Understanding the Political Economy of the Eurozone Crisis

Understanding the political economy of the Eurozone crisis: A Political Scientist's Guide

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Abstract

The Eurozone crisis constitutes a grave challenge to European integration. This essay presents an overview of the causes of the crisis, and analyzes why has it been so difficult to resolve. It focuses on how responses to the crisis were shaped by distributive conflicts both among and within countries. On the international level, debtor and creditor countries have fought over the distribution of responsibility for the accumulated debt; countries with current account surpluses and deficits have fought over who should implement the policies necessary to reduce the current account imbalances. Within countries, interest groups have fought to shift the costs of crisis resolution away from themselves. The essay emphasizes that the Eurozone crisis shares many features of previous debt and balance-of-payments crises. However, the Eurozone's predicament is unique because it is set within a monetary union that strongly constrains the policy options available to policymakers, and vastly increases the interdependence of the euro crisis countries on each other. The outcome of the crisis has been highly unusual, because the costs of resolving the crisis have been borne almost exclusively by the debtor countries and taxpayers in the Eurozone.

1. Introduction

On January 1, 1999, eleven member states of the European Union (EU) triumphantly introduced a single currency, the euro. The Economic and Monetary Union (EMU) capped forty years of efforts to create a single market in which goods, capital, and people could move freely. With a common currency, that movement was powerfully facilitated. Ten years after its introduction, the leaders of the Eurozone – now increased to fifteen members, with four more waiting to enter – celebrated what appeared to be the successful launch of a new European currency.

But within a year of the proud celebration of the euro's tenth anniversary, the Eurozone was thrown into crisis. And the Eurozone crisis has, over the subsequent years, turned into the gravest crisis in the history of European integration, only rivalled by Britain's 2016 vote to leave the EU.

Why did this crisis emerge, and why has it been so difficult to resolve? After all, it took nine years for the Eurozone simply to return to pre-crisis levels of per capita output. This essay aims to answer these questions. It first analyzes the causes of the crisis, and then focuses on how the responses to the crisis were shaped by distributive conflicts at both the international and national levels.

The essay emphasizes three main points. First, the Eurozone crisis is just one in a long series of debt and balance-of-payments problems that the world has experienced in the past 200 years. As has been true of all of these crises, the eurozone crisis has led to stark political conflicts about its resolution, both between and within

states (e.g., Dyson 2014, Frieden 1991, Pepinsky 2009, Walter 2013). Debtor and creditor countries fight over the distribution of responsibility for the accumulated debt; countries with current account surpluses and deficits fight over who should implement the policies necessary to reduce the current account imbalances. Within countries, interest groups fight to shift the costs of crisis resolution away from themselves. The issue at stake, in the Eurozone as so often elsewhere, has been who would bear the burden of adjustment: who would make the sacrifices necessary to clean up the mess of accumulated, bad, debts (Frieden 2015b). These similarities of the Eurozone crisis with previous crisis allow us to analyze its political economy with tools that have been honed in Latin America, Asia, and other parts of the world (Copelovitch et al 2016).

Second, for all these similarities, the Eurozone's predicament is unique. Not only is this a debt crisis among developed countries, which has not happened since Germany in the 1930s.[1] This crisis has taken place in the unique setting of EMU, which involves a wide range of economic and political relations among members of a single market and a common currency. This strongly constrains the policy options available to policymakers, and vastly increases the interdependence of the euro crisis countries on each other. At the same time, the centrality of Europe's monetary union to the development of the EU makes a lasting resolution of the Eurozone crisis crucial to prospects for the future of European integration more generally. Nonetheless,

[1] Industrial countries have resources at their disposal that developing countries do not: stronger financial systems, better social safety nets, more established creditworthiness. So the parallels between Spain and, say, Argentina are strong, but not perfect.

although there has been more institutional reform at the European level than one would have thought possible at the outset of the crisis, these reforms have done little to resolve the Eurozone's root problems.

Third, despite this high level of interdependence, the political conflicts about sharing the burden of adjustment in the Eurozone crisis have played themselves out in unusual ways. One set of countries, the creditor states, have been exceptionally successful in shifting most of that burden onto the debtor states. It is not surprising that the Eurozone debt crisis has led to huge bailout programs combined with strong conditionality that have forced the crisis countries to implement harsh austerity measures and pushed the crisis countries into deep recessions; this is a commonplace of debt crises. But it is striking – and extremely unusual – that the creditors have not granted the debtor countries (with the exception of Greece and Cyprus) any significant debt relief or debt restructuring and that the burden of crisis resolution has been pushed almost entirely onto the shoulders of taxpayers in both debtor and creditor states. Nevertheless, no country has left the Eurozone so far, and the crisis countries have implemented austerity packages on a scale unprecedented in Europe. As a result, the costs of resolving the crisis have been borne almost exclusively by the debtor countries and taxpayers in the Eurozone.

2. Causes of the Euro Crisis

In its essence, the crisis in the Eurozone is a classic debt and balance-of-payments crisis.[2] Countries in the Eurozone borrowed heavily, largely to finance current consumption, as financial institutions in the rest of Europe were eager to lend. Large current account imbalances developed, as capital and goods flowed out of countries with current account surpluses into those countries with current account deficits. Borrowing fed economic expansion, which grew into a boom, then a bubble, largely in housing markets. When the bubble burst, lending dried up, and the heavily indebted countries found themselves unable to service their debts, unable to make up for the collapse of domestic demand by exporting, and unable to borrow additional funds in order to cover their continuing payments deficits. As with all debt and balance-of-payments crises, the result was economic distress and political conflict. In this section, we provide an overview of the origins of the crisis.[3]

Macroeconomic divergence and capital flows with a single currency

In the late 1990s, Economic and Monetary Union (EMU) was completed and the euro came into existence. By definition, the monetary authorities of a single currency area – including a nation-state – must adopt a single monetary policy. This can be economically and politically difficult when different regions, and different groups within regions, face different conditions (Mundell 1961). At the time of the creation of

[2] The two are roughly identical: a country running a balance of payments deficit is accumulating debts. The payments balance measures flows; debts are a measure of stocks.

[3] Baldwin et al. (2015) provide a very useful compendium of the now generally accepted consensus among economists about the economic causes of the crisis. The discussion here parallels the consensus view presented there.

the Eurozone, there were major divergences among the macroeconomic circumstances of its constituent member states. These countries varied significantly with regard to growth and inflation, as well as in their institutional configurations and growth models (Hall & Franzese 1998, Iversen et al 2016, Johnston et al 2014).

