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The eurozone crisis

Growing pains or doomed from the start?

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> The euro house, for all its rickety defects, has proved durable through three years of stormy weather, relying on one shoddy compromise after another. The house may sag in places, the floorboards may be warped, and the roof may leak. But for all that, there is no reason to believe that it cannot long remain habitable, albeit uncomfortable. Europe's leaders will not let it fail. Europe's politics will not let it succeed. The euro, defective but defended, will simply endure.
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> *Benjamin J. Cohen (2012, 699)*

Introduction: From global financial crisis to European sovereign debt crisis

The creation of the euro at Maastricht in December 1991 was intended to be the next step towards post-Berlin Wall political unity: through economic convergence, Europe would become a more politically integrated region. Instead, policy efforts that were theorized to lead toward economic convergence actually resulted in economic divergence. In an ironic twist, this divergence has reawakened old political divisions on the European continent—the very problem that the euro was introduced to put to rest once and for all.

Catalysts of the euro crisis

The sovereign debt crisis that continues to shake the eurozone and took the Brussels-based policy elite by surprise in the spring of 2010 was in many ways the logical consequence of the global financial crisis. The underlying causes of that crisis have by now been widely debated and analysed by academics, journalists and policymakers alike, but no single dominant narrative, able to reconcile those multiple but often contradictory accounts, seems to have emerged (Lo 2012). That being said, most observers would probably agree that the crisis had its roots in the bursting of the mortgage debt bubble caused by the collapse of the US housing market in 2007. Once it became clear how a 'global inverted pyramid' of debt was actually built on a very thin base of dilapidated American sub-prime mortgages, the 'debt balloon started to deflate, at first slowly, [but] ultimately with devastating speed' (Skidelsky 2009, 4). Banks soon stopped lending

altogether—both to each other and to their private customers—which caused a 'credit crunch' in the beginning of 2008, putting an enormous deal of pressure on the American and global financial system.

The investment bank Bear Stearns was the first major victim of the crisis. On the brink of failure in March 2008, it was rescued at the 11th hour by JP Morgan Chase, which was persuaded by US authorities to buy the bank only after firm guarantees of direct government support for the takeover. By the summer of 2008 commodity prices had started to fall and the two giant American mortgage lenders, Fannie Mae and Freddie Mac, were formally taken into public ownership (Skidelsky 2009, 4–5). These incidents were part of the run up to the astonishing events of September 2008, when the world economy was at the edge of an abyss and flirted with complete meltdown: Lehman Brothers was forced to file for bankruptcy, Merrill Lynch narrowly avoided Lehman's fate by absorbing into Bank of America, and large banks all over the world had to be rescued by their governments. Furthermore, despite the injection of record amounts of liquidity into economies by central banks world-wide, stock markets plunged. The prevailing uncertainty led to a massive slide of the real economy, resulting in falling output levels, rapidly increasing unemployment, weakening consumption and rising savings: a classic case of a Keynesian liquidity trap (Matthijs 2010, 190).

As the world's major capitals were haunted by the spectre of a new Great Depression, only one thing seemed certain in the midst of the prevailing financial market chaos: governments had to step in to rescue their banking systems and guarantee most of their banks' deposits if they were to avoid a repeat of the 1930s. Central banks quickly slashed interest rates to close to zero, and governments' budgetary authorities—in haste—put together fiscal stimulus packages of a magnitude unparalleled in peacetime. Nevertheless, these efforts would not be enough to avoid the world economy's first output contraction since World War II, shrinking by 0.6% in 2009. The advanced economies contracted by 3.5% on an annual basis, while emerging and developing economies barely grew, recording a meagre 2.7% average growth rate that year (IMF 2013, 149). While the world economy did steer clear of another Great Depression, it was definitely dealing with a 'Great Recession', and a fierce debate over what had caused the series of events leading up to the economic calamity quickly entered into full swing (Lo 2012).

The initial focus of the financial crisis—during the autumn of 2008 and spring of 2009—was on those countries with heavily developed and exposed financial sectors, like the USA, the UK and Iceland. Around that time one could detect some not so thinly veiled *schadenfreude* in the capitals of Continental Europe, with economic and political elites in Paris and Berlin revelling in the superiority of their 'Rhineland' model of social market capitalism. In the minds of German Finance Minister Peer Steinbrück and French President Nicolas Sarkozy, to name just two examples, the crisis was laying bare all the structural shortcomings of the Anglo-Saxon model of 'financialized' capitalism preached by Washington and London since the early 1980s. In Britain, there was even brief talk among academics, Liberal Democrats and pro-European Labour politicians of the 'missed opportunity' of not having joined Europe's Economic and Monetary Union (EMU) in the late 1990s (Buiter 2008, 269). During a ceremony at the European Parliament in January 2009 to mark the 10-year anniversary of the single currency, the overall atmosphere was one of 'euro-phoria' and self-congratulation (Trichet 2009).

However, the continental hubris would be short lived. The financial crisis quickly spread from the USA and the UK to Continental Europe (and also to the rest of the developed and developing world). In order to stem wholesale financial collapse, all advanced industrial states of the eurozone—especially Germany and Ireland, who had allowed their banks to invest heavily in the American mortgage market—authorized large bailouts of their financial sectors and passed fiscal stimulus plans to support their economies (Scharpf 2011, 21). By mid-2009 it was clear

that many governments in the eurozone—with the Southern European countries along the Mediterranean (Greece, Italy, Portugal, Spain) and Ireland (all five together soon dubbed the 'PIIGS' by financial markets) in the vanguard—were facing the consequences of a triple fiscal blow: a collapse in government revenue due to the recession, a fast increase in spending due to rising unemployment and large stimulus bills, and the extra cost of adding the toxic private debt onto public sector balance sheets. Together, these three blows translated into ballooning budget deficits and sovereign debt. The eurozone suddenly went from a zone of stability to the centre of the financial storm.

