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The Eurozone: From Crisis to Resilience?

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Introduction

The Eurozone found itself on the precipice several times between spring 2010 and mid-2012. The EMU Maastricht 1.0 normative order turned out to be a fair-weather policy regime, unable to withstand the storm and the disruptive shocks without major changes to its economic constitution. The crisis only receded after the famous 'whatever it takes' statement from Mario Draghi, then president of the European Central Bank, in July as market actors regained confidence in the Eurozone's survival. However, policy-makers arguably failed to address comprehensively the underlying root causes of this crisis and the design flaws of the Eurozone.

The Eurozone crisis provides us with a key example of a multidimensional crisis. It was characterized by an intensive interaction between gaping current account imbalances, a public and a private debt crisis feeding into a banking crisis feeding back into a sovereign debt crisis – a 'deadly embrace' or a 'doom loop' between banks and sovereigns. The fiscal consolidation imposed on debtor countries led to domestic political crises of legitimacy in some member states with steeply rising support for populist parties from the left (e.g. Greece and Spain) and the right (e.g. Italy). Because of its multidimensional nature, the Eurozone crisis had great potential to sow the seeds of destruction not only for the Eurozone itself and for its single currency, but also for the single market and the wider EU (Dyson, 2017).

Coming as a sudden shock, this highly disruptive crisis provides us with a very instructive case of 'high-impact low-probability systems failures and traumatic events' (Brasset et al., 2013: 222), the favourite study object in resilience research. In this type of crisis, urgent action is needed because 'the cost of non-action during this hottest phase of the crisis is high' (Brack and Gürkan, 2020: 3). Moreover, these status quo costs were very hard to assess *ex-ante* by policy-makers. Hence, their willingness to embark upon the path of important governance reforms changing the EMU's economic constitution.

Undoubtedly, the underlying causes of this crisis were of a longer-term nature. With the benefit of hindsight, we see a 'longer tail' (see introduction by Nugent, Paterson and Rhinard, in this volume), slow-moving causal processes at work, and a creeping crisis under the surface of public visibility.[i] Trigger events turned it into an open, full-blown, accelerating, and highly salient crisis. Policy-makers did not only take action of the fire extinguishing or short-term

crisis management nature but they also dealt with longer-term fire protection and prevention issues, addressing the crisis' incremental and cumulative causes. A series of governance reforms created tools to fight this crisis and provided for reforms to avoid the next one —or at least reduce the vulnerability of the Eurozone in case it should be hit by yet another shock.

After a flurry of reforms in the first half of the 2010s, the reform dynamic slowed down.[ii] Did the reforms adopted, based on difficult compromises between debtor and creditor countries, between adherents of a stability union and adherents of fiscal union, properly address the root causes of the crisis and reduce the likelihood of future endogenous shocks and the vulnerability of the Eurozone? The main questions this contribution sets out to answer can be summarized as follows: Did the Eurozone reach a stable equilibrium after the series of governance reforms in the 2010s, making the Eurozone more resilient to economic shocks? If not: why is this?

When the new exogenous shock of the Covid-19 pandemic hit, it provided a test case for the resilience of the Eurozone, even though the shock had an impact on all EU member states, not only on Eurozone members (see chapter by Webber in this volume). However, it provided the Eurozone with a kind of a real-life stress test from which we can draw important lessons on the value of past governance reforms and the instruments policy-makers had added to the Eurozone's toolkit.

This contribution proceeds as follows. First, it sketches out a resilience perspective applicable to the Eurozone crisis. Next, it looks at short-term crisis management, at long-term prevention measures, and at the improvement of the Eurozone's self-observation and monitoring capacities. Based on this, we try to assess the Eurozone's transformative capacity to improve its resilience.

A Resilience Approach

The European Monetary Union's (EMU) deep crisis started in late 2009 and caught policy-makers unprepared. The measures adopted in response to the crisis ranged from immediate reactions in terms of 'fire extinction' to longer-term governance reforms, adding new instruments and institutions to serve 'preventive fire protection' purposes and to limit moral hazard. Recurrent themes in the literature are not only the euro area's recovery from this existential crisis, but also the assessment of its vulnerability to future shocks, the extent of policy learning and policy change.

The answer to the question of whether the Eurozone reached a stable equilibrium after the series of governance reforms in the 2010s, making the Eurozone more resilient to economic shocks, depends largely on the interpretation of the root causes of the crisis and the suitability of recent reforms to address them. Authors adopting a Varieties of Capitalism (VoC) framework argued that the extent of structural and institutional differences between different types of capitalism, their export or demand-based growth models and their diverging wage-setting institutions will continue to produce diverging trends, permanently sowing the seeds of the Eurozone's destabilization. Hence, they advocated a return to a reformed European Monetary System (Höpner and Lutter, 2018; Scharpf, 2012). Other scholars advocated a partial dissolution as they saw the need for a solid political union underpinning monetary union, but had serious doubts about the Eurozone's member states being able to reach the necessary extent of integration any time soon (Sinn, 2014). Coming from a very different theoretical and political starting point, the authors of an 'embedded currency area' approach likewise affirm that the Eurozone's survival hinges on the addition of a fiscal union, a banking union and a political union to embed monetary union in social and political institutions providing it with long-term stability (Matthijs and Blyth, 2015).

However, far-reaching changes as advocated by these schools of thought are not on the European political agenda, neither leading in the direction of major steps towards an 'embedded currency area' nor towards an orderly dissolution of the Eurozone. Against this background, the question of the Eurozone's stability, vulnerability, shock absorption capacity and adaptability after a period of crisis is all the more important. One way to approach these 'big questions' is to adopt a resilience perspective that allows for an integrative view on a highly complex subject area. A key assumption in resilience research is that the next crisis is sure to come, just as the Covid-19 pandemic put the Eurozone's resilience to the test.

The resilience concept pervades the crisis-related discourses of EU policy-makers.[iii] It also crops up in several social science disciplines, from the sociology of risk and catastrophes to the political science literature dealing with the stability of political systems or fragile states and in security studies. Contributions in economics using the resilience concept deal with issues such as financial market stability and macroprudential policy and regulation.[iv] What makes it a promising perspective when looking at the EMU's crisis? Social science resilience literature refers to reactions of complex and tightly interconnected adaptive systems or social units to highly disruptive events or shocks and to their capacity to assure their own survival.

