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The Politics of Bad Options

Walter, Stefanie, Ari Ray, and Nils Redeker

Chapter 1

Introduction

Abstract

The introductory chapter lays out the main research questions and puzzles motivating the book: Why did the Eurozone crisis prove so difficult to resolve? Why were adjustment burdens distributed so unevenly and why did no country leave the Eurozone? Who supported and opposed different policy options and how did the distributive struggles both within countries and between countries shape crisis politics? The chapter provides an overview about the trajectory of the crisis and highlights the unusual characteristics of the crisis, most notably the unequal distribution of crisis resolution costs between deficit-debtor and surplus-creditor countries in the Eurozone. It then presents the policy options available to policymakers in both crisis countries mired by debt and balance of payments problems, as well as surplus-creditor countries characterized by large current account surpluses. The chapter then presents a brief overview over the book's main argument that societies' and political actors' vulnerability profiles play an important role in shaping crisis policies and politics. The chapter concludes with an outlook and brief summary of the book's empirical chapters and a discussion of the book's contributions to research on the Eurozone crisis, crisis politics, and the role of trade-offs in policymaking more generally.

The Eurozone crisis began in late 2009. It followed in the wake of the Global Financial Crisis and quickly developed into one of the most serious economic and political crises in the history of the European Union (EU). Nonetheless, after a decade of unsuccessful attempts to resolve the fundamental structural and institutional issues that underlie the Eurozone's problems, a long-term reform that addresses these problems remains elusive (Mody 2018). Although no country so far has seriously entertained the idea of leaving the Eurozone, the monetary union's problems are far from resolved. The dominant approach has been to force the countries hit hardest by the Eurozone crisis to implement unprecedented austerity. These policies have resulted in a huge loss in confidence in national governments (Foster and Frieden 2017; Kriesi 2012), the EU (Hobolt 2015; Hobolt and de Vries 2016a), and democracy more generally (Armingeon and Guthmann 2014; Cramme and Hobolt 2014; Streeck and Schäfer 2013), and they have helped pave the way for the rise of Eurosceptic parties across the Eurozone (Bellucci, Lobo, and Lewis-Beck 2012; Kriesi and Pappas 2015; Usherwood and Startin 2013). Despite these fundamental challenges, no consensus about how to fundamentally reform the monetary union has emerged (for a review, see Sadeh 2018). Although the EU has of late been battling with other crises as well, the unresolved problems of the Eurozone remain the Union's Achilles' heel.

The inability or unwillingness of Eurozone governments to change course in their attempts to resolve the Eurozone's problems is particularly puzzling because the European approach to resolving the crisis has been very unusual. The Eurozone crisis is in its essence both a classic debt and balance-of-payments (BOP) crisis, caused by huge imbalances in capital and trade flows (Baldwin et al. 2015; Lane 2013; Wihlborg, Willett, and Zhang 2010). Such crises are costly: debts have to be repaid or written off to address the debt problem, and macroeconomic policies have to be adjusted to prevent a further build-up of debts in the future. This means that not just the problem of the stock of debts has be resolved, but also the flow problem, because debts owed to foreign actors usually accumulate in the wake of an extended period of current account deficits which by definition also imply a capital account deficit (both are contained as mirror images in the balance of payments). Countries with current account deficits thus not only import more goods and services than they export, but also experience net capital inflows. Debtor countries therefore need to reduce not just the accumulated debts but also their current account deficit; they do so my implementing austerity and other measures to reduce spending, repay their debts, reduce imports, and stimulate exports. These adjustments become necessary irrespective of whether the crisis was predominantly caused by financial flows or by flows of goods and services.

In contrast, creditor countries are often characterized by current account and capital account surpluses,[1] which means that they export more goods and capital than they import and therefore build up financial claims in the deficit countries. These countries can contribute to crisis-resolution costs by agreeing to restructure or even write-off debts and by creating new export opportunities for debtor countries via a boost in domestic demand in their own economies (Frieden 2015b). Usually, debtor and creditor countries share these crisis resolution costs, even though the weaker bargaining position of debtor countries means that they usually pay a larger share of these costs (Dyson 2014; Eichengreen 1991).

In contrast with other debt and BOP crises, the political conflicts about sharing the burden of crisis resolution in the Eurozone crisis have played themselves out in unusual ways. Although the crisis happened in the context of a close economic and political union, whose members are highly interdependent, the amount of burden sharing has been surprisingly small. One set of countries, mostly

[1] Because current account and capital account surpluses and deficits are two sides of the same coin, the convention is to refer only to the current account, even though current account adjustments always implicate changes in the capital account as well.

the creditor countries and those states with large current account surpluses, has been exceptionally successful in shifting most of the crisis resolution burden onto the debtor states mired in crisis. While debtor states were forced to implement austerity measures and structural reforms that were almost unprecedented in scale, surplus countries did not significantly adjust their economic policies. When compared with other financial crises, it is particularly unusual that surplus countries agreed only to minimal debt relief and debt restructuring in the debtor countries, limited to Greece and Cyprus (Zettelmeyer 2018). And 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 neither resolved the Eurozone's fundamental problems nor fostered a more equal distribution of crisis-resolution costs among Eurozone member states (Jones, Kelemen, and Meunier 2016). Instead, creditor countries undersigned huge bailout programs combined with strong conditionality that pushed the crisis countries into deep recessions. This put the burden of crisis resolution almost entirely on the shoulders the debtor states, who implemented austerity packages on a scale unprecedented in Europe (Perez and Matsaganis 2018).