As Reinhart and Rogoff explained, we should not be surprised that financial crises often lead to fiscal and sovereign debt crises (Reinhart and Rogoff 2009). And to paraphrase the title of their book, this time was no different. Governments, after having bailed out their financial sectors with an unmatched infusion of public money, suddenly found themselves owning all that bad debt. As the focus of financial market participants gradually shifted from private debt in 2008–09 to sovereign debt in late 2009 and early 2010—triggered by Europe's initial hesitation on what to do about Greece's pending sovereign debt default—concerns about the long-term fiscal solvency of Europe's periphery led to the evaporation of confidence in 'PIIGS' bonds and the subsequent flight of capital to safety. Bond traders sold risky Mediterranean sovereign debt and purchased perceived risk-free assets such as German *bunds* and American *T-bills*, which only served to worsen the debt situation, forcing Greece to the brink of an actual default. This uncertain situation led to a highly fluctuating euro–dollar exchange rate and rapidly widening sovereign debt yield spreads within the eurozone during the spring of 2010. As *The Economist* put it at the time, now it was the rescuers who needed rescuing (*The Economist* 2010).

The euro crisis holds valuable lessons for the global governance of finance and money. It taught us about the collective action problem with 17 national players, the intrinsic difficulty of dealing with international capital flows that are regulated mainly nationally, the tension between democratic national legitimacy and the power of supranational institutions, the dangers of an incomplete monetary union, the relevance of competing economic paradigms in solving crises and the fact that monetary policy is not just a purely technical matter. This chapter proceeds in five main sections. The next section analyses the multiple narratives informing Europe's response to its sovereign debt woes. Central to understanding the various ad hoc solutions cobbled together by the various European players is recognizing which explanations of the causes of the crisis eventually won out or proved more influential. The following section gives a brief overview of the main decisions that were taken during the multiple summits that took place over three years between late 2009 and late 2012, while the section after that analyses those decisions from interest-based (*players*), institutional (*power*) and ideational (*paradigmatic*) points of view. The penultimate section looks at the future of the eurozone, assesses the viability of a more permanent solution and outlines the main lessons of the euro crisis for the global governance of finance and money. The final section concludes.

Causes of the euro crisis: multiple explanations and competing narratives

A crisis is usually typified by high levels of uncertainty and multiple, competing explanations about its main causes (Blyth 2002). How the various crisis narratives play out politically is crucial to understanding the eventual policy response, and whether the reforms will be incremental or more radical in nature (Matthijs 2010, 2). This section will give the reader a sense of the eurozone debate by surveying seven of the different, and often overlapping, explanations of what went wrong with the euro. Naturally, those differing explanations also offer very different solutions to the crisis.

For most American economists, the euro crisis was a 'crisis of design' because Europe does not fulfil most of the conditions that would qualify it to be an optimum currency area. Northern European public opinion generally holds that this was a budgetary crisis of excessive spending and deficient tax collection, noting especially the high fiscal deficits and debt-to-gross domestic product (GDP) ratios in Southern Europe. For German industrialists, this was a crisis of competitiveness; labour costs in the PIIGS economies rose too fast in the previous decade compared to the North. For many academic observers, the euro crisis was a crisis of intra-EMU macroeconomic imbalances due to integrated European capital markets lacking a common debt instrument, and too high savings in the North offsetting too low savings in the South (Wolf 2010). For many politicians and pundits on the left, it was a crisis of 'efficient' financial markets, while for European Union (EU) scholars it was a crisis of European institutions. Finally, some blamed European policymakers themselves for making the crisis worse by 'spooking the markets' every time they made conflicting statements during the numerous crisis summits held in Brussels (Jones 2011). I will now examine those competing crisis narratives one by one.

The first explanation of the euro crisis is put forward by many American economists and is best captured by Martin Feldstein who has argued that this was a crisis of institutional design (Feldstein 2012). According to this view, the Economic and Monetary Union of the original 12 member states that physically introduced the euro in 2002 was not an optimum currency area (OCA) (Mundell 1961). Therefore, the project, though it could well work for a long time under favourable economic conditions, would eventually end in crisis the moment conditions became unfavourable. No monetary union, as the OCA argument went, could ever survive without a serious fiscal transfer mechanism, which would be needed in the case of asymmetric shocks. Furthermore, there was insufficient business cycle convergence and too little labour mobility in Europe, while product and labour markets remained relatively rigid in Southern Europe compared to Northern Europe at the time the common currency came into effect. In order to counter the unpalatable directives of OCA theory, the European Commission and European Central Bank (ECB) put forward the theory of 'OCA endogeneity', arguing that the introduction of a monetary union would increase trade and financial integration by a steep decline in transaction costs and the elimination of all exchange rate risk (Mongelli 2002; Matthes 2009). Thus, increased trade and financial integration would lead to greater business cycle convergence, and therefore a greater fitness of the participating countries to join a currency union. The benefits would soon outweigh the costs. Most economists countered that the endogeneity thesis was too optimistic. As early as the 1990s, Feldstein had argued that it confused European dreams with reality (Feldstein, 1997).

The second explanation, popular in much of Northern Europe, is that this was simply a budgetary or fiscal crisis. From this point of view, the Stability and Growth Pact (SGP), which had built on the Maastricht 'convergence criteria' that had to be met in order for a country to join EMU, was far from 'stupid', as former Commission President Romano Prodi once called it, but rather a good idea that was never actually implemented. Had it been, budgetary and fiscal excesses would not have been tolerated and they would have been nipped in the bud early on. This 'good idea' was undercut by the European Council, in trumping the European Commission's power over a looming 'excessive deficit procedure' for France and Germany in 2003. Ignoring the SGP then, as the Council did in 2003, opened up Pandora's proverbial box, and set a dangerous precedent for smaller, peripheral countries who drew the conclusion that their fiscal profligacy would go unpunished in the future. The result was widening public sector borrowing, and increased public spending, facilitated by an accommodating financial environment (low interest rates) which made borrowing cheap and ostensibly low risk. Southern European countries especially took advantage of the historically low interest rates—courtesy of

Germany's credibility—to go on a public spending spree. Once the financial sector collapsed and needed a bailout in 2008, many governments, which were already deeply overleveraged, had to go deeper into debt to save their financial systems from collapse. This view—which is not borne out by the facts, and to some extent only applies to Greece—corresponded to the German nightmare scenario of the early 1990s. The German fear at the time was that other EMU members would free ride on German credibility and be able to borrow cheaply, hence undermining the credibility of the eurozone as a whole.