The experiences of Germany and Spain are typical. Between 1998 and 2007, inflation in Germany averaged 1.5% a year, compared to 3.2% in Spain. Over the decade this led to a substantial divergence in prices. Moreover, German labor-market institutions led to wage restraint, which was not the case in Spain, so that wages diverged even more: in those ten years, unit labor costs in Germany fell by 3.9% while in Spain they rose by 30.4%.[4]

The European Central Bank (ECB) had to devise one monetary policy despite this divergence in national economic conditions. Not surprisingly, it tended to choose an interest rate somewhere between what would have been ideal for slow-growing countries such as Finland, Germany, France, Benelux, and Austria and the fast-growing periphery in Ireland and Southern Europe. This did little to combat slow growth in the core, where domestic investment opportunities were limited, and created strong incentives to invest abroad both in the Eurozone and outside it. At the same time, low or negative real interest rates in the periphery gave these countries substantial incentives to borrow.

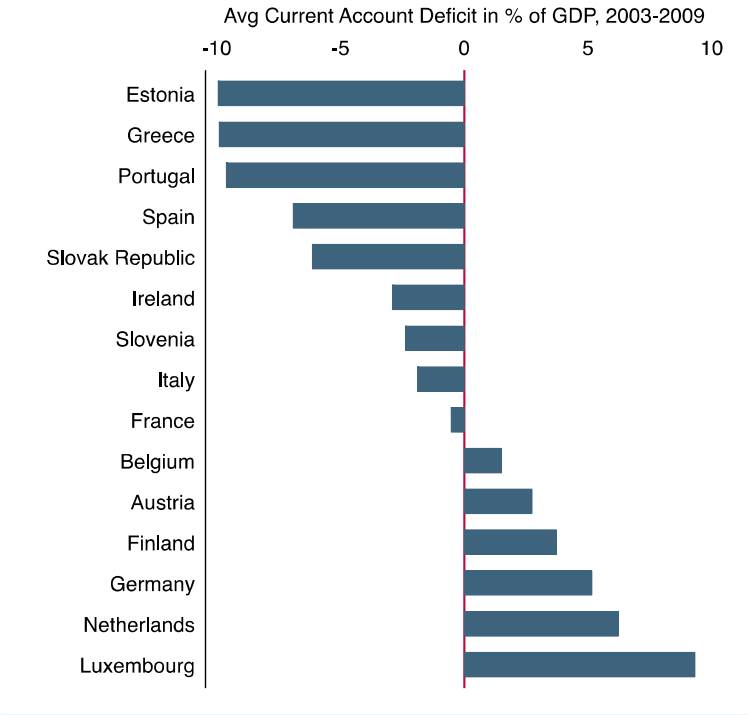
The difference in underlying conditions thus interacted with monetary policy to encourage capital flows. Almost immediately, financial institutions in slow-growing

[4] Data are from Frieden (2015a), chapter 4.

northern European countries searched for higher-yielding opportunities in the more rapidly growing periphery in Central, Eastern, and Southern Europe and capital began flowing from the North to the periphery. Most of the loans ended up going into the periphery's expanding housing market and the related construction industries. In Portugal, and especially in Greece, the government also took advantage of rock-bottom interest rates to finance growing public deficits.

The process was self-reinforcing: the more capital flowed into Spain or Ireland, the faster they grew and the more asset prices there rose, the more attractive they looked to lenders, drawing in still more capital (for overviews, see for example Lane 2012, Wihlborg et al 2010). Borrowers and lenders fed an upward spiral, with capital flows driving expansion and expansion encouraging further capital flows. The result was first a boom, then a bubble, primarily in housing but in asset markets more generally. At the same time, unit labor costs and real effective exchange rates rose significantly, eroding competitiveness especially vis-à-vis the core economies, where wage bargaining institutions allowed for wage moderation (Johnston et al 2014). As a result, large current account surpluses in the core and similarly large current account deficits in the periphery emerged (see figure 1). The Eurozone experience thus had all the features of a classic capital-flow cycle.

Figure 1: Average Current Account Deficits in the Eurozone, 2003-09



Bailout expectations

These dynamics were further fueled by an expectation on the part of investors that in the event of a crisis in one of the debtors, the other member states would be forced to intervene. It was clear that contagion from a financial crisis in one country would be extremely rapid, and potentially extremely damaging, within a common currency area. The expectation was that EMU made each member state "too connected to fail," as a result of which a country in financial distress would be bailed out.

Governments understood that this bailout problem created moral hazard. The knowledge that the other states would be likely to bail out a country in financial problems could induce reckless behavior, which in turn might in fact make a bailout

necessary. Faced with the prospect of this moral hazard, the founding governments of the Eurozone declared that there would be no bailout.

However, the "no-bailout" declaration rang hollow. It was not enough simply to say that there would not be a bailout, for investors and other observers had long experience with governments being forced into bailouts against their will and better judgement. What could, and should, have been done, was to design an institutional structure to deal with financial difficulties in one member state – a highly conditional fund patterned on the IMF, a plan to wind up troubled banks, a mechanism to restructure debts. But some of the principal member states seemed to believe that any discussion of ways to deal with a financial crisis would only stimulate fears, and so the member states never considered a strategy more pragmatic and realistic than simply saying "No" over and over.

The result was that the "no-bailout" commitment was not credible. Bailout expectations meant that even the least creditworthy member states were able to borrow at rates roughly equivalent to those charged to Germany (Chang & Leblond 2015) . This was especially striking in the case of Greece, which joined the Eurozone in 2001. No sensible observer regarded Greece as a credit risk equivalent to Germany; but the expectation was that if Greece got into trouble, Germany and other more creditworthy member states would bail it out. And, of course, the ability of the Greek government to borrow at unprecedentedly low interest rates gave the government major incentives to borrow far more than was prudent.

Inadequate policy responses

European policymakers could have responded to the build-up of these imbalances by implementing appropriate fiscal policies. Germany and other northern European countries could have stimulated domestic economic growth, and absorbed more of their own savings, with an expansionary fiscal policy of tax cuts and spending increases. This would have reduced their current account surpluses, and kept more capital at home. Similarly, the peripheral European countries could have counteracted the slippery slope to a boom and bubble with more restrictive fiscal policies. Portugal and Greece were running government budget deficits, and they certainly could have dampened the irrational exuberance with tax increases and spending cuts. The Spanish and Irish government budgets were balanced, but the logic of counter-cyclical fiscal policy would have dictated that they accumulate surpluses – again, raising taxes and cutting spending – so as to restrain their overheated economies.

However, there was little or no national interest in adopting the appropriate counter-cyclical fiscal policies – in fact, fiscal policies became more pro-cyclical after the euro was introduced (Bénétrix & Lane 2013). Germans appeared perfectly happy to see their financial institutions lend wildly to the European periphery, even while they maintained their traditional fiscal conservatism at home. Spaniards and others in the fast-growing periphery had no interest in reducing the pace of economic growth.