The costs of crisis resolution in the Eurozone crisis were, thus, borne almost exclusively by indebted deficit countries, whereas the creditor-surplus states did little to share the burden (Copelovitch, Frieden, and Walter 2016; Frieden 2015b; Frieden and Walter 2017).[2] This is an unusual outcome, especially since it happened in the unique setting of the European Economic and Monetary Union (EMU), which involves a wide range of economic and political relations among members of a single market and a common currency (Mabbett and Schelkle 2015). Such a setting usually facilitates cooperation (Keohane 1984). One would also expect more burden-sharing because a lasting resolution of the Eurozone crisis is central to the stabilization of the monetary union and, thus, the future of European integration.[3]

Our book sets out to explain the unusual European crisis experience by examining the politics surrounding the choice of crisis strategies in both debtor-deficit and creditor-surplus countries. Although it is well understood that the structural diversity of the Eurozone is an important cause of the crisis and a major obstacle to its resolution (Hall 2012; Moravcsik 2012; Scharpf 2013; Streeck and Elsässer 2016), what is less well understood is how these structural constraints translate into politics, particularly, how they affect the political will on the part of policymakers to find a viable long-term solution to the ongoing crisis. Who supports and opposes different policy options domestically? How do distributive struggles among interest groups and voters shape and distributive conflicts both within countries and between countries shape crisis politics?

This book answers these questions by investigating how the structural characteristics of a diverse set of Eurozone economies have affected the interests of important societal and political actors and how these interests, in turn, have shaped Eurozone crisis management. It argues that as in all debt and balance-of-payment crises, distributive concerns—both within countries and among countries—have shaped the politics of Eurozone crisis resolution.[4] At the international level, creditor countries with current account surpluses have fought with debtor countries with current account deficits over who should implement the policies necessary to reduce the current and capital account imbalances and who should take responsibility for the accumulated debts. Within deficit-debtor and surplus-creditor countries, interest groups and voters have fought to shift the costs of crisis resolution away from themselves. Such contexts make crisis resolution difficult for policymakers, especially if crisis-resolution preferences vary widely. Swift and substantial policy adjustment is easiest when politically influential interest groups clearly favor one type of crisis-resolution strategy. In contrast, in contexts

[2] For a discussion of the burden-sharing that did occur, see Schelkle (2017)

[3] There is also a normative argument that can be made for more solidarity (Viehoff 2018).

[4] See for example Eichengreen (1996), Frieden (1991a), Nelson (1990), Pepinsky (2009), Simmons (1994), Walter (2013).

where significant parts of the society are vulnerable to any type of reform, crisis politics becomes contentious and much more difficult to resolve.

A better understanding of Eurozone crisis politics, thus, requires a systematic comprehension of the policy options available to policymakers during the crisis as well as the trade-offs and costs associated with each of these alternative options; and it involves an analysis of how politically influential actors evaluate these policy options on that basis. Our book focuses on the three broad strategies that can be pursued in order to resolve the imbalances underlying much of the Eurozone's problems: internal adjustment, external adjustment, and financing (such as bailouts or debt relief). It examines the vulnerabilities of deficit-debtor and surplus-creditor country economies to each of these strategies on the macro level and on the level of interest groups and zooms in on the difficult policy trade-offs that these options entail. Our analyses suggest that surplus-creditor country governments faced strong domestic incentives to push most of the adjustment burden onto deficit countries and to provide external financing in the form of bailout packages to deficit-debtor countries in return. Since deficit-debtor countries mired in crisis were in a weaker position to push adjustment costs onto surplus-creditor countries, they ultimately accepted this crisis-resolution approach. Distributional conflicts in the crisis countries, therefore, revolved mostly around how the cost of adjustment was to be distributed among different societal groups.

Overall, the book explores why the Eurozone crisis proved so difficult to resolve, why adjustment burdens were distributed so unevenly, and why despite all this, no country left the Eurozone during the crisis. As such, it presents a theoretical framework and an analysis that applies broadly to financial crises which require macroeconomic adjustment.