Resilience can be conceived of as being 'the capacity of a social system (e.g. an organization, city, or society) to proactively adapt to, and recover from, disturbances that are perceived within the system to fall outside the range of normal and expected disturbances' (Comfort et al., 2010: 9). The latter definition seems well suited to our field of inquiry as it stresses not only the highly unexpected nature of the disturbance but also covers *proactive* measures of adaption, not merely *reactions* to an observed critical event. In the same line of thinking, Walker and Cooper (2011) refer to resilience as an 'anticipatory form of governance'. However, the underlying paradigm of resilience thinking is not one of prevention. Rather, it is one of uncertainty, of living with risks, of anticipating severe shocks and of finding ways to cope with them and to raise the level of preparedness instead of sticking to the idea that such disruptive events, shocks and deep crises can be completely avoided.[v]

Resilience is not just about the stabilization of a social entity after a disruptive event, allowing it to return to a former state of equilibrium; rather, actors are able to learn from disruptive experiences and shocks and can reduce the level of vulnerability of their resilient unit by a deliberate process of change, adapting or partially transforming their social unit. Disruptive shocks, then, can be interpreted as windows of opportunity, creating room for social innovations, opening policy windows after 'focusing events' in the sense of John Kingdon's analysis of political agenda-setting processes (Kingdon, 1984).

'Vulnerability' is a concept very closely related to resilience. It points to the unpredictable and unforeseeable nature of concrete dangers and shocks. It is to be distinguished from the concept of risk, which presupposes that both the likelihood of danger and the amount of potential damage can be calculated in advance. Resilience thinking and resilience strategies prefer to use the concept of vulnerability instead of risks.[vi]

How can we use resilience research to analyse responses of key actors and assess the change in the level of vulnerability and resilience of the EMU? Folke et al. (2010) use a trinity of concepts – 'persistence', 'adaptability' and 'transformability' – in order to distinguish different types of reactions to disruptive events. In a similar vein and building on this analytical distinction, Keck and Sakdapolrak (2013) refer to 'coping capacities', 'adaptive capacities' and 'transformative capacities' when analysing actors' responses to risks and shocks. Along these lines, we refer to coping capacities or persistence as the capacity of a social unit or system to withstand a shock without any purposeful change in structure, function, or identity by reacting in the short term and making use of existing resources and instruments immediately at hand. Adaptive capacity refers to more far-reaching, yet incremental changes that not only react to

current disturbances but can also be preventive in nature, implying processes of learning along the lines of current or foreseeable trajectories of the social unit under consideration and purposefully influencing the resilience of a social unit. Transformability, finally, is defined as 'the capacity to create a fundamentally new system when ecological, economic, or social structures make the existing system untenable' (Walker et al., 2006: 5). The concept of 'transformative capacity', as used by Keck and Sakdapolrak (2013: 10-11), also implies this idea of a sweeping and radical shift towards a new trajectory preparing a social unit *ex-ante* for possible future shocks.

There are obvious parallels to the literature on policy change, policy learning and paradigmatic change. The concept of coping capacity reminds us of Peter Halls 'first order change' where the setting of existing instruments is changed to cope with a challenge. Hall's 'second order change', by way of adding new instruments to the toolbox, is closely related to the idea of a social unit's adaptive capacity. The sweeping, radical changes referred to in the concept of transformative capacity might - but must not necessarily - imply a 'third order change' in the sense of Peter Hall including a change of the underlying policy paradigm and the goals policy-makers pursue (Hall, 1993). The new trajectory embarked upon is the result of a critical juncture and might be institutionalized over time (Pierson, 2004).

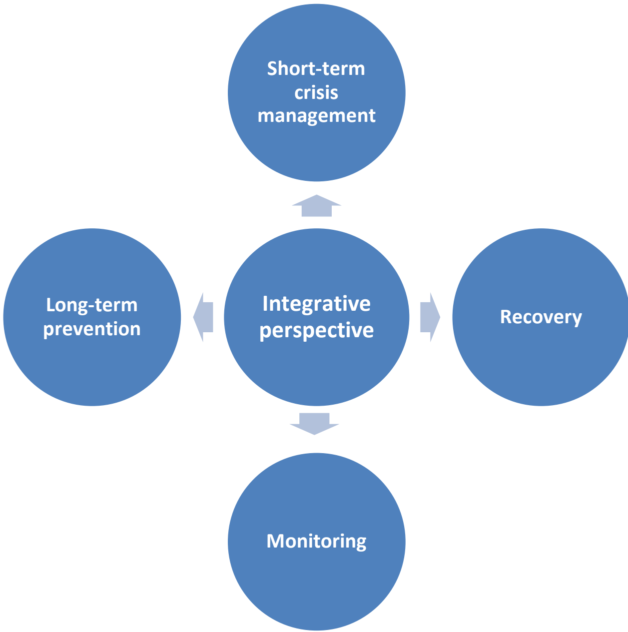

Figure 1: Four Dimensions of Improving the Euro area's Resilience (own compilation)

Adopting a comprehensive resilience perspective, we might look at four different dimensions: a) short-term crisis management capacity, drawing on coping capacities and eventually on adaptive capacity, b) recovery from the shock, c) monitoring of current and future

vulnerabilities and d) the prevention of future crises, basically by changing incentive structures in a way that reduces the accumulation of risks and limits the Eurozone's vulnerability to future shocks (see figure 1).[vii] The latter can be achieved thanks to the transformative capacity of the Eurozone.

Short-term Crisis Management

There is a broad consensus that the Euro area found itself in a state of high vulnerability prior to the unfolding of the sovereign debt and banking crises for two main reasons:

1. Policy-makers were not prepared to deal with a sovereign debt crisis and had no ready instruments at hand for crisis management.[viii] The crisis 'exposed brutally the "fiscal void" of the monetary union' (Schelkle, 2014: 105) because the redistributive fiscal capacities of the EU budget, in particular the structural and cohesion funds, were not well suited for dealing with asymmetric shocks. Moreover, the Eurozone lacked a lender of last resort, considered to be another fundamental design failure by De Grauwe (2013). When negotiating the Maastricht Treaty, negotiators (especially the Germans) put the main emphasis on rules (no-bail-out clause; no monetization of public debt; debt and deficit criteria and excessive deficit procedure) and institutional designs (independence of the ECB) to prevent such a sovereign debt crisis from happening in the first place (Dyson and Featherstone, 1999). With the benefit of hindsight, this trust in the disciplining force of rules and of bond markets' pressures to prevent unsustainable fiscal policies was clearly proved wrong.
2. A sovereign debt crisis following irresponsible national fiscal policies was the main scenario that the contracting parties had in mind when putting the EMU on track. Many policy-makers shared the interpretation of the crisis, in its early phase, as being foremost a sovereign debt crisis. Paul de Grauwe, however, identified the 'unsustainable debt accumulation of the *private* sectors in many Eurozone countries' as the 'root cause of the debt problems in the Eurozone' (De Grauwe, 2010: 1 (emphasis in the original)). [ix] The vulnerabilities caused by unsustainable levels of private debt, housing bubbles and related banking crises, huge current account imbalances and possible external shocks with tremendous spillover potential in highly integrated financial markets were not addressed *ex-ante* by policy-makers.