The third crisis narrative, common among German business elites, is that this is a crisis of competitiveness in Southern Europe. North-South divisions widened after the euro launch in 1999 because labour costs in the Mediterranean rapidly increased and total factor productivity divergences quickly priced their goods and services out of the Northern European market. As the economies of Southern Europe and Ireland were booming in the early 2000s, wages tended to go up faster in those countries compared with their trade partners, especially Germany, which saw slightly negative wage growth from 2000 to 2007. The persistence of growth and inflation differentials therefore led to significant trade imbalances within the euro area, with Germany seeing record trade surpluses and the PIIGS suffering ever larger external deficits. In this view, Germany is more competitive than the rest of Europe because of the painful reforms enacted under the Schröder Governments in the early 2000s, which meant that German unions accepted wage restraint, allowing growth in productivity to outpace the increase in labour costs (Scharpf 2011, 13–15). As this reasoning went, the introduction of the euro in 1999 took away all incentives in Southern Europe to continue the structural reforms that it had started in the 1990s.

Financial Times columnist Martin Wolf most forcefully argued for the fourth explanation, which is to some extent the flip side of the previous crisis narrative. According to this view, the euro crisis happened because of unsustainably large intra-European macroeconomic imbalances. Initial bond spreads in the 1990s allowed market participants, especially pension fund managers, to buy higher yield (and triple-A rated) Mediterranean bonds and sell their lower yield Northern European bonds. This flooded Southern European countries with capital, fuelling a cycle of housing booms and consumer spending, causing their current accounts (and goods markets) to adjust. The evidence for this view seems considerable (Blyth and Matthijs 2012): while Germany's trade surplus with the rest of the EU was €46,400m. in 2000, it had grown to €126,500m. in 2007. Looking more closely at the evolution of Germany's bilateral trade surpluses with the Mediterranean countries between 2000 and 2007, Greece's annual deficit with Germany grew from €3,000m. to €5,500m., Spain's almost tripled from €11,000m. to €27,200m., Italy's doubled from €9,600m. to €19,600m., and Portugal's quadrupled from €1,000m. to €4,200m. (Eurostat 2010, 145). Similarly, an IMF (International Monetary Fund) working paper revealed Germany and France to be the two biggest net creditors within the eurozone in 2008 with intraeurozone net investment positions of +€735,000m. and +€764,000m., respectively, the exact mirror image of Portugal (–€136,000m.), Greece (–€199,000m.), Italy (–€334,000m.) and Spain (–€794,000m.) (Waysand *et al.* 2010; Matthijs and Blyth 2011). According to this view, it was the capital flows from North to South in the late 1990s and early 2000s that caused the current account divergences across Europe. Capital markets cleared first, goods markets followed later (Jones 2010b, 14).

The fifth narrative, often ignored in much of the academic literature, but mainstream among social democratic politicians in Europe, is that this was a failure of efficient financial markets. Interest rate convergence between Northern and Southern Europe should not have happened according to this view, since it was based on a fundamental mispricing of risk in the sovereign debt holdings of different European countries. The idea that Greece and Germany could

borrow at almost the exact same interest rates over 10 years was based on financial market participants ignoring the 'no-bailout' clause in the Maastricht Treaty. This narrative also singles out the international ratings agencies, such as Moody's, Standard and Poor's and Fitch, for failing to lower the triple-A rating of the PIIGS countries much earlier on, which would have tempered the excessive public and private borrowing during the 2003–07 boom. In a way, the higher yields for certain EMU countries starting in 2010 signified a return to 'normal' interest rate pricing, in which policies deemed deficient are instantly punished with default premiums by financial markets. Also, this narrative emphasizes Hyman Minsky's observation that financial markets tend to underprice risk during economic booms and overprice risk during recessions (Minsky 1986). In other words, markets tend to discipline governments excessively during downturns by charging too high interest rates and do not rein in spending sufficiently during economic upswings by setting interest rates that are too low.

The sixth euro crisis explanation has many scholars of European integration look at Europe's sovereign debt crisis as a crisis of European institutions (Schmidt 2012). The problem at the heart of European institutions is that of 'divided sovereignty' and the lack of a true 'economic government' for the eurozone (Jabko 2011). Since the eurozone's monetary policy is conducted exclusively at the European level by the ECB in Frankfurt, while most other policies—including banking supervision, deposit insurance and fiscal policy—are set at the national level, there was bound to be an eventual clash over economic policy. Moreover, since the eurozone has no common debt instrument (a 'Eurobond'), there is no European safe asset that all members are able to issue. This means that, during a financial panic, capital will flow out of the weaker member states into the stronger member states, rather than from one asset class to another. This European institutional narrative views deeper economic integration as a necessary step to solve the crisis once and for all. However, at the same time, these scholars are aware that there is very little political desire for a 'transfer union' and domestic politicians in most member states are loth to give up more of their sovereignty to Brussels (Jabko 2011). The fact that decision-making at the European level happens by consensus makes the crisis response often too slow to reassure fast moving international financial markets, which has a tendency to deepen the eurozone's problems.

The seventh and last crisis narrative blames the euro crisis on bad information and a series of missteps by European policymakers during the crisis. Conflicting statements about the no-bailout clause, the size of the European Financial Stability Facility (EFSF), IMF involvement, conditionality, whether weaker eurozone members should be allowed to leave or be kicked out, and so on, 'spooked' the markets, artificially worsening the crisis (Jones 2012b, 146–51). This last view is complementary to the previous view, namely that more effective institutions at the EU level, together with more transparent tools for information and communication, a more cohesive decision-making process, and a broader mandate for the ECB could have stopped the crisis from turning a lot worse in 2010. Furthermore, the continued dithering and indecisiveness on the part of EU policymakers, as well as national leaders—especially German Chancellor Angela Merkel—added to the anxiety and panic in the markets. A much more decisive and rapid response in early 2010, a financial 'bazooka' similar to the way the US Treasury and Federal Reserve responded to the US meltdown in September 2008, could have reassured financial markets early on and averted the worst of the euro crisis in 2011 and 2012.