The principal argument for altering national fiscal policies was that it would help stabilize the Eurozone as a whole; but no nation's politicians, or public, seemed concerned about the Eurozone as a whole, focusing instead on domestic matters. In

other words, for fiscal policies to have their full effect, member-state governments would have had to cooperate in designing and implementing them in the interests of a common purpose; and there was little or no political support for altering national policies in order to serve a vague Eurozone-wide common purpose. Attempts to coordinate fiscal policies at the EU-level through the Stability and Growth Pact also largely failed (Alt et al 2014, Baerg & Hallerberg 2016). As a result, fiscal policies remained uncoordinated, and indeed exacerbated the underlying macroeconomic imbalances (Lane 2012).

It is interesting and important to note that this was not a solely Eurozone phenomenon. The United States and the United Kingdom, for example, also experienced large-scale capital inflows that led to rapid increases in the price of assets, especially housing, eventually leading to a housing bubble. In that sense, the process in the Eurozone was simply a microcosm of what was happening elsewhere. But EMU made a difference. One main difference was that the non-Eurozone countries that were undergoing this capital-flow cycle had full independence to design their own monetary policies, including the ability to devalue the exchange rate, an ability that proved particularly important when the bubble burst. Another was that they were less interconnected to each other, and a third was that their fiscal policies produced fewer externalities than in the Eurozone.

These features reflected gaps in the original design and implementation of the Economic and Monetary Union. They were widely understood at the time, and observers on both sides of the Atlantic warned that they would need to be addressed

(for an overview, see Jonung & Drea 2010). It was well understood that the ECB would have trouble designing one monetary policy for such a disparate set of countries, and that the absence of fiscal policy coordination would cause problems. And the central issue of a prospective bailout, and of the lack of credibility of the no-bailout commitment, was also generally understood (e.g., Frieden 1998).

But attempts to address these issues ran, over and over, into domestic and international political realities that militated against their resolution. No government was willing to alter its policies enough to deal with the systemic dangers that were building up in the Eurozone. And so as lending grew, the borrowing economies expanded, and asset and housing prices rose, neither national governments nor the institutions of the European Union and the Eurozone were able to address the stresses and strains that informed observers knew were building up.

The bubble bursts: How a private debt crisis turned into a sovereign debt crisis

The global financial crisis that began late in 2007 brought the merry-go-round to an end. Peripheral European nations faced a "sudden stop." The lending spigot was shut, and the borrowing nations were left with massive debts, a collapse in housing and other asset prices, and a terrible recession. It was soon clear that the continent's financial system was saddled with trillions of euros in debts that were very unlikely to be serviced as originally contracted, presenting a serious threat to the health of financial institutions that had been lending. Without direct intervention, European finance was likely to collapse.

The Eurozone crisis began in earnest when in late 2009, the Greek government disclosed that Greece had lied about its public deficit for years, and disclosed a budget deficit much larger than had previously been reported.[5] Spreads on Greek bonds surged, and soon the Greek government found itself unable to service its debt. A few months later, a first, then a second bailout package was put together to help Greece weather the crisis. Financial markets, it turned out, had been right to doubt the "no-bailout" commitment.

Whereas the Greek crisis was a genuine sovereign debt crisis, it is important to understand that for most other Eurozone countries this crisis did not result from government borrowing (Blyth 2013). In fact, at its outset, the crisis was mainly one of private loans to private borrowers – a private debt crisis and not a state-to-state issue at all. But as the crisis evolved, this slowly changed and eventually evolved into a sovereign debt crisis. It came to implicate national governments at least in part due to the unwillingness or inability of debtor and creditor governments to force "their" private financial institutions to bear the full costs of their mistakes.

Two things contributed to this evolution. The first was the general concern that problems in one nation's private sector could affect general economic conditions in the country as a whole. This commonplace view gives governments reasons to be concerned about private financial difficulties, as a loss of confidence in the banking system can lead to a more generalized loss of confidence in the economy as a whole.

[5] For a precise trajectory of the crisis see, for example, Copelovitch et al. (2016).

Despite the private-to-private nature of the vast majority of the loans when the crisis hit, problems would inevitably affect general economic conditions and thus were of concern to national governments.

A second development was crucial in turning a private debt problem into a major issue among governments. As debts went bad in the debtor nations, debtor-country banks risked illiquidity and insolvency. To prevent a financial meltdown, governments ended up assuming many of the bad debts of their banks – converting private into sovereign debts. But this led to growing public debt, which increased the country's sovereign credit risk, which further weakened the financial system, and thus created a negative bank-sovereign loop (Acharya et al 2014). In Spain, for example, the government stepped in to nationalize or bail out its troubled banks, in the process borrowing heavily to finance the bailouts. Financial institutions in the creditor nations similarly faced collapse as their debts went unserviced, leading governments to devise means to support its financial sectors. Whether this socializing of losses was due to the fear that not intervening would have caused major economic disruptions; or to the desire to shore up economically and politically important private banks, it should be clear that both debtor and creditor governments chose to shunt the costs of the crisis almost entirely onto the backs of taxpayers.

With peripheral governments now heavily in debt to creditor governments, and more broadly to other Eurozone member states and to Eurozone and EU institutions, the intra-European politics of the debt crisis became particularly troubled. As always, the core question was which countries would bear the principal costs of dealing with

the accumulated debts: how the adjustment burden would be distributed (Dyson 2014, Frieden 2015b).

3. Crisis resolution: Options and Choices

The main issue of contention in debt crises is how to deal with accumulated bad debts. One option is for debtor countries to *repay the outstanding debt*, mobilizing domestic resources by cutting spending or increasing taxes. Another option is for creditor countries to grant *debt restructuring*, providing some relief to debtor countries. This creates a conflict of interest: creditors want to be paid back in full, or as close to that as possible, while debtors want their debts to be restructured and reduced to the largest extent possible. Both sides have bargaining chips: creditors threaten to block future access to credit, debtors threaten to stop payment. This is why in most debt crises, creditors and debtors share the debt burden, although the precise terms vary.

Debt are closely related to balance-of-payments crises. The resolution of debt crises concentrates on the stock of accumulated debts, whereas the resolution of BOP problems focuses on economic adjustments to address the flow problem of continuing current account imbalances that fuel the debt problems. BOP deficits imply that the country imports both more goods and capital than it exports, which means that current account deficits are associated with rising external debt levels. Not surprisingly, all the main Eurozone crisis countries ran sizeable current account deficits in the years before the crisis (see figure 1). Thus, to resolve a debt crisis, debtor countries not only have to resolve the problem of accumulated debts but typically also have to turn their current

account deficit into a surplus, to start exporting more goods and services than they import in order to earn the funds needed to repay the accumulated debts (the alternative is, of course, to default or restructure those debts). Likewise, creditor states can contribute to resolving these crises by boosting domestic demand to reduce their current account surplus.