The Eurozone crisis, starting in late 2009, laid bare both the Eurozone's design flaws and policy failures. In terms of long-term prevention, the central pillars of the Maastricht 1.0

framework neither proved able to prevent a build-up of increasing current account imbalances nor did they dissuade governments from running unsustainably high deficits and accumulating public debt. The no-bail-out clause (Art. 125 TFEU) did not deliver in terms of inducing investors to assess risks of government bonds in a differentiated way and to put pressure via higher risk premia on governments running unsound fiscal policies. Nor did the fiscal rules keep deficits and debt in check or provide incentives to bring debt levels down in good times. Regulatory policy failures allowed reckless borrowing and reckless lending by banks and investors/consumers and the build-up of speculative bubbles in housing markets. Moreover, the assumption that the move towards EMU would lead to increased economic convergence among the participant states simply proved wrong (Chang, 2016: 492).

National policy failures added to the picture. Policy-makers turned a blind eye to deteriorating competitiveness and low growth, as in Italy and Portugal, and shied away from unpopular structural reforms of labour markets and social security systems. Hence, we see an example of a creeping crisis that came to the fore with the successive economic shocks of the global financial market crisis in 2008 and the following Eurozone crisis.

These disruptive shocks laid bare the almost complete lack of a coping capacity in terms of short-term crisis management and 'fire extinction' tools. European-level fiscal facilities to bail out insolvent states had to be invented from scratch, as they were intentionally not foreseen by the European treaties in order to prevent moral hazard. Nor was the alternative of an orderly state insolvency procedure in place that would have made private investors foot the bill. Furthermore, the treaties did not allow the ECB to play the role of a lender of last resort to governments by way of monetizing government debt.

Because of this state of unpreparedness and in view of the imminent danger of a break-up of the Eurozone, coping strategies did not suffice. The EU, lacking instruments for short-term crisis management, had to invent them in the midst of the ongoing crisis. The ECB's traditional interest rate policy was arguably the only important available instrument for coping strategies. Hence, adaptation and transformation were on the political agenda from the outset. Indeed, most instruments deployed at the EU level to deal with the crisis fall into the two categories of adaptation and transformation. Table 1 displays a number of new instruments and governance reforms that can be interpreted either as examples of the EMU's adaptive capacity through political learning, the creation of new instruments and reformed governance institutions or as

examples of outright transformation, with far-reaching long-term consequences in terms of major changes in the EMU's trajectory.

Table 1. Changes in policy instruments and governance reforms

	Coping	Adaptation	Transformation
Fiscal Capacities			
EFSF / EFSM		X	
ESM			X
Next Generation EU / RFF		X[x]	
ECB Policy			
Lowering interest rates	X		
Fixed-rate, full allotment liquidity provision		X	
LTRO (Long Term Refinancing Operation)		X	
Security Markets Programme (SMP)			X
Outright Monetary Transactions (OMT)			X
Public Sector Purchase Programme (PSPP)			X
Pandemic Emergency Purchase Programme (PEPP)		X	
Banking Union			
Single Supervisory Mechanism (SSM)			X
Single Resolution Mechanism (SRM)			X
Single Resolution Fund (SRF)			X
Economic Governance Reforms (rules)			
SGP Reform		X	
Macroeconomic Imbalance Procedure & MIP Score Board		X	
Fiscal Compact (TSCG)		X	
Economic Governance Reforms (decision-making bodies)			
Institutionalization of Euro Summits		X	

Source: Own compilation.

As regards the Eurozone's adaptive capacities, a mixed picture emerged. Optimum Currency Area (OCA) theory emphasizes the importance of the adaptive mechanisms in cases

of asymmetric shocks: flexible labour and product markets allowing for internal devaluation in crisis-ridden countries with high current account deficits and the corrective mechanism of cross-border labour mobility. They worked only to a quite limited extent. On the other hand, both governments and the ECB came up with new instruments, demonstrating their adaptive capacity and improving the Eurozone's future coping capacities. The fiscal side reacted with the temporary rescue funds EFSF and ESFM, established in 2010, and the permanent rescue fund ESM created in 2011. The permanent ESM surely improves the Eurozone's future capacity to deal with disruptive economic shocks. However, it arguably transforms the EMU's trajectory as it undermines the credibility of the no-bail-out clause permanently. This potentially creates moral hazard and undermines national responsibility for sound and sustainable economic policy-making. The extent to which its limited resources will be sufficient to cope with future crises is open to debate. So is the willingness of member states to make use of ESM funds, as there are strings attached, namely the structural adjustment programme. Making use of ESM loans has high reputational and domestic audience costs for governments and might feed into a domestic legitimacy crisis.

On the monetary side, the ECB not only used existing instruments for coping with recessions. With its long-term refinancing programmes for banks (LTRO and later TLRTO), it adapted its toolbox. As banks in the periphery used this instrument to buy government bonds of their home countries, it arguably increased the vulnerability to shocks as it reinforced the potentially deadly embrace between banks and sovereigns. In 2010, the ECB started its highly controversial Security Market Programme (SMP) of indirect purchases of government bonds in secondary markets. The transformative nature of this instrument, coming very close to the monetization of government debt, led to the resignation of the ECB's chief economist, Jürgen Stark and the president of the German Bundesbank, Axel Weber, declined to run for the ECB presidency. Furthermore, in 2015, the ECB started its policy of quantitative easing with huge asset purchase programmes, most importantly the Public Sector Asset Purchase Programme (PSPP). This provides us with another example of transformative crisis response as this programme enters deeply into the field of fiscal policy, enlarging the fiscal space for governments thanks to artificially supressed interest rates. Moreover, it arguably increases vulnerabilities fuelling housing and stock market bubbles.