Three years of EU summits and EU solutions: an overview

It is fair to say that all seven crisis narratives discussed above informed the debate and search for solutions at some point during the eurozone crisis, but it was clear from early on that some

narratives, especially the second (fiscal) and third (competitiveness), were more influential than others. Why exactly that was the case is analysed in the next section, applying the Handbook's main theoretical framework of the three Ps—players, power and paradigms. But, first, we need to understand how exactly the euro crisis unfolded, from a Greek fiscal drama to a full-fledged European sovereign debt crisis: a crisis that would call into question the very existence of the euro and the future viability of Europe's bold monetary experiment.

After a snap election called by Prime Minister Kostas Karamanlis of the New Democracy Party (NDP) in October 2009, Greeks, frustrated by a weak economy, voted for change and George Papandreou and his Pan-Hellenic Socialist Movement (PASOK) swept to power. The new Government would soon uncover that the country's public finances were in a much worse state than previously believed, and blamed faulty accounting practices for concealing excessive borrowing during the NDP administration. In November 2009, Papandreou announced Greece's budget deficit at 12.7% of GDP for the year, twice as high as previously estimated. Markets initially remained calm, with Greek–German bond spreads barely moving, as the risk of a higher-than-expected deficit was already priced in. After sovereign downgrades by all three main rating agencies at the beginning of 2010 and a deteriorating stock market, and with total Greek debt now estimated at 113% of GDP, Papandreou unveiled a draconian austerity plan in February 2010 aimed at reducing the deficit by close to 10% of GDP in just two years. The plan included various tax increases and a freeze on public sector wages. However, as riots and wildcat strikes crept up all over Greece, and the deficit for 2009 was further revised upward to 13.6% of GDP, it became clear that the country could not cut its way out of its crisis and would need outside help. Due to initial dithering at the EU level, the rating agencies downgraded Greek sovereign debt to junk status in April 2010, and financial market panic now started to spread to the rest of the eurozone periphery, resulting in widening bond yield spreads between Germany and the PIIGS countries and a tumbling euro vis-à-vis the dollar (Jones 2010a, 25–30).

After weeks and months of uncertainty at the EU level, filled with fragmented and uncoordinated meetings between the main European players, including German Chancellor Angela Merkel and French President Nicolas Sarkozy, the Greek crisis was countered with a €110,000m. bailout package put together jointly by the EU and the IMF in early May 2010. The bailout was conditional on a whole series of new austerity measures, including tax hikes and expenditure cuts. The markets did not think this sufficient, as the problem now had moved beyond Greece to Ireland and Portugal, with the sights of the financial markets increasingly fixated on Spain and Italy—all economies with high deficits and rising debt levels. Just one week after the Greek bailout was announced, the EU member states and the IMF responded by putting together a rescue package of €750,000m. for the currency bloc. The rescue plan consisted of €440,000m. eurozone-backed loan guarantees for crisis-stricken members raised by a newly created (and triple A-rated) European Financial Stability Facility (EFSF); a European Union balance of payment facility totalling €60,000m. to raise debt by the European Commission using the EU budget as collateral; and €250,000m. in loans from the IMF. Furthermore, the ECB promised to intervene in secondary public and private debt markets, and take extra measures to boost eurozone bank liquidity. However, rather than putting the crisis to rest, all this did was buy a couple of months' time.

After a relatively quiet summer for the eurozone, Ireland's central bank announced in September 2010 that the cost of bailing out Anglo Irish Bank, which had been taken into public ownership by the Irish Government in January 2009, was a lot higher than expected, bringing the Irish budget deficit for 2010 to an astronomical 31.2% of GDP (Eurostat 2012). After a bilateral meeting between Angela Merkel and Nicolas Sarkozy in Deauville in France, where

they agreed on the need for private sector involvement (PSI) to solve Greece's debt hangover, the Irish crisis intensified, making an Irish bailout all but inevitable (BIS 2010). During the European Council meeting a couple of days later in Brussels in late October 2010, the EU heads of state agreed to amend the Lisbon Treaty in three significant ways. First, the EU would create a new macroeconomic surveillance network to detect emerging imbalances and risks, including divergences in competitiveness. Second, EU leaders agreed to strengthen national governments' fiscal responsibility under a revised and much stricter Stability and Growth Pact. In the future, progressive sanctions would kick in earlier in the budgetary surveillance process, and public debt would also be taken into account, alongside the existing deficit criterion, in determining whether EMU members were abiding by the rules. Third, the establishment of a permanent crisis mechanism (the European Stability Mechanism—ESM) was proposed to safeguard the financial stability of the euro area. EU Council President Herman Van Rompuy committed himself to open consultations with the member states on a limited treaty change required to establish such a mechanism. In the mean time, the Irish crisis pushed Irish Prime Minister Brian Cowen, after months of initial delay, to apply for an €85,000m. bailout from the EU and the IMF in November 2010 and to announce a general election, which took place the following spring, bringing in a new government.

In February 2011, European Finance Ministers formally agreed to create the permanent crisis mechanism already floated in October 2010: the ESM. The ESM would consist of a permanent €500,000m. fund that could serve as lender of last resort for all crisis-stricken eurozone countries. But, given the overall size of Italy's outstanding sovereign debt (estimated at over €2,000,000m.) and Spain's huge deficits, financial market participants immediately questioned whether the fund would be big enough to bail out the two larger eurozone members in trouble. (The ESM would only start functioning in September 2012, after the German Bundestag ratified it.) In March 2011, Portugal's Prime Minister José Sócrates resigned after opposition parties rejected his proposed austerity budget. Now in a caretaker capacity, Sócrates became the third eurozone head of state to apply for an EU–IMF bailout in April 2011, when Portuguese yields rose to unsustainable levels, due to further downgrades by Fitch and Standard & Poor's. One month later, European leaders approved a €78,000m. bailout package for Portugal, again under the condition that the Portuguese authorities implement a series of austerity measures.

During the summer of 2011, after it had become clear that the first Greek package had been insufficient, the EU member states were forced to extend another bailout package of €109,000m. to Athens. In order to further stabilize the euro as a whole, existing Greek loans were restructured, with the cost of the changes being passed on to private bondholders, who agreed to take a significant 'haircut' in a voluntary debt swap deal. The first selective government default within the eurozone became a fact.

