of euro-only, non-euro and all-EU support with a constant but changing role of conditionality. By separating the regime's main features, a more nuanced distinction between significant and perfunctory change can be given, illustrating that, from an institutional standpoint, crisis episodes accounted for continuity and change in the 50-year development of the regime (see Table 1).

Using in particular *layering* and *redirection* to assess punctuated change, this article demonstrates that path dependence and gradual change are truly two sides of the same coin, as critical juncture outcomes often unfolded their transformative forces in the periods after crises, continuing, for example, the erosion of punctuated changes, or reversing their course altogether. At the same time, changes introduced through *layering* and *redirection* ensured the continuity of the overall institutional structure within the broader EMU configuration. Gradual change emanating from major developments in the broader institutional configuration of EMU led to gradual *displacement* in the formal element of assistance coverage which later was corrected in a critical juncture. The reason that *drift* – which is the non-decisions or inaction to adjust an institutional configuration (Streeck and Thelen, 2005, p. 25; Mahoney and Thelen, 2010) – did not occur is simply explained by the opposite development through active *layering* and *conversion* by policy-makers to keep the institutional structure relevant.

More recent developments in response to the public health crisis cannot yet be assessed in terms of their longevity. However, it can be shown that the notion of financial assistance has been broadened significantly by including grants and by legally spreading into provisions meant for structural funds, previously used for project-related financing and not direct government support. Even though the newly elected German government emphasized the non-permanency of the RRF, the historical perspective of the analysis presented in this article argues that the EU will see the use of this form of support in subsequent economic shocks, as long as the fiscal constraints and the ESM's loan structure remain. Similar dynamics can be found with regard to the first community loans, which were also considered temporary and which were revived by a subsequent economic shock as no other effective support mechanisms existed, effectively leading to the *displacement* of other regime elements. Once a feasible solution is found, it is difficult to erase it as a possible (future) response, especially if other regime alternatives fail.

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Supporting Information

Additional supporting information may be found online in the Supporting Information section at the end of the article.

Table S1. Selected legislation on financial assistance.
Table S2. Selected legislation on financial assistance.
Figure S1. EEC/EU and Euro Area Assistance as per cent of total EEC/EU GDP.
Figure S2. Available assistance by instrument (in € billion).