The reform of decision-making institutions provides an example of adaptation by way of improving the Eurozone's coping and short-term crisis management capacities. The Eurogroup performed a central role in preparing and informally adopting decisions on crisis

management. The involvement of the highest political authorities of the Eurozone member states in crisis management through the institutionalization of Euro Summits in 2011/12 should make speedy decision-making easier in situations of 'supreme emergency' (Dyson, 2013) and facilitate decision-making on key issues entailing high risks, important distributive consequences and long-lasting effects. In general, the Eurozone crisis is seen to have upgraded the role of the European Council in crisis management (see chapter by Nugent in this volume).

The capacity of actors to provide leadership in the EU's highly complex, fragmented and consensus-oriented system of governance is of crucial importance for its resilience to unforeseen shocks (see chapter by Bulmer and Paterson in this volume). The Eurozone member states and institutions' reaction to the twin banking and sovereign debt crisis indeed displayed instances of successful leadership. In the early crisis years 2010-12, Germany and France were able to act as agenda setters and strike bilateral compromises acceptable to other member states on a number of issues. Thus they proved able to provide intergovernmental leadership on key questions, such as the reform of the Stability and Growth Pact, the 'fiscal compact', the ESM and the related Treaty reform (Schild, 2013).

This provision of leadership by member states, however, was not sufficient to calm the speculative pressure of financial markets betting against the survival of the Eurozone in its current composition. In this situation, the capacity of the ECB to act unilaterally, based on its delegated powers in monetary policy-making, proved crucial for overcoming a potentially destructive dynamic of the financial markets (Schoeller, 2019).

Recovery

The speed of recovery was limited by the absence of a Eurozone specific budget able to perform macroeconomic stabilization functions or alternatively automatic stabilizers and shock absorbers such as the European-level unemployment (re-)insurance scheme. Policy choices added to this. On the fiscal side, creditor countries asked for fiscal consolidation efforts from member states - Cyprus, Greece, Ireland and Portugal. They had to sign up to structural adjustment programmes in order to be bailed out. At the national level, there is hardly any alternative to fiscal consolidation efforts for insolvent countries which have lost access to private capital markets. However, fiscal consolidation produced recessionary effects (Bini Smaghi, 2013; Blyth, 2013). Current account surplus countries, most importantly Germany, did not boost their domestic demand to stabilize aggregate demand in the Eurozone. When an IMF study on the fiscal multiplier estimated it to be greater than 1, and hence accelerating the

contraction caused by cuts in public budgets, an increasing number of policy-makers advocated an end to 'austerity'. On the monetary side, the ECB's early rise in interest rates in July 2011 was denounced as being 'the most egregious policy error of the crisis' (Mody, 2017: 17). Furthermore, the Lisbon treaty did not allow the ECB to act as lender of last resort to governments. Hence, the 'recovery since the financial crisis has been long by historical standards' (European Commission, 2020: 16).

Long-term Crisis Prevention

A number of reforms adopted in the last decade pursued the goal of addressing underlying causes of the multidimensional crisis, to make endogenous crises less likely and to reduce the Eurozone's vulnerability to future shocks. Policy-makers addressed the fiscal dimension by strengthening the rules of the Stability and Growth Pact in 2010/11. The 'Six Pack' legislation not only provided for a strengthening of the Stability and Growth Pact's preventive arm (including possible sanctions); it also empowered the Commission and the Council to issue preventive recommendations to member states in the framework of the excessive imbalance procedure (EIP). The introduction of a reverse qualified majority was to facilitate the use of sanctions against rule-breakers. The reform put greater emphasis on the debt criterion, which is a more important indicator of longer-term vulnerabilities than the deficit criterion. These are examples of adaptation and policy learning.

Pushed by Germany, with French support, the European Council adopted the Euro-Plus pact in 2011 to coordinate policies in the area of structural reform, thereby trying to address the competitiveness dimension of the Eurozone crisis.[xi] This reform, however, was never properly implemented (Eckert et al., 2020).

With the work on the Banking Union, starting in June 2012, the EU launched arguably the most important deepening of economic integration since the Maastricht Treaty's decision to pave the way towards EMU, an example of a transformative crisis response. It served the purpose of breaking the 'doom loop', the strong interdependence between the sovereigns and national banks, and increasing the resilience of banks and the financial sector. As financial market stability was a common concern for all EU members, the Single Rule Book for banks and the transposition of Basel-III rules, most notably their higher own capital requirements, applied to all. The euro-ins added additional steps. The new supranational powers of the ECB in the field of banking supervision overcame the uneasy co-existence of integrated financial markets and fragmented national supervision of financial institutions, improving the capacity

to detect and address vulnerabilities at the level of individual systemically relevant institutions early on.

The supranationalisation of bank resolution provided the next pillar of the Banking Union, with the Single Resolution Board (SRB) and the Single Resolution Fund (SRF). The latter, gradually built up from 2016 until 2023 and intended to reach at least the level of 1% of the covered deposits, shall provide the necessary resources for resolving failing banks. Additionally, an ESM treaty change in 2014 provided for an instrument of direct bank recapitalization of up to € 60 bn. It was replaced by a public backstop for the Single Resolution Fund in 2021. The last pillar of the edifice, however, the European Deposit Insurance Scheme (EDIS), made little progress due to the reluctance of the German government and the entire German banking sector to share risks as long as the risks on banks' balance sheets, mostly in Italy and Greece, are not effectively reduced (Donnelly, 2018; Howarth and Quaglia, 2018). If established, one can expect EDIS to perform a preventive function by making bank runs less likely, as depositors would fear less for their guaranteed deposits, and to work as a shock absorber in case of the winding down of a bank. In addition, the banking package adopted in 2019 with a series of capital and liquidity enhancing and risk reduction measures and changes to the bank resolution framework is intended to 'reduce risks in the banking sector by further reinforcing banks' ability to withstand potential shocks' (European Commission, 2019).

Improved Monitoring

Self-observation capacities can be regarded as crucial for improving the resilience of a social unit. Monitoring refers to the capacity of a social unit to observe itself, to monitor and assess the state of its own vulnerability permanently in order to detect current or potential future vulnerabilities and creeping crises early on by institutionalizing procedures of self-surveillance.

In this respect, the EU and the Eurozone are surely better equipped today than in the past. The European Semester with its 'information-driven surveillance process' (Delivorias and Scheinert, 2019: 1) provides a framework for tighter and permanent monitoring of the of the Eurozone member states' fiscal and broader economic policies. The Commission increased its internal budgetary and economic surveillance capacity (Savage and Verdun, 2016). Additionally, in 2015 it set up a European Fiscal Board, serving as an independent advisory body on fiscal policy issues. Not only did the European level improve its monitoring capacities and independent advice, so did the national level. The Fiscal Compact included the obligation of signatory states to set up independent fiscal institutions at the national level. They monitor

the compliance of governments with the fiscal rules they have subscribed to, evaluate or produce macroeconomic forecasts underlying the budget and can advise the governments on fiscal policy issues.