In August 2011, pressure mounted on the coalition of Italy's Prime Minister Silvio Berlusconi, as 10-year Italian government bond yields surpassed 6%, which were widely judged by the markets to be untenable given the country's high debt. After a joint letter by ECB President Jean-Claude Trichet and (then still) Bank of Italy Governor Mario Draghi asking the Italian Government for 'immediate and bold' measures, Berlusconi responded by proposing €45,000m. in spending cuts and tax increases in an effort to calm the markets. Undeterred by protests and a one-day general strike called by Italy's largest labour union, Italy's legislature eventually approved a revised austerity package of €54,000m. with the intention of balancing the country's budget by 2013. But constant redrafting of the budget had exposed the fractious and unstable centre-right coalition that Berlusconi was leading and the major credit rating agencies responded by downgrading Italy in September 2012, citing political uncertainty (Jones 2012a, 1–5).

As anti-austerity protests and riots swept across Southern Europe, European leaders met in Brussels in late October 2011 to discuss another 'comprehensive solution' to the crisis, with Sarkozy and Merkel privately negotiating with Greek bondholders, which resulted in a bond swap that would effectively halve the total value of all Greek debt. A few days later, Greek Prime Minister Papandreou—in despair—called a referendum on the bailout plan, sending shockwaves across global financial markets. European leaders, irked by Papandreou's populist theatrics, responded by saying openly for the very first time that Greece would have to choose whether it wanted to stay in the eurozone, or leave. Papandreou was forced to abandon his referendum idea, and his position became increasingly tenuous, forcing him to step down a couple of days later.

In November 2011, the eurozone witnessed three changes of government, in Greece, Italy and Spain. In Athens, Papandreou resigned and was replaced by Lucas Papademos, an unelected technocrat and former vice-president of the ECB. In Rome, Berlusconi effectively lost his majority and proposed to resign under the condition that the legislature approve his austerity budget for 2012, which it duly did on 12 November. Mario Monti, another unelected technocrat and former European Commissioner, took over from Berlusconi with markets initially responding negatively as Monti's government formation was delayed. On 20 November, Spain voted out the socialist Government of José Luis Zapatero, and Mariano Rajoy, leader of the Popular Party (PP), was tasked with forming a new government.

In December 2011, exactly 20 years after Maastricht, European heads of government met in Brussels for a summit that promised to reshape the European Union. But, while many far-reaching changes to the institutional design of the EU were proposed, the major outcome was nothing more than a new Fiscal Pact that stipulated additional penalties for countries exceeding budget deficit benchmarks. British Prime Minister David Cameron, unable to secure regulatory exemptions for London's financial sector, refused to sign on to the new Fiscal Pact. Also, the Czech Republic decided not to participate. The summit was dubbed a failure in the financial press, even though 25 out of 27 member states vouched to press ahead with the required treaty changes. The gap between the UK on the one hand and France and Germany on the other appeared wider than ever, at a moment when European unity was needed the most.

A week after the December summit, the European Central Bank's newly installed president, Mario Draghi, who had succeeded Trichet at the end of his term, surprised markets and policymakers alike by announcing an early Christmas present in the form of unlimited Long Term Refinancing Operations (LTROs). Right after Draghi's announcement, more than 500 European Banks took up the ECB's offer, which added up to €489,000m. in three-year loans during this first round. Draghi justified the LTROs as designed to prevent a credit freeze. Their widespread adoption by European banks demonstrated, initially, a marked improvement in sentiment of the private banking sector, which so far had assumed that the ECB would not be making the kind of direct capital injections that had characterized the Federal Reserve's response to the banking crisis in the USA. The ECB's new approach would again bring a couple of months of calm to the markets, especially after a second round of LTROs was injected into the European banking sector in late February 2012.

In March 2012, there was the signing of the new pact on fiscal discipline by 25 of the 27 EU members, with the UK and Czech Republic opting out, as well as another Greek bond swap, which wiped out about €100,000m. of Greek government debt. Unlike in July 2011, this Greek debt restructuring was involuntary, and therefore triggered the pay-out of a couple of billion euros in credit default swap (CDS) insurance, which was actually smaller than originally feared. The new Spanish Government led by Mariano Rajoy announced its budget later that month, which shaved 10% off of the previous year's budget, leading to a series of violent

protests in Madrid and Barcelona, as well as a general strike in the country. The eurozone's finance ministers in the meanwhile agreed to expand the EFSF and ESM to have access to a total amount of €800,000m. in order to be able to cope with potential bailouts for Italy and Spain.

Financial market concerns returned to the eurozone in full force in May 2012 as anti-austerity candidates won national elections in both France and Greece, and in regional elections in Italy. Beppe Grillo, an anti-austerity comedian who founded a protest party in Italy, did very well in local elections in Italy, along with the Communists and Greens. More significantly, socialist candidate François Hollande beat Nicolas Sarkozy to become the new president of France, on a platform that rejected the fiscal austerity course for the eurozone followed by his predecessor and his German counterpart Angela Merkel. But, from a financial market point of view, the most important election was taking place in Greece. The same day that Hollande conquered the *Elysée* Palace in Paris, Greece rejected its mainstream pro-austerity parties PASOK and NDP in favour of SYRIZA, an amalgamation of small left-wing parties who ran on renegotiating Greece's bailout with the EU. Since no coalition was able to come out of those elections, new elections were scheduled for the following June. Talk of 'Grexit' (a Greek exit from the eurozone) became louder as Greek deposit holders started to withdraw their money from banks and capital flight out of Greece reached record levels. The crisis suddenly entered an acute new phase.

In June 2012 the Spanish Government, after it was forced to nationalize Bankia, the country's largest mortgage lender, requested €100,000m. in financial assistance from the EU to recapitalize its ailing banking system. While Spanish Prime Minister Rajoy sought to downplay the package as some sort of 'soft loan' from the EU with no strict conditionality, rather than a bailout, the euro 'troika' (EU, ECB and IMF) was quick to point out that they would oversee the loan and any conditions that would be applied to it. Greeks returned to the polls and voted in a new grand coalition of NDP, PASOK and the Democratic Left, with Antonis Samarras becoming the new prime minister. He immediately embarked on a fresh round of austerity measures in order to secure the next tranche of bailout money. Although markets initially celebrated the Spanish bailout and the outcome of the Greek election, the euphoria would once again be short lived. In a matter of days, Cyprus became the fifth eurozone member to apply for a bailout.