A short primer on the Eurozone crisis

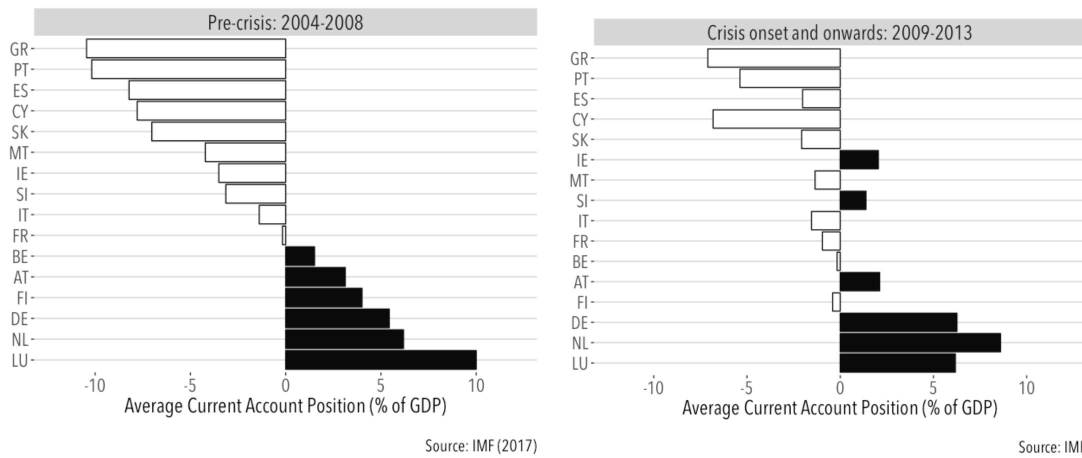
In its essence, the Eurozone crisis is a classic combination of a debt and balance-of-payments crisis (Atoyan, Manning, and Rahman 2013; Baldwin et al. 2015; Gibson, Palivos, and Tavlas 2014; Higgins and Klitgaard 2014).[5] Countries in the Eurozone borrowed heavily, largely to finance current consumption, as financial institutions in the rest of Europe were eager to lend (Fuller 2018). Capital and goods flowed out of countries with current and capital account surpluses into those countries with current and capital account deficits. In the process, the Eurozone developed large current account imbalances (Iversen and Soskice 2018; Johnston 2016; Johnston, Hancké, and Pant 2014). Figure 1 shows just how much the current accounts of Eurozone member states diverged: Whereas Greece and Portugal recorded an average current account deficit of more than 10% of their GDP per year during the five years leading up to the crisis, Germany and the Netherlands recorded current account surpluses that exceeded 5% of their GDP over the same period (IMF 2016). These surplus countries exported more goods and services than they imported, yet they were simultaneously characterized by considerable capital outflows.[6] The resulting financial flows directed savings from surplus economies into mortgage and construction bubbles in deficit states and, at least partly, financed the build-up of substantial debts in the peripheral Eurozone economies by making credit widely available for these countries (Thompson 2016). In some countries, these debts were concentrated in the private sector (e.g. in Irish banks, firms and households), in others in the public sector (e.g. in Greece), and in some

[5] As discussed above, the two are intimately related: a country running a current account deficit is accumulating debts. This is why countries as diverse as Mexico in 1994, South Korea in 1997, or Lithuania in 2008 experienced both debt and BoP crises.

[6] There is an academic debate about whether the current account drives the capital account, or vice versa, which remains unresolved (Caballero and Krishnamurthy 2009; Claessens, Evenett, and Hoekman 2010; Yan 2007). The most plausible theory is that both dynamics occur simultaneously and usually reinforce each other (Obstfeld and Rogoff 2009). Irrespective of how one classifies the cause of a crisis, however, once the crisis erupts, current account adjustment often becomes a core issue for crisis management.

(e.g. in Portugal), the foreign capital flowed into both the private and public sector (Blyth 2013; Sandbu 2017). Despite these different paths, the capital and current account imbalances produced significant risks both financially and the real economy (Fuller 2018; Lane and Milesi-Ferretti 2011; Pérez 2019).

Figure 1: Eurozone current account imbalances before and after the outbreak of the Eurozone crisis



Source: Authors' own calculations, based on data from the IMF (2016)

This macroeconomic divergence was amplified by three features unique to the Eurozone (Copelovitch, Frieden, and Walter 2016). First, because the EMU-wide "no bailout commitment" was not credible, financial markets widely expected that a Eurozone country in financial distress would be bailed out by the other member states. As a result, all member states across the Eurozone could borrow at rates roughly equivalent to those charged to Germany (Chang and Leblond 2015; Ghosh, Ostry, and Qureshi 2013). This made borrowing very cheap. Both private and, to a lesser extent, public actors borrowed heavily, fueling a strong economic expansion and an increase in unit labor costs (Hopkin 2015). Between 2003 and 2007, the Irish economy grew on average by 5.3% per year, the Greek economy expanded by 4.1% per year, and Spain's economy grew at an average rate of 3.6% (calculations are based on Feenstra, Inklaar, and Timmer 2015). Similar to the run-up to many other financial crises (Reinhart and Rogoff 2010), this expansion first grew into a boom and then into a bubble, in which booming housing markets, strong increases in domestic consumption, and concomitant increases in imports were financed by significant capital inflows.[7] Both borrowers and lenders thus contributed to creating a situation that was vulnerable to a sudden stop in capital inflows. When the global financial crisis suddenly halted capital inflows, this resulted in both BoP and debt problems and created the need for adjustment and/or debt relief.