Furthermore, the regulation on the prevention and correction of macroeconomic imbalances from 2011 extends multilateral surveillance beyond the fiscal policies to cover broader fields of member states' economic policy-making. The fourteen indicators and indicative thresholds of the MIP (Macroeconomic Imbalance Procedure) scoreboard[xii], used by the Commission for its alert mechanism reports and for the Council's conclusions on them, serve as an early-warning system to indicate serious imbalances that might endanger the sustainability of national economic policies, possibly undermining the stability of the wider Euro area. The Commission makes member states with serious imbalances the object of in-depth reviews, the results of which are taken into account for the Council's Country Specific Recommendations (CSRs), the key governance instrument of the European Semester.

In terms of financial market stability and the EU's monitoring capacities in this regard, the overhaul of the European System of Financial Supervision (ESFS) included the establishment of the European Systemic Risk Board (ESRB) as part of the ESFS. The ESRB serves the purpose of improving the macro-prudential oversight of the financial system as a whole. Since 2013, the European Banking Authority has added to the EU's improved monitoring capacity by publishing an annual Risk Dashboard online,[xiii] with indicators assessing financial stability risks. The European Central Bank ECB's twice-yearly financial stability review adds to the EU's monitoring capacities.

The European Court of Auditors, on its part, increased the number of special reports and audits dealing with the use and effectiveness of new rules, instruments, and coordination procedures. Among other topics, it evaluated the revised SGP rules in both the preventive arm and the excessive deficit procedure, the first experiences with the Macroeconomic Imbalance Procedure, and the effectiveness of country-specific recommendations in the European Semester framework of policy coordination.[xiv]

Transformative Capacity

This brief summary of major reactions to the Eurozone crisis mainly provided examples of coping and adaptation capacities. Do individual measures taken or the sum of reforms provide evidence for the Eurozone's transformative capacity, creating a fundamentally new system? Is

the Eurozone set on a different trajectory thanks to sweeping and radical changes with a long-term time horizon, and preparing it *ex-ante* for possible future shocks?

Permanent new instruments of solidarity, such as the ESM and the shift towards supranational banking supervision for the 115 most important institutes by the ECB[xv], their potential European-level resolution and the ECB's massive purchases of government bonds on secondary markets arguably all represent instances of transformation. They change the basic structures and logic underpinning the functioning of the EMU. Change there is, the Eurozone embarked upon an altered trajectory, but it is hardly a fundamentally new one. The consensus-oriented EU system, without hegemonic leadership (see chapter by Bulmer and Paterson in this volume), produced a series of ad hoc short-term measures and intricate compromises on longer-term governance issues (Schild, 2020a). These compromises generally followed an additive pattern, without amounting to a coherent reform of the EMU's economic constitution. Only the ECB's unilateral action, based on a supranational-hierarchical mode of governance, departs from this piecemeal and additive pattern. The overall result lacks in both coherence and effectiveness, and produced in part unintended consequences that called for further reforms - a 'failing forward pattern' as Jones et al., (2016) put it. The incremental evolution of fiscal support mechanisms provides us with ample empirical evidence of a 'tug-of-war' between creditor and debtor countries with diverging material interests and policy ideas, limiting the speed, scope, coherence and effectiveness of the steps taken (Rehm, 2021).

Policy-makers faced two basic options. They might have opted for a 'Maastricht 2.0' blueprint, partly inspired by ordoliberal thinking (Sachverständigenrat für die Beurteilung der gesamtwirtschaftlichen Entwicklung, 2012: 102–9), which would have meant sticking mainly to national responsibility for fiscal and, more broadly, economic policy-making, framed by effective and enforceable European-level rules. Such a model implies lending new credibility to the no-bail-out clause, for instance, by defining a credible state insolvency procedure in order to prevent moral hazard both of investors and of sovereigns (Heinemann, 2021). This normative blueprint would allow for a European Banking Union in which common liability and European-level control go hand in hand.

An 'embedded currency area' provides an alternative normative model. It includes a fiscal union with strong fiscal capacities and transfer instruments at the European level, a Banking Union, and ultimately a political union to legitimize strong elements of risk-sharing and sovereignty transfers to the EU level (McNamara, 2015). Some of these elements have been spelt out in the so-called Five Presidents' Report (Juncker et al., 2015) and its 2012 predecessor,

the Four Presidents' Report (Van Rompuy et al., 2012). Both normative models are internally coherent and could serve as resilient governance frameworks. As opposing coalitions advocated these normative models, neither of them stood any chance of prevailing. Leading states in the opposing camps, primarily Germany and France, proved able to use their blocking power to prevent key proposals from the other side from gaining the upper hand—such as Eurobonds blocked by Germany for years, or the effective strengthening of supranational power over national fiscal policy blocked by France (Schild, 2020b).

As a result, todays' Eurozone governance is a kind of hybrid construction in between the two normative models. It combines a hollowed-out Maastricht 1.0 design with only partial elements of an 'embedded currency area'. After successive bail-outs and a treaty change allowing for the establishment of a 'stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole' (Art 136(3) TFEU), the no-bail-out clause of the treaty lost what was left of its credibility. The ECB circumvented the prohibition of monetary financing by the ECB (Art. 123 TFEU) by massively buying government bonds on secondary markets. The 'euro has been built on the principle of monetary dominance' (Schnabel, 2020), a dominance to be guaranteed by the Maastricht 1.0 architecture. The huge amounts of sovereign bonds accumulated by the ECB on its balance sheet sparked a debate as to whether the current situation is not better described as one of fiscal dominance, the ECB losing its independence and its ability to pursue its primary goal of price stability.[xvi] Moreover, the ECB's policy of quantitative easing and the opportunities for cheap borrowing reduced the incentives for Eurozone member states to address their competitiveness problems.

Policy-makers strengthened fiscal rules in line with the Maastricht 2.0 model and the preferences of adherents of a 'stability union'. The growing complexity of these rules and their lenient enforcement - both of the deficit and even more so of the debt rules - by the Commission, however, mean that no member state so far has ever to face a serious threat of financial sanctions (European Court of Auditors, 2016; Sacher, 2021). The mainstream view in the literature on the European Semester and its core instrument, the Country Specific Recommendations (CSRs), is one of low and declining compliance, especially in member states displaying huge imbalances (Darvas and Leandro, 2015; Efstathiou and Wolff, 2018; see also European Court of Auditors, 2020 on implementation deficits).