At the end of the month of June, the 20th EU summit in Brussels since the beginning of the euro crisis finally saw something of a breakthrough. Rajoy and Monti secured more favourable lending terms for their countries, as eurozone leaders agreed that loans from the ESM would not be subject to troika oversight. Also, in addition to some modest growth stimulus measures such as €5,000m. in project bonds, the first steps were taken to establish a eurozone-wide banking union, with common supervisory oversight powers of eurozone banks—a Single Supervisory Mechanism (SSM)—with a key role for the ECB in Frankfurt (European Commission 2012).

The summer of 2012 was marked by continuous protests in Spain, Italy, Portugal and Greece, as all four countries pressed ahead with their fiscal and labour market reforms. Markets remained unconvinced of the feasibility of those countries' strict budgetary measures, as all four countries were in recession and saw their debt-to-GDP ratios go up further, the logical but perverse consequence of harsh austerity measures aimed at reigning in debt. This set the stage for Mario Draghi to enter the limelight and try to take control of the crisis. On July 26, he gave a speech at the Global Investment Conference in London, reassuring his audience—and the markets—with the following words: 'Within our mandate, the ECB is ready to do *whatever it takes* to preserve the euro. And believe me, it will be enough' (emphasis added) (ECB 2012).

Financial markets rallied. In early September 2012, Draghi made good on his promise by unveiling a bond-buying plan that would be a 'fully effective backstop', also clearly stating the euro to be 'irreversible' (BBC 2012). For the first time, the ECB showed its willingness to intervene directly in the bond markets of Italy and Spain by 'outright monetary transactions' (OMTs), which would have the effect of lowering Spanish and Italian interest rates and reassuring the markets that the ECB would indeed do 'whatever it takes' to save the eurozone.

Meanwhile, the eurozone as a whole slid further into recession, and EU leaders made very slow progress towards a full banking union, with Germany postponing the launch date to some time in late 2013 or early 2014. The ECB's decision brought some relief to markets as well as EU officials. However, it was not clear that it would last, given that all the big institutional decisions (banking union, closer fiscal union, political union) were postponed to a later date.

By the autumn of 2012, after three full years of eurozone crisis, it became clear that, for all its obvious economic problems that had pretty straightforward solutions, this was first and foremost a political crisis for which there was no easy solution. The political economy of the European monetary union did not just turn out to be a merely technical matter. At the heart of the crisis was a complex interplay of different national and supranational players' conflicting interests; power tensions and a game of chicken between private bondholders and public sector debtors; incomplete eurozone and EU institutions lacking real power; and a debate between differing economic philosophies, or paradigms, which will be discussed in the next section.

Assessing the EU response: players' diverging interests, (lack of) power of incomplete institutions, and unsustainable paradigms

The euro crisis has been multifaceted and complex. The main players included the eurozone member states and international institutions like the EU, the IMF and the ECB. However, other actors also played key roles in its theatre, such as: the UK, the USA, the big emerging market economies of China, India and Brazil, the Group of Twenty Finance Ministers and Central Bank Governors (G-20), and of course, financial market participants and the financial press. Looking at the main events as they unfolded from late 2009 onwards as outlined in the previous section, and the various crisis responses that were agreed to in more than 20 EU summits over the span of those three years, one can see that the answers to the euro crisis were a compromise of competing interests and ideas, with imperfect eurozone institutions at its heart.

The different crisis narratives from section two at various times informed the interests of the different players as well as the responses of the European institutions and policymakers. Since the euro crisis dominated world financial news headlines for most of those three years, it would be impossible to pin the crisis down by simply looking at it as a conflict of interests, a crisis of institutions or a battle of economic ideas. One must look at the crisis through the lens of all three explanatory factors—players, power and paradigms—in order to make sense of what happened. Understanding the overlap of interests, institutions and ideas, and their contribution to the various EU solutions, will be crucial to its conclusion. Let me now consider these three factors one by one.

First, numerous scholars have looked at the process of European integration from an interest-based perspective (Hoffmann 1966; Frieden 1991; Moravcsik 1998; Milward 2000). Their analysis is 'state-centric', in that they see EU member states as the main players in deciding whether to give up sovereignty to the supranational institutions of the European Union. As long as it is in the material interest of states to give up sovereignty, they will go ahead with further integration; when material gains are insufficient, the integration process will stall. The clear clash of interests during the sovereign debt crisis was between the surplus eurozone members of

Northern Europe, including Germany, Finland and the Netherlands, who took a hard line on any requests for EU bailout money, and deficit Southern eurozone members, including Portugal, Spain, Italy and Greece, but also Ireland, who were being targeted by financial markets. This divergence of interests can also be seen from a creditor versus debtor point of view, with the Northern banks being the main creditors and holders of Southern sovereign debt, and the South having built up substantial public and private debt mainly owed to the North. This division has no clear place for France, which sits somewhat uncomfortably in the middle, since its banks were heavily exposed to Mediterranean sovereign debt, making it a creditor nation, but its policies and deficits were closer to Southern Europe, which occasionally put it at the mercy of the financial markets itself, just like Italy or Spain. France, more than any other EU member state, also has a keen interest in maintaining a close relationship with Germany as together they had traditionally formed the joint engine of European integration.

However, it is not immediately clear who controls the agenda in a creditor versus debtor conflict. To paraphrase Keynes, 'if you owe the bank one hundred pounds, you have a problem; but if you owe the bank a million pounds, the bank has a problem'. The creditors usually are in a somewhat stronger position since they can impose certain conditions on their debtors in order to be paid back, but they have to be careful not to be too harsh since they risk losing everything in the case of a sovereign default. The debtors' main interest is to maintain their creditworthiness with international financial markets, and they will therefore go to considerable lengths to sort out their fiscal situation. But, in the short term, cutting spending and increasing taxes—the standard economic technique to improve a country's fiscal situation—actually worsens their budgetary position by causing a recession.