A second feature was the lack of fiscal policy coordination, which meant that Eurozone governments had little incentive to adjust their fiscal policies to counteract the growing imbalances (Baerg and Hallerberg 2016). Research suggests, for example, that the consequences of the crisis would have been much less severe if deficit had followed more conservative fiscal policies during the boom (Martin and Philippon 2017). Yet the political incentives to so this were small. That said, it is important to note that this was not a crisis of government overborrowing; it was not the countries with the highest debt-to-GDP ratios that were hit hardest by the crisis (Johnston, Hancké, and Pant 2014; Wihlborg, Willett, and Zhang 2010).

[7] For a detailed discussion of the causes of the Eurozone crisis, see, for example, Baldwin et al (2015).

Finally, the weak fragmented nature of financial regulation coupled with the creation of a single market in financial services in the Eurozone created possibilities for regulatory arbitrage, which financial institutions readily exploited. At the same time it did not create any incentives for national regulators to internalize the potential systemic effects of the rapidly increasing financial flows between countries (Jones, Kelemen, and Meunier 2016). The institutional setup of the Eurozone institutions remained incomplete and would soon prove inadequate in dealing with the challenges of the crisis. All these developments attest to the difficulties of managing risks in a confederation of structurally diverse states bound together by an economic but not a political union (Hall 2012; Matthijs and Blyth 2015; Moravcsik 2012).

As a result of these developments, on the eve of the crisis, many financial institutions in the Eurozone's northern member states were exposed to both public and private debt from the periphery, whereas the financial, corporate, and/or public sector in the deficit countries were highly indebted to the North (Fuller 2018; Lane 2013), which is why the Eurozone crisis has been identified as a crisis of systemic over-lending by European banks (Matthijs and Blyth 2015). As in many other banking crisis before the European banking crisis (Copelovitch and Singer n.d.; Jorda, Schularick, and Taylor 2010), massive capital inflows preceded the outbreak of this crisis.

The shock waves caused by the global financial crisis that started in 2007 then served as a trigger and catalyst for these European imbalances to erupt into a major debt and balance-of-payment crisis, the Eurozone crisis (Aizenman, Hutchison, and Lothian 2013; Lane 2012). Lending dried up, leading to a "sudden stop" of capital inflow (Merler and Pisani-Ferry 2012; Milesi-Ferretti and Tille 2011), and the heavily indebted borrowers found themselves unable to service their debts. What was initially predominantly a banking crisis quickly developed into a sovereign debt crisis. Because most foreign capital had flown into countries' private sectors in the boom years, at its outset the crisis was mainly one of private loans to private borrowers (Blyth 2013; Sandbu 2017).[8] Only when private banks approached illiquidity and insolvency, governments came to their rescue to prevent a financial meltdown. In the process of these massive banking crises, governments assumed many of the bad debts of their banks, which turned a private debt crisis into a sovereign debt crisis (Mabbett and Schelkle 2015).

However, the growing public debt increased the country's sovereign credit risk, which further weakened the financial system and, thus, created a negative bank-sovereign "doom" loop (Acharya, Drechsler, and Schnabl 2014). Markets panicked and risk premia surged, especially in those Eurozone countries with the largest current account deficits saw their premiums spike (Baldwin and Giavazzi 2015: 20; Johnston, Hancké, and Pant 2014). Governments in deficit countries suddenly faced a large debt burden, a deteriorating financial situation, and a collapse of domestic demand. In the face of these problems, financial markets panicked and risk premia on sovereign debt soared, further deteriorating the financial situation of crisis country governments. Unable to cover their continuing payments deficits by exporting or by borrowing additional funds, these governments suddenly were faced with a very real risk of sovereign default, which loomed large over several Eurozone countries and an emerging balance-of-payments crisis (Quaglia and Royo 2015). At the same time, surplus country creditors saw their investments in the Eurozone's periphery increasingly at risk.

The first country to face an imminent risk of sovereign default was Greece.[9] In late 2009, the Greek government revealed that its budget deficit was much higher than it had previously reported. The financial markets reacted immediately, and Greek borrowing costs soared. Soon, the Greek government had to ask for outside help. Although there was widespread agreement that a breakup of

[8] This is why government deficits prior to the crisis do not predict the severity with which the countries were hit by the crisis (Johnston, Hancké, and Pant 2014).

[9] We only present a brief overview of the Eurozone crisis here. For a more detailed account of the trajectory of the crisis see, for example, Copelovitch et al. (2016) or Mody (2018).

the Eurozone was to be avoided at all cost, it took protracted deliberations and negotiations, before European governments approved a financial assistance program in May 2010, in which Eurozone member states together with the IMF would provide Greece with financial assistance on the condition of fiscal austerity and structural reforms. But this did not end the crisis. Rather, it quickly spread, and Ireland and Portugal, where huge credit booms had also turned into busts, equally had to ask for financial help. Both countries received bailouts—Ireland in November 2010 and Portugal in May 2011—under the auspices of the Troika, a tripartite committee formed by the European Commission, the European Central Bank (ECB), and the International Monetary Fund (IMF). Again, these bailouts were granted under the condition that the countries implement far-reaching austerity measures and structural reforms. As a result, unemployment surged, poverty spread, and most people in deficit countries saw their incomes fall (Dølvik and Martin 2014).