Regarding the efforts to reduce moral hazard by making private shareholders and investors contribute to bank resolutions, the first experiences in Italy and Spain provide us with a mixed picture. The Italian government found ways to use the loopholes in the regulation on

the resolution of banks to avoid the use of the new bail-in tool. Hence, shareholders and creditors did not pay their share in bank resolution procedures and were not liable for their private risk-taking when things went wrong (Donnelly and Asimakopoulos, 2020). Furthermore, key elements advocated by the adherents of a Maastricht 2.0 normative model, such as an orderly state insolvency procedure, did not make their way onto the political agenda. The combination of hollowed-out treaty stipulations, unenforced rules and little effectiveness of policy coordination frameworks testifies to a trajectory of the EMU moving away from a Maastricht 1.0 or 2.0 blueprint. From the perspective of adherents to a 'stability union' and the Maastricht 2.0 model, there is a missing link between elements of increased solidarity and common liability, which are very real, and elements of sharing sovereignty on fiscal policy and structural reforms which are conspicuously absent.

As regards steps taken towards an 'embedded currency area', we find a mixed picture. On the 'solidarity' side, we find a strong increase in common liability via the member states' capital shares and credit guarantees in the ESM, the public backstop to the Single Resolution Fund (SRF), the increasing amount of sovereign bonds on the ECB's balance sheet and the target 2 payment system's imbalances. On the other hand, key policy instruments advocated by adherents to this school of thought never carried the day - at least before the pandemic hit. This holds true for strong elements of fiscal transfers either via a separate Eurozone budget large enough to perform macroeconomic stabilization functions or a Eurozone-level unemployment (re)insurance scheme. The option of national governments issuing Eurobonds backed by joint and several liabilities never stood a chance of being accepted by Germany, nor did other instruments entailing the risk of permanent transfers and redistribution between Eurozone member states (Howarth and Schild, 2021). Plans for a sizable Eurozone budget, advocated most forcefully by the French president, able to perform macroeconomic stabilization functions, found only lukewarm support from Germany and were met with outright hostility from the 'New Hanse' states. The latter watered them down to 'homeopathic insignificance' (The Economist, 2020) before they were dropped altogether in the context of the negotiations on the EU's Multiannual Financial Framework in 2020 (Schoeller, 2020). Policy-makers took some steps in the direction of a 'Fiscal Union' and an 'embedded currency area'; from the viewpoint of their advocates, however, EMU remains a half-built house at best.

In sum, the transformative capacity of EMU up to the start of the pandemic proved to be quite limited, resulting in an unstable disequilibrium, a kind of dangerous 'no man's land' between two normative models. EMU did not combine the strength but rather the weaknesses

of the two models. The Eurozone members neither strengthened its fiscal recovery and bouncing back capacities by way of fiscal capacity building to absorb huge asymmetric shocks or spread their impact via deeper capital market integration; nor did they improve the Eurozone's resilience and crisis prevention capacity by restoring national responsibility for economic fiscal policies, reducing moral hazard and effectively implementing fiscal rules.

However, the vulnerability of the Eurozone to disruptive shocks has arguably decreased. A devastating sovereign debt crisis leading to the breakup of the Eurozone is much less likely than in 2010. The permanent ESM rescue fund provides an instrument for cases of insolvency of sovereigns endangering the survival of the Eurozone. Moreover, a devastating banking crisis with cross-border contagion effects seems less likely today than ten years ago. The reduction of non-performing loans during the last decade, higher own capital and liquidity requirements for banks, supranational bank supervision, the establishment of the SRF and a fiscal backstop in case the latter were to prove insufficient for bank resolution all increase the financial system's resilience. Nonetheless, serious doubts remain as to the efficient and effective functioning of 'untried systems' (Mayes, 2018). These doubts arise from the complexity of the decision-making procedure for bank resolution in a crisis. Additionally, 'undercapitalized banks, combined with the absence of credible resolution financing, have resulted in a European bank resolution regime that is bound to fail' (Asimakopoulos and Howarth, 2021: 2). Moreover, the danger of a 'deadly embrace' between sovereign and banks still exists as long as the regulatory failure of considering sovereign bonds on bank's balance sheets as risk-free is not addressed and as long as major portions of national sovereign bonds are held by national banks.

Growing dissatisfaction with the existing Eurozone governance framework found its expression in a Commission review and assessment in February 2020, just before the economic shock of the pandemic hit. As regards fiscal governance, the Commission noted that 'Member States' fiscal policies have remained largely pro-cyclical' and that 'despite the reinforced preventive arm, many Member States did not make use of the more benign economic times to build up counter-cyclical buffers' (European Commission, 2020: 8). Furthermore, the governance framework for addressing macroeconomic imbalances, the Macroeconomic Imbalance Procedure (MIP) 'has not generated the political traction necessary to sustain reform ambition in Member States where imbalances persist', notably in current account surplus countries (European Commission, 2020: 13).

The COVID 19 Resilience Test

The economic impact of the COVID-19 pandemic provided the EU in general and the Eurozone in particular with a real-life test of its vulnerability and resilience.[xvii] Did the Eurozone's governance system successfully cope with and adapt to the new disruptive shock of the COVID-19 crisis based on existing instruments and procedures and their adaptation without transforming itself once more? Long-term prevention should not focus exclusively on avoiding future disruptive shocks. It should also serve the purpose of reducing vulnerabilities and having effective instruments and governance institutions in place to deal with the inevitable next shock. As the pandemic was an exogenous shock, it did not put the Eurozone's preventive capacity to the test.

During the Eurozone crisis, vulnerability came basically in two forms: banks lacking their own capital to absorb losses and sovereigns with an unsustainable deficit and debt levels being vulnerable to new risk assessments of private lenders suddenly unwilling to provide loans at affordable interest rates. Ten years after the start of the Eurozone crisis, banks were much less vulnerable. Thanks to better regulation (Basel-III rules, implemented in the EU in the Capital Requirements Directive IV package in 2013), the own capital ratios of banks were much higher on average in 2020 compared to 2010, allowing them to better absorb pandemic-induced shocks and losses on non-performing loans. The capital ratios even improved during the first pandemic crisis year. The hardcore capital (Common Equity Tier 1 Capital – CET1 ratio) increased to a 'new all-time high' of 15.5 % and the non-performing loan ratio decreased to 2.6 % in the last quarter of 2020 (European Banking Authority, 2021: 1). Hence, a banking crisis was much less likely than a decade earlier. On the other hand, the government debt-to-GDP ratios – a longer-term indicator of fiscal vulnerabilities – signalled a higher vulnerability ahead of the pandemic (84 % in the last quarter of 2019) compared to the situation at the start of the Eurozone crisis (80 % in 2009, up from 66 % in the last quarter of 2007, before the Global Financial Crisis hit). By mid-2021, it had jumped to 98 % on average.