At the same time, what complicates things is that eurozone members are also each other's most important trading partners. A recession in one country will have knock-on effects in other member states. Since Germany found itself in the stronger position—being Europe's paymaster, having the eurozone's largest economy and holding a significant amount of PIIGS sovereign debt—it was in some sense able to dictate the terms of the bailouts and attach strict reform conditions, premised on the need to avoid a similar crisis in the future. But, since all member states, especially Germany, had a vested interest in keeping the euro together—for historical, political and economic reasons—the need to compromise was crucial. In game-theoretic terms, there were multiple equilibriums possible between the players, but some were more favourable towards creditor nations, while others were more favourable towards the debtors. Thus, from a state-centric interest point of view, the outcome of the euro crisis would be the result of the efforts of EU institutions to balance competing players' interests and find an acceptable compromise for all players involved.

The second approach to looking at why certain decisions were made is from an institutional lens. From this perspective, it is no surprise that the old contest between 'EU integrationists', who want to see a stronger role and more power for the EU Commission, and 'inter-governmentalists', who want to keep the main decision-making power in the European Council (comprising all EU heads of state), flared up once again during the eurozone crisis. The Maastricht Treaty had created a monetary union without a real fiscal union, no banking union and a 'no-bailout' clause, and therefore did not contain the institutional tools necessary to deal with a crisis of this nature. Money moved around freely between the eurozone member states' banks but was still regulated at the national level. Furthermore, the sole mandate of the ECB was to maintain price stability—a rate of inflation close to, but below, 2%—and Frankfurt lacked the far-reaching powers of the Federal Reserve in the USA to calm the markets through quantitative easing. Lastly, the Stability and Growth Pact (SGP), the surrogate for a real fiscal union, had been broken by France and Germany in 2003, and did not have real teeth. But even

if it had been adhered to by all member states, it was obvious that it would not have prevented the eurozone crisis from happening, especially since Ireland and Spain had been running substantial fiscal surpluses—not deficits—during the years preceding 2010. Moreover, the overall structure of the EU by definition makes it hard to deal with real-time financial crises. The eurozone's 'hyper consensus' model on fiscal and financial issues means that consensus development is much like herding cats: 17 finance ministers have to agree on a joint response, rather than just one Treasury Secretary, as is the case in the United States (Hix 2008).

The main institutional innovations during the crisis were incremental rather than radical, underlining the path-dependent nature of EU integration, at a time when more radical changes were probably needed to take full control of the crisis at the EU level. The centrepiece of those institutional efforts was the new Fiscal Pact, which was signed in early 2012 by 25 of 27 EU member states. The Fiscal Pact really was nothing more than a stricter version of the SGP, with a heavier emphasis on balanced budgets and quasi-automatic sanctions that would be harder in the future to ignore. However, there was a lack of real progress on correcting for external imbalances and no agreement on establishing a European rating agency to compete with the three main American ones. On the most important institutional questions—a catch-22 where Germany wants closer 'political union' before committing to Eurobonds, while France insists on an 'economic government' and the establishment of Eurobonds before committing to a political union—little progress was made. However, the EU-wide banking union and Single Supervisory Mechanism will probably see the light of day in 2014 with expanded regulatory powers for the ECB, but is unlikely to be sufficient to solve the crisis. The main flaw of institutional design—that of an incomplete monetary union which lacks a real fiscal and financial union—remains and is unlikely to be agreed on as long as nation states insist on keeping their monopoly power over taxation and spending.

The third approach to understanding the various eurozone responses to the crisis is ideational or from the point of view of different paradigms. This approach says that the euro crisis, at its heart, was a battle of ideas. Given the environment of high uncertainty and complexity, the way the crisis was described or narrated was just as important as the objective facts themselves. This paradigmatic approach suggests that, to understand any solution to the crisis, one needs to look at which economic ideas informed Europe's decisions and why.

Throughout the crisis, there was constant tension between two opposing economic paradigms. On the one hand there was what one could call the 'French-Mediterranean' Keynesian view, which emphasized growth, a European economic government, the need to avoid IMF involvement at all cost, and arguing that similar crises in the future should always be solved by political actors. On the other hand, there was the 'German-Northern European' *Ordoliberal* view, which emphasized price stability and national fiscal discipline, the need for IMF conditionality and technical assistance for any bailout, and quasi-automatic rules to deal with similar crises in the future. Given Germany's growing position of strength during the euro crisis, the ideas held by its policy elites proved crucial when putting together a joint response. Hence, one can see Germany's influence in the eurozone response in the heavy emphasis on 'putting one's fiscal house in order' and regaining competitiveness by cutting wages (crisis narratives number two and three), rather than focusing on fiscal solidarity, intra-EMU imbalances or the creation of Eurobonds (crisis narratives one, four, five and six).

The irony of this strategy, of course, is that it rests on a rather partial reading of what caused the crisis in the first place. In the case of Ireland for example, it is hard to understand why a fiscally sound country which had slashed public spending and public sector wages in response to the 2008 financial crisis, well before the eurozone sovereign debt crisis emerged, could solve a banking crisis with even more austerity measures. Yet, that is what all countries that requested a

bailout ended up doing. There is a fallacy of composition at the heart of this logic, namely that the debtor countries should all become more like Germany. But this is of course impossible. The rest of Europe cannot become more like Germany if the whole point is that Germany could only be Germany because the others were not. Not everyone can be a net exporter by saving more than they invest. We still do not trade with Mars or Venus. Any current account surplus means that another country has a current account deficit. Any creditor nation needs a debtor nation (Matthijs and Blyth 2011). As long as austerity was the only answer, the crisis would worsen in the short term, with debt-to-GDP ratios increasing, as they had in the case of the Mediterranean eurozone members, with the markets responding by charging higher interest rates, which would only exacerbate the problem. Thus, with the German paradigm holding sway and informing the main narrative of the eurozone crisis, all other possible solutions would be ignored.