Policymakers have several policy choices at hand when it comes to resolving the flow problem of BOP imbalances (Broz et al 2016, Walter 2013). The necessary policy adjustment can occur in both surplus and deficit countries, in an externally or internally oriented way; and adjustment can be avoided altogether if the current account deficit is financed by external sources of money instead (see Table 1).

Table 1: Options for resolving BOP imbalances

	EXTERNAL ADJUSTMENT	**INTERNAL ADJUSTMENT**	**FINANCING**
DEFICIT COUNTRY	Exchange-rate devaluation	Austerity and structural reforms	Cover funding gap through external funding
SURPLUS COUNTRY	Exchange-rate appreciation	Inflation and reforms aimed at boosting domestic demand	Provide financing for deficit countries with BOP problems.
IMPLICATION FOR THE EUROZONE	Euro breakup	Convergence of deficit and surplus countries	Permanent financing structures (e.g., fiscal federalism, automatic stabilizers etc.)

The first option for rebalancing the current account, *external adjustment,* involves a change of the country's exchange rate. This has been the standard response for deficit countries in the past. By devaluing its currency, domestic products become more competitive, which reduces imports and stimulates exports. A surplus country can revalue its currency, making domestic products more expensive relative to foreign products, thereby increasing imports and reducing exports.

In contrast, *internal adjustment,* means that relative prices are adjusted through domestic macroeconomic policy changes and structural reforms. For deficit countries, this strategy is also known as "internal devaluation" and implies austerity policies such as public spending cuts and tax increases, and structural reforms that increase competitiveness. Because these measures aim at reducing domestic demand and a deflation of domestic prices, they are typically associated with increased unemployment, lower wages, asset price deflation, and recession. For surplus countries, internal adjustment implies policies that increase relative prices, for example through loose monetary or fiscal policy or reforms that stimulate domestic demand and increase inflation.

Both internal and external adjustment can be painful and costly for policymakers. Devaluations often cost policymakers their jobs (Frankel 2005) and recessions reduce politicians' reelection chances. Policymakers therefore frequently resort to a third option: *financing the current account deficit* with public funds. Initially, deficit countries often respond to BOP pressures by drawing on their foreign currency reserves. When these dry up, they need external support. Surplus countries, which

tend to be the creditors of deficit countries, are often willing to grant such support, either bilaterally or through international organizations such as the IMF, because it not only reduces the risk that a deficit country defaults on its debt, but also allows surplus countries to forgo adjustment at home. But the financing strategy has one important downside: it does not resolve the underlying structural BOP imbalances, and often aggravates them, so that this approach carries the risk that eventual adjustment will have to be more extensive than if it had been implemented early on (Frankel & Wei 2004). Debt and balance-of-payments crises thus confront policymakers with a list of unattractive options. Different socioeconomic groups, and, at the aggregate level, different societies differ in the extent to which they are vulnerable to each of these options. It should therefore come as no surprise that distributive concerns - both within countries and among countries – always influence the politics of resolving debt and balance-of-payments crises.

What does this mean for the politics of the euro crisis? In principle, these policy options exist in the euro crisis as well. But because the debt and balance of payments crises occurred within a currency union crisis resolution has proven very difficult and the Eurozone's policy response is unusual in a number of respects.

In essence, Europeans have opted for a strategy that mainly relies on debt repayment by and internal adjustment in debtor states, coupled with temporary financing and expansionary monetary policy.[6] Large bailout programs have been set

[6] For simplicity, we will mostly refer to debtor and creditor states in the discussion that follows. But it is important to keep in mind that debtor states start from a position as deficit state, whereas creditor states usually start from a position as surplus country.

up, but crisis countries have been forced to implement austerity and reforms in return, and no meaningful debt relief has been granted.

On the one hand, this choice of crisis response – a combination of internal adjustment and financing rather than external adjustment and default – is not surprising. In the context of Europe's Economic and Monetary Union, external adjustment implies a *breakup of the Eurozone*. Different variants of such a breakup are thinkable, ranging from the exit of a single country to the formation of two or more currency blocs or the introduction of parallel currencies. But whatever its form, external adjustment would mean that the euro would cease to exist in its current form, and this would carry huge costs for everyone involved. For this reason, this adjustment path has so far been ruled out by virtually all Eurozone policymakers. Removing external adjustment from its menu of options, the Eurozone is left with the alternatives of internal adjustment and financing.

What is more surprising is the willingness of the debtor countries to accept the creditors' refusal to grant debt relief and their insistence that they should shoulder the burden of internal adjustment almost entirely, which has resulted in deep recessions and record levels of unemployment in the debtor countries, while creditor countries have been much less affected by the crisis. The costs of the crisis have hence been very unequally distributed among the countries of the Eurozone. And inequality with regard to burden-sharing does not end at the international level: The costs of crisis resolution has also been very unequally distributed within countries, where some groups have been much harder hit than others.

It is therefore not surprising that there has been a great deal of conflict both among and within countries. Coming on top of the complex political structure of the EU, and the high level of uncertainty regarding the viability of different policy options, these conflicts have resulted in the Eurozone's piecemeal approach to addressing the crisis, and help explain why many key issues still remain unresolved.

4. Crisis resolution at the European level: conflict among countries

Debt crises typically give rise to conflict between creditor and debtor countries, and the Eurozone crisis has been no exception. Creditors and debtors have squared off over how to address the enormous stock of accumulated debts; surplus and deficit countries have argued over who should be doing the adjusting. In the case of the Eurozone debts, inter-state conflict was complicated by the fact that private debts were quickly assumed by the governments of both debtor and creditor nations, and by European institutions more generally. Of course, this threw every interaction between debtor and creditor governments into the cauldron of intra-European politics, pitting national governments with divergent interests against one another.

Indeed, from the moment the crisis began, debtor and creditor states have jockeyed for position in this difficult bargaining interaction (Schimmelfennig 2015), leveraging both bargaining power and (mostly self-serving) ideas in the process (Bulmer 2014, Dyson 2010). Although they agreed that external adjustment – some form of euro breakup – was not an option, they agreed on little else.