Furthermore, there is still a concentration of vulnerability in a small number of countries that were strongly hit during the Eurozone crisis (Greece, Portugal, Spain, Italy) and once again during the pandemic, most notably Italy and Spain. This holds true for their debt/GDP ratios in 2021 (2nd quarter), with Greece (207 %), Italy (156 %), Portugal (135 %) and Spain (123 %) being the most vulnerable, and also applies to their higher than average non-performing loans ratio. For Italy, we have to add political vulnerability owing to the prominence of populist parties, the Lega and the Five Star Movement, and the steep rise of Giorgia Meloni's far-right

'Brothers of Italy' in opinion polls. The Lega's hostility to a loan against conditionality approach made the use of ESM funds in Italy politically a no-go area. This points to the multidimensional nature of the Eurozone crisis as the use of a key fiscal instrument to fight an economic crisis might trigger a domestic political crisis.

Thanks to the low interest-rate environment and the instruments put in place by the ECB, the risk spreads for government bonds showed only very modest differences after the pandemic-induced recession hit.[xviii] However, perceptions of Eurozone members' debt rollover and servicing capacities will probably change and could make the southern European states vulnerable as the ECB announced a policy shift in March 2022, planning to stop net bond purchases and probably raising interest rates to fight quickly rising inflation fuelled by the pandemic and the economic fallout of the Russian aggression in Ukraine. We cannot exclude rapidly rising risk premia for some Eurozone members. A populist backlash and populist parties in government pursuing Eurosceptic agendas and unsustainable fiscal policies could produce the same effect.

What about the Eurozone's coping and adaptive capacity? Policy-makers had the panoply of instruments developed during the Eurozone crisis and some new instruments along the lines of existing ones at hand to deal with the new disruptive shock. In part, we saw path-dependent reactions along the routes embarked upon during the previous Eurozone crisis (Ladi and Tsarouhas, 2020). This holds true for ECB instruments such as long-term refinancing operations for banks and its Pandemic Emergency Asset Purchase Programme (PEPP), an example of adaptive capacity as this instrument resembled the earlier instruments in the ECB's Asset Purchase Programme. The ECB increased the PEPP's size in two steps from initially € 750 bn. to € 1,850 bn. By massively buying sovereign bonds, with a bias in favour of Italy, the ECB successfully 'assuaged bond-market actors' fears about the viability of southern European members' projected budget deficits', thus preventing speculative attacks on them (Webber, this volume; see also chapter by Armingeon et al. in this volume).

Compared to the Eurozone crisis , the monetary side reacted more swiftly than a decade ago with quantitative easing instruments, as did the fiscal side. Governments coordinated national fiscal stimulus programmes quite swiftly. This time, governments did not meet problems of access to markets at affordable interest rates when issuing government bonds (Camous and Claeys, 2020: 334). At the European level, the Commission, the ESM and the European Investment Bank (EIB) put together a package to the tune of € 540 bn in April 2020, only a couple of weeks after the pandemic fully started to spread in the EU. However, no

member state ever used the ESM's new Pandemic Crisis Support credit line, owing to the domestic reputational costs for governments of borrowing money from the ESM. Hence, one key instrument put in place to deal with future crises and shocks turned out to be of little help during the economic crisis triggered by the pandemic.

The capacity of the EU and the Eurozone to recover from this sudden economic shock was much higher than a decade ago during and after the Eurozone crisis. In 2021, the Commission expected no less than 19 Member States to reach their 2019 pre-pandemic GDP levels (European Commission, 2021b: 4). Huge deficit spending at the national level is part of the explanation for this swift recovery. A flexible reaction at the EU level added to this, the suspension of fiscal and state aid rules providing key examples. According to the Commissioner for the Economy, Paolo Gentiloni, 'this is not the time to restore our public finances as uncertainties persist'.[xix] However, the national crisis reactions reflected the legacy of the Eurozone crisis, most notably the diverging fiscal policy space caused by divergent fiscal capacities as an outcome of the earlier crisis. 'Probably because countries' fiscal spaces were not comparable at the beginning of the crisis, the magnitude of the fiscal packages (especially when excluding guarantees) appeared to be inversely proportional to the economic shock at least in the early phase of the crisis' (Camous and Claeys, 2020: 4). This adds to the tendencies of divergence among Eurozone member states manifest since 2010.

However, coping with the crisis only by using existing instruments of national deficit spending and ECB instruments of quantitative easing did not suffice. Thanks to yet another example of Franco-German leadership capacity in critical moments, the EU made use of its adaptive capacity by inventing new instruments (Krotz and Schramm, 2021). The most important instrument on the fiscal side came with the Next Generation EU programme and its key component, the Recovery and Resilience Facility (RRF) to the tune of additional spending of up to € 750 bn until the end of 2026 (see chapters by Armingeon et al., and Webber in this volume). By foreseeing not only loans but € 390 bn in grants and by financing this programme through allowing the Commission to contract debts, the EU broke two taboos (handing out grants instead of loans and financing by them by debt).

Do these changes provide evidence for the EU's and the Eurozone's transformative capacity, changing its trajectory? Did we witness a critical juncture, setting the Eurozone on a new path with the RRF redistributive instrument (Ladi and Tsarouhas, 2020)? The jury is still out. The large-scale issuing of European bonds hollowed out the treaty even more as the EU, according to article 310(1) TFEU, has an obligation to ensure that 'revenue and expenditure

shown in the budget shall be in balance'. Is the EU on the road towards a 'transfer and debt union', fundamentally altering its trajectory (Kerber, 2021)? The answer to this question largely depends on the permanent or non-permanent character of these changes, new instruments and transfer payments. The increase in the EU's own resources ceiling is limited in time. The Next Generation EU programme's resources must be spent by the end of 2026. The repayment of the new debts, however, runs until 2058. The Commission launched a broader debate on new own resources to repay the incurred debt (European Commission, 2021c). Even though the new instruments are temporary and pandemic-related – as the Merkel government repeated time and again – they set a precedent. It did not come as a big surprise that French president Macron advocated a debt-financed resilience facility after the start of the war in Ukraine to invest in European sovereignty in defence and energy (Pollet and Noyan 2022).