Figure 2a: Creditor country bank claims on deficit countries

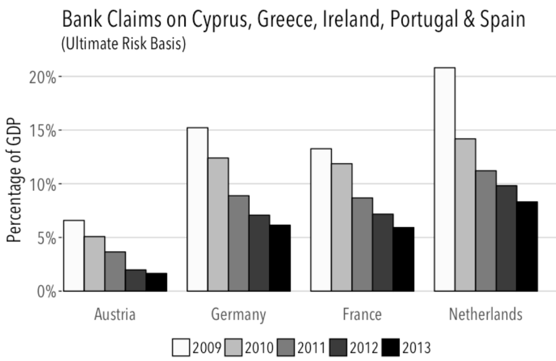
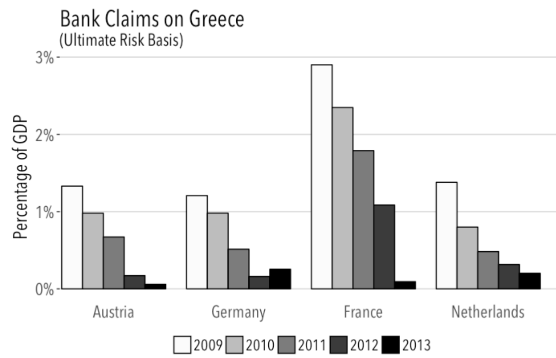


Figure 2b: Creditor country bank claims on Greece



Source: Authors' own calculations, based on data from the Bank of International Settlements (2016)

In the meantime, financial institutions in the creditor countries—which were still weakened from the 2007–2009 global financial storm—used the time bought by the bailouts to deleverage. Figure 2a shows how quickly and how pervasively these banks reduced their exposure to crisis-country debt, which, at the same time, reduced the risk that a sovereign default in the Eurozone periphery would seriously threaten the stability of banks in the creditor states. Three years into the crisis, creditor country banks had reduced their claims on the main crisis countries by about half. Figure 2b shows that by the time Greece received a second bailout package in March 2012, the exposure of German, Dutch, French, and Belgian banks to a Greek default or a debt restructuring had dramatically decreased. Although this second bailout package for the first time included a significant debt write-down, a so-called haircut, for private creditors and wealthy bank depositors, the effect on surplus country investors was, thus, limited (Zettelmeyer, Trebesch, and Gulati 2013). Spain also received financial assistance in June 2012 and Cyprus in March 2013. The Cypriot bailout package was unusual in that it also included a haircut especially on wealthy (and mostly Russian) depositors.

In effect, the bailouts made it possible for surplus country governments to support their domestic banks indirectly via a bailout of a Eurozone debtor state (Ardagna and Caselli 2014; Mody 2018; Thompson 2015). Although this allowed surplus country governments to avoid a second round of banking crises and costly bailouts at home, this was not how they framed the international bailouts in the public debate, most likely because bank bailouts, whether direct or indirect, were deeply unpopular among the public (Goerres and Walter 2016; Thompson 2015), and because they would have had to acknowledge that it this strategy allowed creditor country banks to offload their exposure to creditor country taxpayers and socialize the potential losses from investments gone bad (Blyth 2013). Rather, surplus country policymakers engaged in a narrative of "northern saints and southern sinners"

(Matthijs and McNamara 2015), in which the bailout packages were presented as acts of "solidarity" and necessary evils designed to protect the European project (Degner and Leuffen 2016; Wendler 2014), arguments that generally resonated with the public (Bechtel, Hainmueller, and Margalit 2014). Nonetheless, surplus country taxpayers were not particularly positive about the bailouts, and crisis politics became contentious in these countries even though surplus country governments tried to time and design the bailouts in a manner that would not alienate their voters too much (Schneider and Slantchev 2018). In January 2012, 61% of German respondents in a large survey reported that they were against bailout payments for over-indebted EU countries (Bechtel, Hainmueller, and Margalit 2014). In November 2011, 60% of Dutch voters thought that their government should stop lending money to Eurozone countries in crisis, and another survey found that 64% opposed the creation of a rescue fund for crisis countries at the European level (Die Presse 2011; Maurice-De-Hond 2011).

In addition to the bailout packages, European policymakers also worked to address the crisis at the European level. The Eurozone governments created the European Financial Stability Facility (EFSF), later replaced by the European Stability Mechanism (ESM), a permanent international financing institution with a mandate and funds to provide assistance to member states in financial distress. They adopted "six-pack" and later the "two-pack" reforms intended to strengthen the Stability and Growth Pact and to introduce greater macroeconomic and fiscal surveillance in an effort to improve compliance with the Pact's rules. In March 2012, all European leaders, except those from the UK and the Czech Republic, signed the "fiscal compact," a treaty designed to force member state governments to balance their budgets over the business cycle. In June 2012, Eurozone leaders also endorsed the idea of a banking union, in which Eurozone banks would operate under a set of common rules, with a single supervisory authority and a single resolution mechanism for bank failures—an idea that has however since been implemented with much delays and in an incomplete manner, as attempts to establish a European deposit insurance scheme have been derailed (Gros and Schoenmaker 2014; Howarth and Quaglia 2014, 2018).