Conflicts about how to share the adjustment burden

In these conflicts, both sides have weapons, which is why virtually all debt crises end with some form of compromise: creditors threaten to block future access to credit, debtors threaten to stop payment. Creditors typically hold most of the bargaining chips, for the threat of freezing errant debtors out of credit markets is very real, and very threatening. But debtors can and do threaten to default, which can cause damage to creditor financial markets. In the Eurozone crisis case, both sides have had additional weapons, given their common membership in both the EU and the Eurozone. Creditors could and did threaten errant debtor states with expulsion from the EU or the Eurozone, although the legal basis for this was unclear. Debtors, for their part, knew that if one member state defaulted there was likely to be a panic on bond markets that would affect all member states – including the creditors.

This makes it all the more striking that the member states, and the institutions of the Eurozone, have shied away from what is the most common sort of response to a debt crisis, debt restructuring. Although there has been some debt restructuring in the cases of Greece and Cyprus,[7] there has been no debt relief or restructuring in Spain, Portugal, and Ireland. There have been financial rescue packages to help debtor governments meet their obligations in the midst of massive recessions, but there has been no meaningful debt relief. This is extraordinary, because virtually all debt crises eventually lead to some form of debt relief, just as corporate bankruptcies lead to a

[7] Greece's debt was so enormous that it was clear almost from the start that it could never be serviced, so significant portions of that country's debt have been restructured. In Cyprus, debt restructuring was part of the conditions attached to a bailout package from the Troika.

restructuring of the bankrupt company's liabilities. As with corporate bankruptcies, it is widely recognized that debt relief can be beneficial to both debtors and creditors, inasmuch as it puts troubled debts on a sounder footing. Debt restructuring, indeed, is widely regarded as a very common Pareto improvement. To be sure, it is not uncommon for the principal adjustment burden to fall upon the debtor countries. But the absence of any real debt relief for the three principal Eurozone debtors thus makes this crisis extremely unusual – perhaps even unique – among sovereign debt crises.

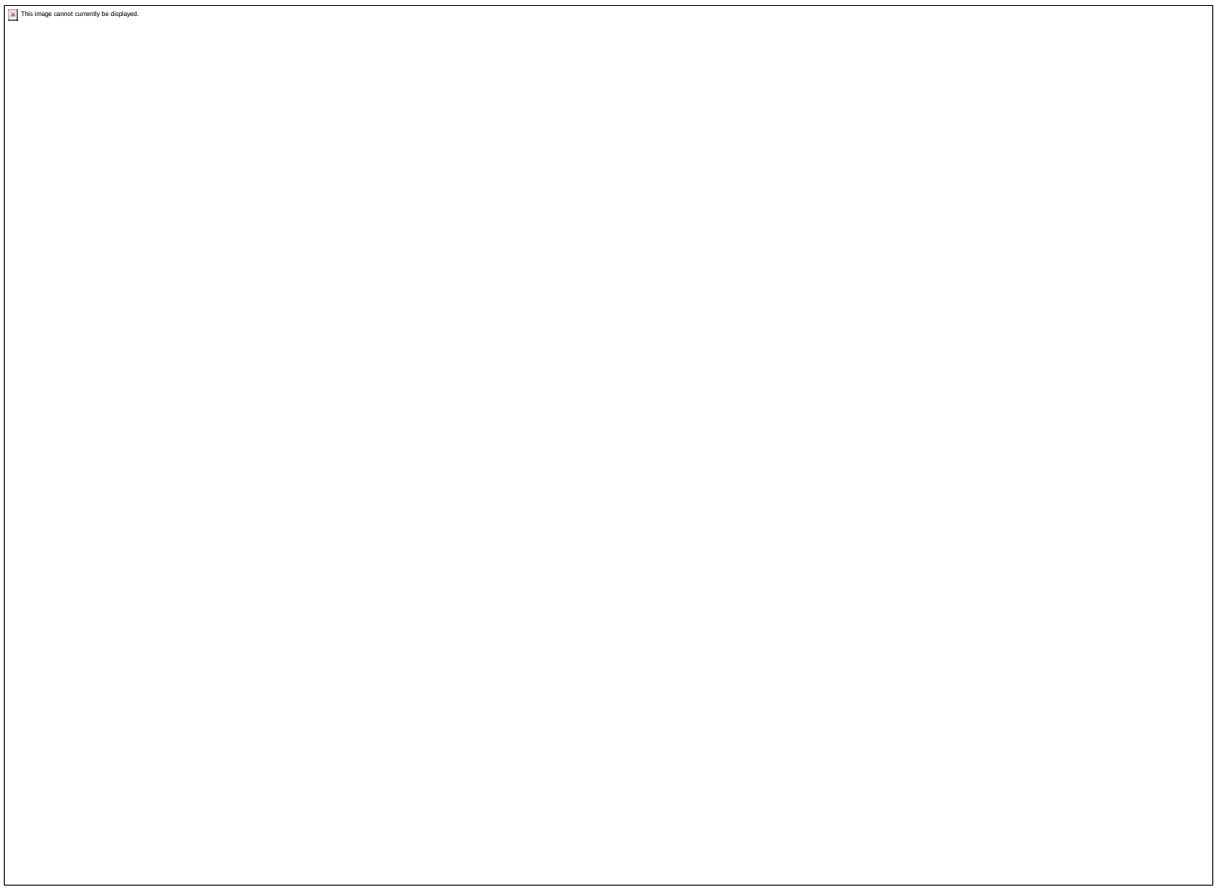
Pressure from creditor countries has also, as is often the case, taken the form of insistence that the debtors undertake substantial structural reforms in order to address chronic balance of payments problems (Copelovitch & Enderlein 2016, Hall 2012). But Spain and Ireland are not developing countries, and pressures from creditors have led these countries to predominantly rely on austerity rather than significant reforms of social policies or labor market institutions.[8] The effect of this strategy on economic growth and employment prospects in these countries has been harsh.

As a result, in the Eurozone crisis, the burden of adjustment has been put almost exclusively on the shoulders of the debtor countries. Figure 2 illustrates how unequally the costs of the adjustment have been spread across Eurozone countries. It shows how different Eurozone countries have fared throughout the crisis, tracing their economic development between 2007 to 2013 (noted by a triangle). It shows that the five main Eurozone debtor countries – Ireland, Italy, Portugal and especially Spain and Greece

[8] Indeed, it has also been difficult to credit insistence on structural reforms when so many of the creditor countries have been unable or unwilling to carry them out themselves.

– have witnessed massive increases in unemployment. GDP had fallen back to the levels of when the Eurozone was founded in three of these countries (the 1999 level is represented by the value of 100), and GDP decreased significantly in all five debtor states. In contrast, the economic cost of the crisis have been much smaller or even nonexistent in the creditor states.