The pandemic also sounded the death knell for fiscal rules as we know them. The Commission announced a proposal to reform the fiscal rules for mid-2022. The reform process to change them is not very likely to lead to their hardening, quite to the contrary. The political coalition advocating flexible and watered-down rules will gain the upper hand. Against the background of a huge surge in debt-to-GDP ratios and important upcoming investments in the energy transition and the digitisation of the economy, it is almost certain that policy-makers will scrap the rule of bringing debt levels beyond 60 per cent down by $1/20^{th}$ per year. How can the Greek and the Italian governments bring down their debt ratios by 7 and 6 per cent respectively in one single year without committing political suicide?

It therefore seems safe to assume that the pandemic has moved the Eurozone further away from the Maastricht 1.0 or 2.0 template. Will it, however, go all the way towards an 'embedded currency area'? Doubts remain. Very much will depend on Germany and its 'traffic-light coalition' that took office in December 2021. Will it stick to its 'Nein' to a transfer union, limiting the fiscal capacity building at the Eurozone or EU level and preventing a Next Generation EU type of instrument to be made permanent (Howarth and Schild, 2021)?

Conclusion

Resilience thinking provides us with some interesting questions and useful concepts to analyse the Eurozone's crisis and its past, current, and future vulnerability and resilience. This highly disruptive and deep crisis provides us with a very instructive case of a high-impact, low-probability event, the favourite type of study object in resilience research. Clearly distinguishing between vulnerability as a state and resilience as a process, namely the capacity

to withstand, innovate and adapt and to transform itself in order to survive current and future crises, can provide new insights and allows for the development of a broad and integrative perspective on this object of study.

Considering the root causes of the Eurozone crisis and the vulnerability of this entity, we can conclude with four observations. Firstly, current account imbalances are largely reduced a decade after the start of the crisis. They do not create vulnerabilities for the time being. Secondly, a banking crisis is much less likely in the years to come thanks to reduced risks, higher liquidity and own capital ratios and supranational supervision. The doom loop between banks and sovereigns is, however, not fully addressed as long as sovereign debts on banks' balance sheet are considered risk-free and as long as sovereigns can circumvent bail-in rules and inject taxpayers' money into failing banks. Thirdly, diverging economic trends in terms of growth potential and public debt-to-GDP ratios in the Eurozone have the potential to feed creeping crises. Trigger events - economic or political - could transform them into a full-blown crisis, in particular in Eurozone member states most hit by the Eurozone's crisis a decade ago and later hard-hit by the pandemic. This points to the interconnectedness of succeeding crises. Fourthly, the transformation of the Eurozone's governance framework so far has not led to a stable political equilibrium because of the continuing opposition of two advocacy coalitions of member states. Advocates of a fiscal union or an embedded currency area approach used the Covid-19 pandemic successfully to push the Eurozone further in the direction of their preferred model without overcoming the resistance of adherents to a stability union model to a permanent transformation of the Eurozone into a fiscal union. As soon as the worst phase of the pandemic is over, the fault lines between these two opposing advocacy coalitions might prove as deep as ever. They are likely to manifest themselves once again in the debates on the end of the relaxation of fiscal rules and their future reform, on the future of national debt brakes, on the creation of new European Union own resources and on making the instrument of the Union to contract debt to finance investments a permanent one.

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[i] On the concept of creeping crises, see Boin et al., 2020; see also Pierson's typology of the time horizon of different causal accounts of crises (Pierson, 2004: 79-102).
[ii] For an overview on implemented and non-implemented reforms in the areas of financial stabilisation, economic governance, fiscal support mechanisms, and cooperative dissolution plans for the Eurozone, see Eckert et al., 2020.
[iii] The Commission's communication on 'The European economic and financial system: fostering openness, strength and resilience' mentioned the concept "resilience" and "resilient" 26 times (European Commission, 2021a). Moreover, the main fund to cope with the economic impact of the pandemic is named "Recovery and Resilience Facility" (RRF). The regulation establishing this fund (Regulation (EU) 2021/241) uses these concepts no less than 284 times!
[iv] In this policy field, resilience language clearly entered into the discourse of policy-makers and expert networks, see Financial Stability Forum (2007) and Basel Committee on Banking Supervision (2009). For an early literature review covering several disciplines, see Martin-Breen and Anderies (2011).
[v] One prominent example in economics of this kind of thinking, even though not couched in resilience language, is Reinhart and Rogoffs seminal work on international financial crises (Reinhart and Rogoff, 2009).
[vi] On the use of vulnerability and resilience and their mutual relationship, see Bürkner (2010). Boin et al., (2020: 122) use the concept of (accumulation of) threat potential which is close to vulnerability. We prefer the concept of vulnerability as a threat potential can be traced back to specific root causes whereas vulnerability is more agnostic about where the specific threat might come from.
[vii] In a similar way, the Commission uses the concepts of risk management/prevention, crisis management, rehabilitation and monitoring in reports on member states' and European-level disaster prevention policies, see Joseph (2014: 297); see also European Commission (2012).
[viii] As an example of a widespread type of crisis interpretation, see the contribution of the two Commission collaborators Buti and Carnot (2012). And see De Grauwe (2013) for an influential interpretation of the EMU's 'design failures'.
[ix] For a similar line of argument, see Pisani-Ferry (2010) and Buti and Carnot (2012).
[x] This assumes Next Generation EU / RFF to remain a temporary instrument.
[xi] See Gros and Alcidi (2011) for an early critical assessment.
[xii] See
http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_scoreboard/index_en.htm
[xiii] https://www.eba.europa.eu/risk-analysis-and-data/risk-dashboard
[xiv] For a list of the European Court of Auditors' reports and audits on economic and monetary affairs, see https://www.eca.europa.eu/sites/ep/en/Pages/Policy-areas.aspx (last access: 2 January 2022).
[xv] As of 1 November 2021.
[xvi] Cf. Heinemann and Kemper (2021); this interpretation is, of course, refuted by the ECB, see Schnabel (2020).
[xvii] See the chapters by Armingeon et al. and Webber in this volume.
[xviii] Data from ECB Statistical Data Warehouse and Eurostat Scoreboard Euro indicators.
[xix] Interview of Paolo Gentiloni with Le Monde, 4 June 2021, my translation.