The negotiations on how to address the crisis and on how to try to prevent future crises were difficult from the start. Although Eurozone governments agreed from the start that any form of a Eurozone breakup was not an option, they agreed on little else. The core divide between Eurozone governments in all these negotiations was between current-account surplus-running creditor states and deficit states with large current account deficits (Armingeon and Cranmer 2017; Tarlea et al. 2019). For example, different proposals for new financing schemes—from Eurobonds (e.g., De Grauwe and Moesen 2009) over a European deposit insurance scheme (Donnelly 2018; Howarth and Quaglia 2018) to a European unemployment insurance scheme (Claeys, Darvas, and Wolff 2014)—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. A large-scale study of intergovernmental negotiations on 47 Eurozone-related issues between 2010 and 2015 found a fundamental divide between these states (Wasserfallen and Lehner 2018), with a conflicts between the two couched mainly along the fiscal transfers vs. fiscal discipline divide. Surplus countries generally supported reforms that would require more fiscal discipline, whereas deficit countries were in favor of designing European-level schemes in ways that would result in fiscal transfers. States leveraged both their bargaining power and (often self-serving) ideas to support their preferred positions (Blyth 2013; Bulmer 2014; Dyson 2010, 2017; Howarth and Quaglia 2015; Matthijs and McNamara 2015; Moschella 2017; Schimmelfennig 2015).

Considering the politicization of the issues and the loss of popular trust in the EU, the institutional reforms on the European level went further than many predicted and are seen by some as a major leap in integration (Börzel and Risse 2018; Schimmelfennig 2018). More often than not, however, these European-level solutions did not address the fundamental Eurozone problems (Copelovitch, Frieden, and Walter 2016; Jones, Kelemen, and Meunier 2016; Matthijs and Blyth 2015; McNamara 2015; Mody 2018; Della Porta et al. 2016).

This left the ECB as the principal Eurozone economic institution to manage the crisis at the European level. It took quite aggressive measures designed to provide relief to deficit countries and banks, including a substantial bond-buying program to shore up financial markets as well as a monetary policy to push interest rates into negative territory. However, these policies also embroiled the ECB in political controversy. Many in northern Europe criticized the central bank for its expansionary monetary policy and unconventional measures, whereas for many in peripheral Europe, it did not do enough to alleviate the impact of the crisis.

It was also the ECB who managed to mark a turning point of the crisis: In July 2012, ECB president Mario Draghi famously stated that the ECB stood ready to do "whatever it takes to preserve the euro," as the bank unveiled a new bond-purchasing program, called "Outright Monetary Transactions" (OMT). This statement significantly calmed financial markets. The crisis returned briefly—albeit vigorously—to the center of European politics in July 2015 when difficult negotiations between the new populist left Greek government and the Troika culminated in a referendum about Greece's bailout package that almost pushed Greece to the brink of Eurozone exit. After Greece received a third bailout package, however, the Eurozone crisis slowly calmed down.

While financial market volatility has subsided, many of the underlying problems that fueled the outbreak of the Eurozone crisis remain unresolved (Mody 2018). The euro still binds together a highly diverse set of countries within a uniform monetary framework. Some progress has been made, for example with the establishment of the ESM or the single supervisory mechanism, but other institutional reforms, such as the new the single resolution mechanism remain inadequate (Jones, Kelemen, and Meunier 2016). Proposals that aim at more risk-sharing among Eurozone economies (such as Eurobonds or a pan-European unemployment scheme) have so far not gone anywhere.

The severe consequences of the crisis also linger. Unemployment rates are still high in many crisis countries, and rather than shrink, the current account surpluses of countries such as Germany or the Netherlands are now higher than before the crisis. Moreover, the political ramifications of the crisis have been enormous (Hernández and Kriesi 2015; Kriesi and Pappas 2015; Kurer et al. 2018; Della Porta 2015; Streeck and Schäfer 2013). The austerity measures and structural reforms in the crisis states were difficult and politically costly. One government fell after another. In the deficit countries, voters' support for democracy (Armingeon and Guthmann 2014; Armingeon, Guthmann, and Weisstanner 2016), their trust in national governments (Foster and Frieden 2017), and their general satisfaction with the EU reached unprecedented lows (Guiso, Sapienza, and Zingales 2016; De Vries 2018). The crisis also fueled support for Eurosceptic parties in both surplus and deficit states and especially among those voters hit hardest by the crisis (Hobolt and de Vries 2016b). And although support for the euro remained remarkably high in all Eurozone countries throughout the crisis (Hobolt and Wratil 2015; Roth, Jonung, and Nowak-Lehmann 2016), populist support for leaving the Eurozone or dissolving it altogether gained significant momentum (Heinen et al. 2015). Explicit support for dissolving the monetary union has been most pronounced in the surplus countries: the Dutch PVV, the German AfD, the French Front National, and the Austrian FPÖ have all at times called for a controlled dissolution of the Eurozone, with the True Finns in Finland taking a critical but more cautious position. There has also been a strong push for a referendum on the euro in Italy and by some fringe parties in Greece[10]—even though most parties, including some influential populist parties, such as Spain's Podemos and Greece's SYRIZA, support staying in the Eurozone.