Figure 2: Crisis cost for selected Eurozone countries



Several reasons can be adduced for the fact that the principal burden of adjustment to the Eurozone crisis has fallen upon the debtors. The first is, as mentioned, the general fact that creditors have a very powerful weapon, the threat of financial exclusion. This threat is particularly serious for European countries, which are tightly integrated into European financial markets, and for which exclusion from those markets would be very damaging. A second consideration in the Eurozone case is that creditors have also invoked the requirements of broader EU and Eurozone membership, implying – sometimes stating – that something less than full repayment could result in expulsion from the Eurozone or the EU. Third, whether the threat of expulsion is real or not, certainly the extent of financial and commercial integration among EU members is so high that any loss of credibility on the part of the government and firms of one nation could be extremely costly. This last factor helps explain why many in the debtor countries have in fact been reluctant to press the issue, for fear that it might affect their own economic relations with the rest of the Eurozone. Fourth, the Eurozone creditors used their political influence over the International Monetary Fund to force the IMF to ignore the Fund's own rules, which would have required substantial debt restructuring (IEO 2016). This eliminated the possibility that the involvement of the Fund – a repository of decades of experience in dealing with debt crises – would be objective and even-handed.[9] Finally, emphasizing ordo-liberal ideas,

[9] The report of the IMF's own Independent Evaluation Office (IEO 2016) makes this very clear. The role of political pressure from creditor countries is mentioned, for example, on page 42.

creditor countries have been successful in framing the crisis in ways that suggest that deficit countries caused, and hence should resolve, the crisis (Blyth 2013) .

Conflicts about how to reform the Eurozone

The crisis has also led to some attempts to rework the Eurozone itself. The member states have devised a series of Eurozone-wide mechanisms to attempt to address the fallout of the crisis, and avoid a recurrence. Every step of the way has been controversial (Howarth & Quaglia 2015). While there have been some modest efforts at greater fiscal policy coordination, these have been extremely limited and have had little impact. Instead, attempts to confront the crisis have centered on monetary policy, although the ECB implemented expansionary policies much later than its US and British counterparts. The member states also agreed to a banking union that centralizes and harmonizes a great deal of financial regulation under the auspices of the ECB (Howarth & Quaglia 2014).

Perhaps the most important such institutional innovation is the development of a Eurozone bailout fund, the European Stability Mechanism, to make loans to troubled debtor governments.. The process began with the establishment of two temporary funds, the European Financial Stability Facility and the European Financial Stabilisation Mechanism, which provided funds to troubled debtors (Gocaj & Meunier 2013). In 2012 the member states agreed on a permanent European Stability Mechanism (ESM), to lend to countries in distress. The ESM was capitalized at 80 billion euro, with a total lending capacity of 700 billion euro. Access to ESM funds

depends on approval by the "Troika," the European Central Bank, the European Commission, and the International Monetary Fund (IMF). And use of ESM funds binds the country in question to carry out macroeconomic and other economic policies designed to address enduring payments imbalances. While the ESM is relatively new, it is clear that its operation will raise many of the political issues present in debtor-creditor relations more generally. In a sense, the ESM is like a Eurozone IMF, with all that implies. Member states all want such a mechanism; but they disagree fundamentally on what it should require of governments that have recourse to its funds.

There have been continuing conflicts over other proposals, both to address the crisis and to try to prevent future crises. One discussion has centered on financing, which could provide a route out of this impasse. If financing were provided in a permanent fashion, adjustment would be needed on a much lesser scale. Permanent financing implies some form of a transfer (or fiscal) union, be it in the form of Eurozone-wide welfare policies, Eurobonds, or direct transfers. One very popular suggestion, but forth by a number of economists and eventually supported by the European Commission, was for Eurozone member states to jointly issue bonds backed by all (see for example De Grauwe & Moesen 2009). This would have shared both the risk, and the benefits, of pooling sovereign borrowing. While it clearly benefits the less creditworthy countries more than the rest, there is some reason to believe that it would have enhanced sovereign debt markets more generally, adding to their depth and liquidity. In the event, the idea was opposed by the German government, and has not

been pursued. More generally, financing proposals have faced the problem that they are unpopular in both surplus states – because they would likely foot the bill – and deficit countries – because this would likely reduce their national sovereignty in economic policymaking. More importantly, such permanent financing schemes would require more political integration than is currently feasible.

It is important to recognize that the principal cause of the failure to address the crisis is to be found in the actions of the member states. Certainly the European institutions have not helped much, with the exception of the ECB. But the real obstacle to a constructive resolution of the crisis is that the national governments simply have not been able to agree on how to move forward. The governments of creditor nations have continued to insist that the debtors must shoulder the adjustment burden, contending that only austerity can bring them out of their deep depressions. The governments of debtor nations have persistently maintained that only some form of debt relief will make the burden bearable. Meaningful negotiations to address the core problem, the weight of accumulated debts, have been deadlocked for years, with little sign of forward movement. And it is primarily the member states that are responsible for this deadlock.

The failure of the member states, and of other EU or Eurozone institutions ,to address the debt crisis has left the ECB as the principal – practically sole – Eurozone economic institution capable of attempting to address the crisis. The ECB has in fact taken quite aggressive measures, including a substantial bond-buying program to shore up financial markets, and a monetary policy that has pushed interest rates into

negative territory. The ECB's policies have had some positive impact, especially on confidence in the euro, but the ECB alone was not enough to counteract the massive recessionary impact of the debt overhang.

As might be expected, ECB policy has also been controversial. For many in northern Europe, the central bank's low (even negative) interest rate policy is anathema, limiting the returns to their savers. For many in peripheral Europe, the central bank has not done enough to alleviate the impact of the crisis. Overall, the ECB has become embroiled in political disputes, something its architects explicitly tried to avoid.

One of the more serious effects of the Eurozone debt crisis, and of the inadequacies of the policy response to the crisis, has been the wedge it has driven among Eurozone member states. Rather than build cohesion among the members of the Economic and Monetary Union, the crisis has driven countries into warring camps, each side blaming the other for the crisis and for the extraordinarily slow recovery. Governments in the Eurozone remain at loggerheads over how the address the aftermath of the crisis, and how to move forward once it is past (Dyson 2014).

Overall, neither the institutions of the European Union, nor the constituent member states, have effectively addressed the crisis (Jones et al 2015). There has been no effective coordinated fiscal response, no debt restructuring for any country but Greece and Cyprus, and little substantial reform to national or Eurozone institutions. After years of ongoing problems, the root causes of the crisis are still not resolved

5. Domestic crisis resolution: Politics within countries

The euro crisis has also been characterized by strong distributive conflict *within* countries about how the costs of crisis resolution should be shared. Such conflicts have taken place in both debtor (deficit) and creditor (surplus) states.