The euro's prospects and lessons for global governance: balancing the demand for legitimacy with the need for effectiveness in order to stay relevant

Given the clash between competing interests, weak institutions and contradictory ideas, it should be no surprise that the eurozone sovereign debt crisis has lasted as long as it has, and continues to last at the time of writing. Since—with the notable exception of the Belgium–Luxemburg Economic Union (BLEU)—no multi-state monetary union has ever survived without some kind of political union, there are also no good historical examples from which to learn. The logic of a fully functioning monetary union rests on a solid supranational institutional foundation that the eurozone still lacks. The ECB can bring temporary relief by intervening in the bond markets, but cannot be a substitute for real fiscal and political integration, at least not permanently. As Benjamin Cohen summed it up in the opening quote of this chapter, Europe is caught between the centrifugal logic of domestic politics and the centripetal demands of a supranational currency union. While Eurosceptic analysts who expect the euro to fail underestimate European elites' commitment to European integration, Europhile observers overestimate the willingness on the part of those same elites to give up their fiscal sovereignty. The balancing act remains arduous and needs to marry the conflicting demands for democratic legitimacy (which remains at the national level) and the absolute need for policy effectiveness (which can only be achieved at the supranational level). The most likely outcome in the short and medium term therefore can only be 'muddling through' (Cohen 2012).

However, 'muddling through' does not guarantee that the euro experiment will eventually stumble its way to success. Indeed, the crisis—far from over—may lead to even greater divergence, with some suggesting that dissolution is the only outcome. More immediately, the markets may force the hand of EU leaders. Short-term national interests, informed by misguided ideas, may trump the need for long-term institution-building. In other words, things may need to get worse before they get better: as long as there is no real existential crisis it is unlikely that the European Union will make a dramatic step towards closer political integration, since the short-term costs would be substantial. However, many EU integration observers believe that Europe has emerged stronger out of every past crisis and has always responded with closer integration and new institutions.

That may well be true, but this crisis may also really be qualitatively different from previous ones. Giving up sovereignty over fiscal policy goes to the heart of what the modern nation state is all about; and the nation state is still, for better or worse, where democratic legitimacy lies. What the euro crisis has underscored is that monetary policy is not a mere 'technical' issue, as

was believed in the early 1990s, but an issue that many believe should be subject to democratic oversight (McNamara 1998); thus it becomes a political issue as well. Nevertheless, as hard as it is to expect Europe's leaders to give up their powers in fiscal affairs voluntarily, as they have done in monetary affairs, it is just as difficult to imagine them willingly letting the eurozone collapse. The commitment of EU elites to the project of European integration remains as strong as ever, and no politician wants to be responsible for its failure. If the crisis gets a lot worse, an effective comprehensive solution, that is fiscal and political union, could well be agreed upon.

The lessons for global economic governance are threefold. First, monetary and financial policy is not purely a technical matter as it was believed to be at Maastricht. What central banks do in times of financial crises directly affects the lives and welfare of ordinary citizens. For this reason, which powers central banks have, and how transparent their decision-making is, will always to some degree be influenced by pressure from national governments, and governments in turn by pressure from the public through legitimate democratic processes (as we saw with the election of anti-austerity parties in Greece and France). Moreover, giving up monetary powers to a supranational central bank means giving up inflation and devaluation at the national level, which are two powerful financial tools in a time of crisis. Most countries in the future will think twice before they decide to do so. Thus, the euro crisis showed that a financial crisis at the regional level is highly political. Trying to apply a technical fix to what is ultimately a political problem will not work. The political aspect must be acknowledged and addressed from the start.

Second, do not start a monetary union without a working fiscal and banking union, common deposit insurance and a common debt instrument. While the institutions of the eurozone worked well enough during the upswing of the economic cycle, it proved incapable of dealing with the multiple demands of a full-blown financial crisis. Because of the negative experience with the incomplete institutions of the eurozone, other regional arrangements in the world like Mercosur in Latin America and ASEAN in South East Asia will be careful not to take too many bold and simultaneous steps towards closer economic integration.

Third, global or regional financial crises do not automatically lead to major institutional reforms that prevent similar crises from happening in the future. The problem of collective action at the international level remains as acute as ever, as the lack of action at the G-20 level has illustrated since 2010. Also, it is difficult to build global or regional institutions from the top down, even if there were international agreement on the form they should take and the mandate they should have. Domestic regulatory regimes inform regional arrangements, and regional arrangements will have to inform global ones.

Conclusion

In many ways a logical consequence of the global financial crisis that started in the US housing market in the summer of 2007, the European 'sovereign debt crisis'—as it quickly became known—raised serious questions about the original design and long-term viability of Europe's Economic and Monetary Union, and cast a dark shadow over the success of the European integration project itself. This chapter discussed seven contending and overlapping crisis narratives that informed at various times how Europe's heads of state and their finance ministers cobbled together various ad hoc bailout responses throughout 2010, 2011 and 2012, and at the same time tried to come up with a more permanent solution to avoid similar financial crises in the future.

To make sense of the various policy responses and compromises, the chapter focused on three principal theoretical lenses: the diverging interests among the various players, the relative

(in)effectiveness and power of Europe's supranational institutions to deal with 'real time' financial crises, and the battle of economic paradigms at the heart of the crisis in trying to determine how the eurozone should be governed in the future. Since disintegration and more radical reform of EU institutions are unlikely for multiple reasons, continued muddling through with only gradual, incremental steps towards further integration will continue in the medium term. But that does not mean that the euro will continue in its current form.

This chapter also discussed three lessons from the euro crisis that are informative for global governance issues: money is not a technocratic issue, but a political one subject to democratic control; monetary unions without an economic government, fiscal transfers or a common debt instrument will be at the constant mercy of financial markets; and financial crises do not always lead to major institutional responses, either national or global, that will prevent them from happening in the future. The main difficulty lies with resolving the tension between demands for democratic legitimacy at the national level with the need for policy effectiveness at the supranational level.

Economic integration needs strong institutions to survive and, as the euro crisis affirms, supranational institutions add a layer of technical and political complexity beyond the immediate ken of the traditional nation state and the public that it serves. As this chapter has demonstrated, interests, ideas and institutions all have a role to play in this theatre of economic convergence. How ideas inform interests, and what institutions these interests choose to uphold, will not only colour the details that define global economic governance, they will also determine whether the eurozone crisis was a mere growing pain or whether it was doomed from the start.

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