This development shows that the Eurozone crisis has had consequences that extend far beyond the economy and continue to shape and challenge European politics. The jitters of financial markets caused by the 2018 Italian elections demonstrate that the Eurozone crisis may come back to haunt the EU in the not too distant future. Ultimately, the underlying causes of the crisis have not been resolved, and the political consequences of the crisis still linger. As a result, the narrative that "the crisis is over"

[10] The communist KKE party and the SYRIZA-spinoff Popular Unity party have proposed leaving the Eurozone.

seems misguided. Thus while the short-term panic has subsided, serious questions remain about the future of the monetary union itself. A better understanding about why it has proven so difficult to resolve the Eurozone crisis is, therefore, urgently needed.

The unequal distribution of crisis-resolution costs

In all debt and balance-of-payments crises, governments and societies disagree heavily about the question who should bear the costs of dealing with the accumulated debts and of rebalancing the current accounts, and the Eurozone crisis was no exception (Dyson 2014; Eichengreen 1992; Frieden 2015b; Hall 2014; Simmons 1994; Walter 2013; Woodruff 2016). In the ensuing conflicts about crisis resolution, both sides have bargaining chips: creditor states can threaten to shut errant debtors out of credit markets and to block future access to credit, but debtors can threaten to stop payment, especially if default in one country is likely to cause panic to spread into financial markets more widely. Although deficit-debtor states tend to be in a structurally weaker bargaining position, most crises are resolved with both sides making some compromises about how to share the crisis resolution costs (Dooley, Folkerts Landau, and Garber 2004; Frieden 2015b; Kaufmann 1969; Mabbett and Schelkle 2015).

Nonetheless, debt and BoP crises are characterized by difficult trade-offs and bitter disputes surrounding questions such as: Should debtor countries repay the outstanding debt or should creditor countries grant debt relief? Should current account imbalances be resolved by deficit states cutting back on domestic consumption and increasing their exports or by surplus states boosting their domestic demand? Should adjustment instead work via the exchange-rate, which in a monetary union like to the Eurozone boils down to the question whether that union should be broken up? To what extent should surplus countries' support deficit countries by providing funds to finance the current account deficit?

Not surprisingly, then, the questions of who should adjust and of how the adjustment burden should be distributed were front and center in Eurozone crisis politics as well (Frieden and Walter 2017; Moschella 2017). What makes the Eurozone crisis unusual in comparison to other crises, however, is that relatively little burden sharing occurred. Some risk sharing occurred, although most of this occurred in the form of "solidarity by stealth" (Schelkle 2017): After initial hesitations, the ECB engaged in an expansionary monetary policy of a scale that had been unthinkable only a few years before, it provided emergency liquidity assistance to troubled banks in crisis countries, and ECB president Mario Draghi promised to everything necessary to preserve the euro. Moreover, some debt restructuring occurred in Greece and Cyprus. Yet overall, especially considering the extent of the crisis, little debt relief was granted for the countries hit hardest by the Eurozone crisis, such as Ireland, Portugal, or Spain. Moreover, deficit countries were required to undertake substantial fiscal and structural reforms designed to address their chronic balance-of-payments problems (Hall 2012; Heins and de la Porte 2015). As a result, the burden of adjustment in the Eurozone crisis has been almost exclusively put on the shoulders of the deficit countries (Matthijs and Blyth 2015).[11] The silence on calls for adjustment in surplus countries, in contrast, was often "deafening" (Featherstone 2011).

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[11] There are a number of reasons why the principal burden of adjustment to the Eurozone crisis fell upon the debtors' shoulders (Frieden and Walter 2017). For one, the threat of being cut off from the tightly integrated European financial markets loomed large for the crisis countries and gave creditor countries considerable bargaining leverage. Moreover, surplus countries 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. Whether the threat of expulsion was real and legal or not, many in the debtor countries were reluctant to press the issue, for fear that it might affect their economic relations with the rest of the Eurozone or that it might cause the fickle financial markets to turn against them. In addition, 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 (Copelovitch and Enderlein 2016; IEO 2016; Mody 2018). Finally, emphasizing ordo-liberal ideas, creditor countries have been successful in

Figure 3 shows two examples of just how much surplus and deficit states differed in their contribution to crisis resolution. Figure 3a looks at changes in statutory tax rates in surplus and deficit states during the first five years of the Eurozone crisis. It shows that all deficit states increased taxes during that period in line with their general policy of austerity. Tax reform in surplus states, in contrast, was much more limited or, in fact, non-existent. Rather than lower taxes in an effort to boost domestic demand, these countries (with the exception of Austria) did very little to adjust their fiscal policies. It therefore comes as no surprise that the surplus countries maintained or even increased their current account surpluses throughout the crisis (see Figure 3b) rather than contribute to a rebalancing across the Eurozone. In contrast, the deficit states implemented major current account adjustments during the same period. Over the course of the crisis, all deficit states significantly reduced their current account deficits, with most even turning their deficits into surpluses.