These conflicts have not been fought as conflicts about the appropriate adjustment strategy, but mainly as conflicts about how to implement an internal adjustment strategy (in deficit countries) and how to provide financing and avoid internal adjustment (in surplus countries). This is because external adjustment – that is leaving the euro, forcing one country to leave the euro, or splitting up the Eurozone – has rarely been regarded as a viable option. Support for the euro has remained remarkably high in all Eurozone countries throughout the crisis (Hobolt & Wratil 2015, Roth et al 2015). Although in deficit states most people express a preference for the rather impossible crisis strategy of keeping the euro and ending austerity at the same time (Clements et al 2014, Fernández-Albertos & Kuo 2016), they have shown a strong preference for the euro when pressed to choose between the two (Dinas et al 2016).

So far, only populist parties have called for their country to leave the Eurozone or a dissolution of the Eurozone altogether (Heinen et al 2015): among the creditor states, the Dutch PVV, the German AfD, the French Front National, and the Austrian FPÖ have called for a controlled dissolution of the Eurozone, with the True Finns in Finland taking a critical but more cautious position. Among the deficit countries, there has been a strong push for a referendum on the euro in Italy, supported by Beppe Grillo's Five Star Movement, the Lega Nord, and Forza Italia and in Greece the

communist KKE and the SYRIZA-spinoff Popular Unity have proposed leaving the euro. But in addition to virtually all other parties, there are also a two important populist parties who do not support leaving the Eurozone: Podemos (Spain) and SYRIZA (Greece).

Thus, with the external adjustment option off the table – at least for the time being – national political conflicts have centered on how to manage the crisis within the preferred strategy of internal adjustment in deficit states coupled with some financing from surplus states.

Crisis politics in debtor states

Conflict has been most intense in debtor states, which were hit hardest by the crisis. As countries who have ruled out an exit from the Eurozone, they have been tasked to implement internal adjustment: spending cuts, demand compression, structural reforms. As in many other crises, this setting has created political difficulties, distributive conflicts, and turmoil around the question of how the resources necessary to service debts should be mobilized and which policy reforms should be implemented to rebalance the current account. Given that surplus countries have been unwilling to share the burden of adjustment, politics in deficit countries has centered on who will bear the brunt of the costs of the crisis: consumers, taxpayers, investors, government employees, pensioners, the unemployed, the export sector, the nontradable sector and so on.

Although the fallout from the crisis in deficit states has been huge, its impact has varied significantly among social groups. For example, even though overall unemployment and poverty rates have significantly increased across the board, the young have been hit hardest. Youth unemployment tripled in Ireland between 2007 and 2012, and between 2012 and 2014 more than half of economically active people under 25 in Greece and Spain were without work.[10] More generally, unemployment has hit the young, men and less educated people hardest (Gutiérrez 2014). Likewise, relative poverty rates for young people went up in Italy, Portugal and especially Spain and Greece. At the same time, relative poverty rates for the elderly declined considerably. Interestingly, inequality has only increased in some countries (most notably, Greece), whereas crisis policies seem to have had no or an inequality-decreasing impact in other countries (Matsaganis & Leventi 2014). Both crisis-related policies and the overall impact of the economic crisis in deficit states have thus differed in how they have affected different socioeconomic groups (Avram et al 2013).

More generally, austerity – spending cuts and tax increases – has been the preferred policy choice, whereas structural reforms have been implemented more hesitantly. Given that the latter were often aimed at stripping privileges from politically influential groups, they often have been implemented only under considerable external pressure, and even then compliance has been spotty. Similarly, banks and other financial market participants have largely been able to socialize their losses, rolling them over to taxpayers (Blyth 2013). As discussed above, debtor-country

[10] Eurostat (2016): http://ec.europa.eu/eurostat/web/lfs/data/database

governments ended up assuming many of the bad debts of their banks – which converted private into sovereign debts. Entrenched insider-outsider structures (Bentolila et al 2012), strong resistance by vested interests (Featherstone 2015) and clientelistic politics (Afonso et al 2015) have thus generally protected politically influential groups. Overall, this mirrors earlier crises where governments have shielded their own voter base from the crisis consequences as much as possible (Walter 2016).

These conflicts about how to manage the crisis have reshaped party systems in some crisis countries and paralyzed politics in others. Although some of the discontent has played out in the streets (Accornero & Ramos Pinto 2015, Genovese et al 2016, Giugni & Grasso 2016, Peterson et al 2015), the electoral consequences of the crisis have been more profound, affecting party systems in Ireland (Marsh & Mikhaylov 2012), Portugal (Goulart & Veiga 2016, Magalhães 2012), Italy (Bellucci 2014), Spain (Martín & Urquizu-Sancho 2012, Medina & Correa 2016), and Greece (Dinas & Rori 2013, Rori 2016). In Greece, Italy, and Spain, influential populist and anti-establishment parties have emerged or been strengthened in the wake of the crisis: SYRIZA in Greece, the Five Stars movement and Lega Nord in Italy, and Podemos and Ciudadanos in Spain. Overall, incumbents and mainstream parties have been punished in elections across the board and the crisis has had a destabilizing effect on these countries' party systems (Bellucci et al 2012, Bosco & Verney 2016, Hernández & Kriesi 2015, Katsanidou & Otjes 2016).

Crisis Politics in Creditor states

But creditor states have also been internally conflicted about how to resolve the euro crisis. These countries have grappled with the question of who should bear the main burden. Should financial institutions be made to absorb the losses from the loans they made? Or should taxpayers step in either to shore up the domestic financial systems, or to provide funding to help the debtor countries service their debts? Should surplus countries engage in macroeconomic adjustment to boost domestic consumption and hence lower the adjustment burden on deficit states?

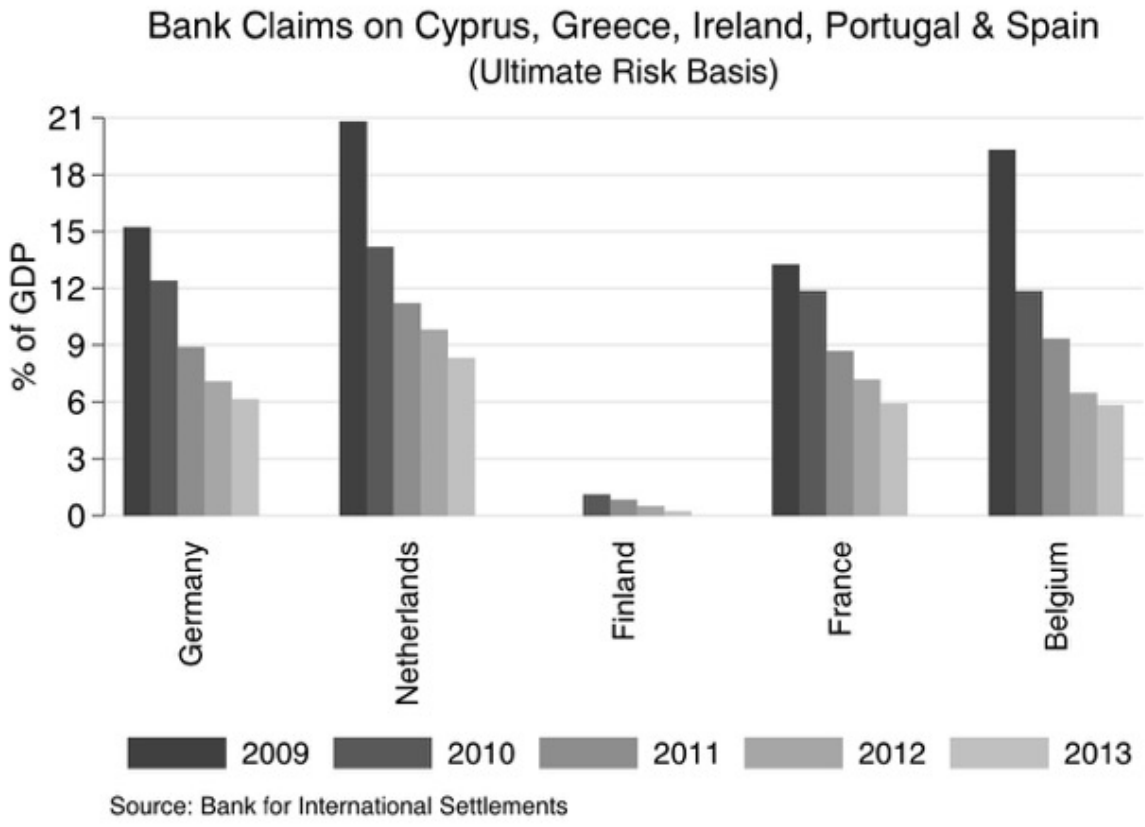
One of the most important distributive questions that faced creditor states early on was whether they should let their financial system absorb the costs of the crisis by defaults or debt restructuring in the debtor states, or whether they should transfer the costs of the crisis onto taxpayers by providing public funds to the debtor countries that would allow them to service their debts.

When the question of whether to bail out Greece first arose in 2010, it was clear that the alternative – a Greek default – might trigger similar defaults in other debtor countries, which in turn would seriously threaten the stability of banks in the creditor states still weakened from the global financial storm of 2007-09. Not only could this have triggered a Eurozone-wide financial crisis and seriously damaged the single currency project, bank bailouts were also deeply unpopular among publics in creditor countries (Goerres & Walter 2016), and hence politically costly. This made it easier to support domestic banks indirectly via a bailout of a Eurozone debtor state (Ardagna & Caselli 2014). Figure 3 shows that this question has been decidedly resolved in favor

of the banks, which have been able to reduce significantly their exposure to crisis countries over the 2009-2013 period.[11] As a result, most of the risks associated with this debt have been passed on to taxpayers in a variety of forms, such as bailout guarantees or growing Target2 balances in creditor states' central banks.

[11] The reduction is even more pronounced when looking at exposure to claims on Greece only.

Figure 3: Bank claims by selected Eurozone countries on euro crisis countries



In short, creditor countries preferred to finance debtor countries temporarily with taxpayer money, while pushing the internal adjustment burden on these countries through strict conditionality and sheltering their own financial institutions from the costs of debt restructuring.

Given the exposure of creditors' national banking systems to bad debts in the Eurozone periphery, it is perhaps not surprising that governments were intent on steering the debate away from the issue. They have been successful in framing the

crisis as a "sovereign debt crisis" of overspending in deficit countries, to which "austerity" in these states is the logical conclusion (Blyth 2013).

Much existing research on crisis politics in creditor states focuses on Germany, where the dominant narrative of the crisis has been one of "Northern Saints and Southern Sinners" (Matthijs & McNamara 2015) not just in the media, but also in the national and international political discourse. For example, in German parliamentary debates over a number of crisis measures, only one party, the populist left "Die Linke," repeatedly deplored the fact that that the bailouts were large redistributive programs from German and peripheral taxpayers to German and other creditor states' banks (Wonka 2016). No other party discussed this issue, framing the debate on crisis management in terms of "solidarity," and "European integration" instead (Degner & Leuffen 2016, Wendler 2014). These more ideological frames seem to have resonated with the German public (Bechtel et al 2014) and even firms (Jäger 2013).

Yet many questions about creditor state politics remain unanswered. Why have left parliamentarians and trade unions in creditor states not framed the debate in terms of internal adjustment, which would justify measures stimulating domestic demand, such as increasing the minimum wage or public spending? Why have interest groups become less visible during the crisis, and why has there been a near consensus on the crisis narrative among policymakers in Germany and Austria (Leupold 2016)? Overall, research on the domestic distributive politics of the euro crisis in creditor states is much less developed than for debtor states. Existing research mostly focuses on the

political struggles about concrete policies, rather than the underlying strategic decision to pursue a path of giving preference to a publicly-funded financing strategy rather than pursuing domestic macroeconomic and structural adjustment. This is surprising, given the dominant role that creditor states have played in shaping the eurozone's answer to the crisis. Analyzing the distributive effects of the euro crisis, their interplay with ideas and narratives, and their effect on crisis politics in creditor states thus is a promising avenue for future research.

6. Conclusion

The Eurozone crisis has dragged on for eight years, and shows no signs of ending. This is a damning indictment of the European Union's member states, and of its constituent institutions. After all, one of the principal justifications for the creation of an Economic and Monetary Union was that the member states together would be able to solve problems that they could not adequately address separately. Instead, amidst the most serious economic crisis in 75 years, the member states have spent nearly a decade in bitter bickering that has, if anything, exacerbated the effects of the initial financial distress. Not surprisingly, among the European public trust in EU institutions (Roth et al 2014) and democracy (Armingeon & Guthmann 2014, Cramme & Hobolt 2014) has fallen significantly over the course of the crisis , and euroskepticism is on the rise (Hobolt & de Vries 2016), with Brexit only the latest and most visible challenge to the EU.

The sources of the crisis are to be found in the political economy of European monetary integration, and in particular in the construction of a common currency without having resolved underlying conflicts over how it would be managed. These conflicts implicate powerful national interests, and equally powerful particularistic special interests. The pulling and hauling of member states with conflicting interests, and of powerful groups with enormous amounts of money at stake, has driven the European Union into the most serious crisis in its history. It will only emerge from the crisis once it manages to reconcile the various national and group interests in conflict in a manner acceptable to at least the bulk of the Union's member states and citizens. So far, it has shown little ability to find its way toward such a resolution.

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