Figure 3: Varieties of adjustment: Deficit and surplus countries in the Eurozone crisis

Figure 3a: Fiscal reform

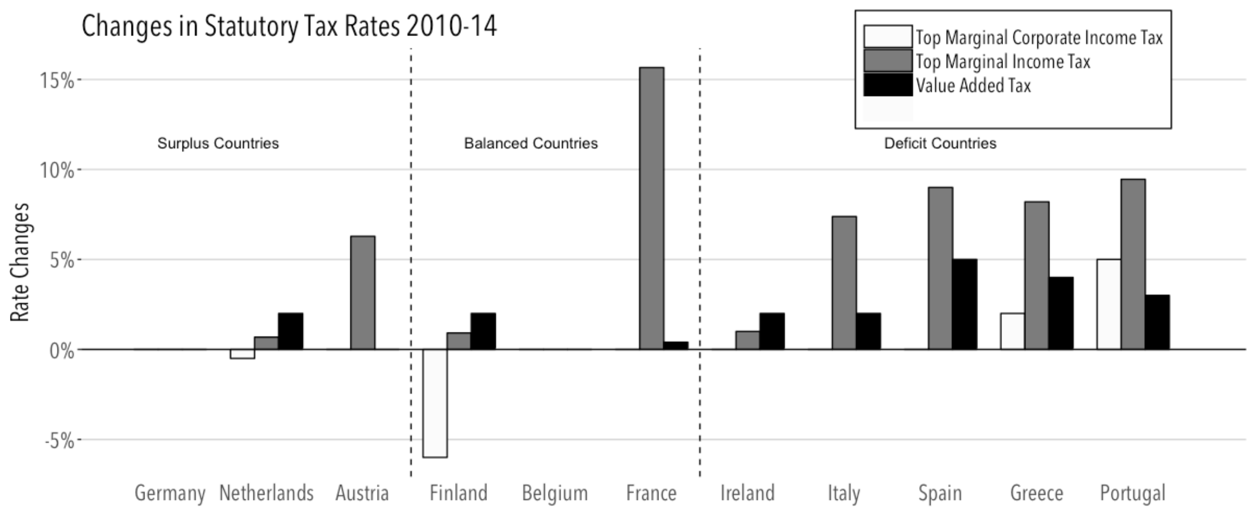
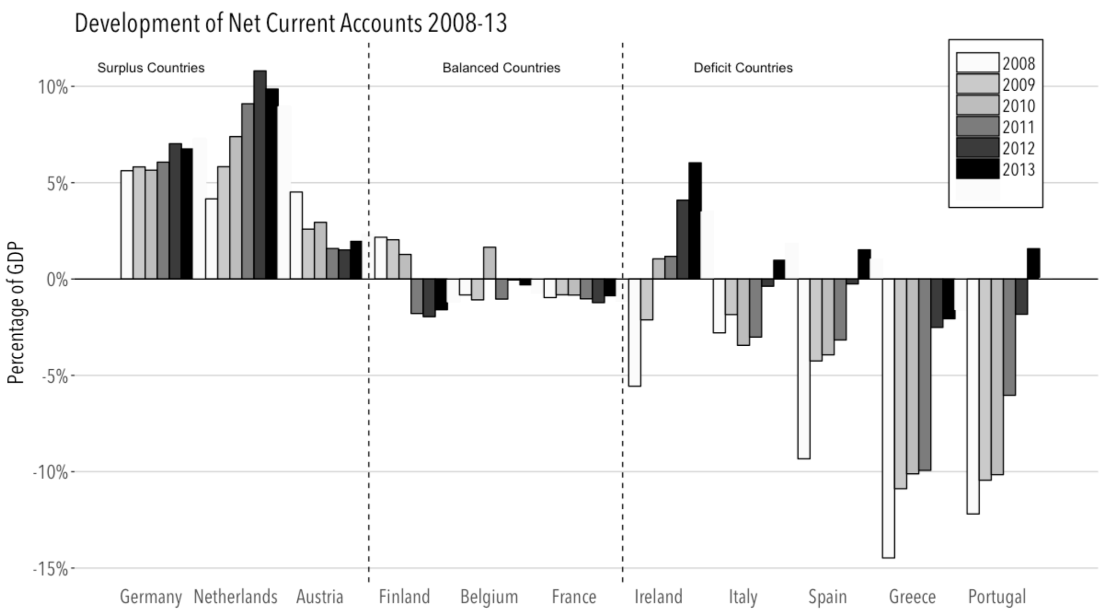


Figure 3b: Current account

framing the crisis in ways that suggest that deficit countries caused, and hence should resolve, the crisis (Blyth 2013; Matthijs and McNamara 2015).



Sources: Authors' own calculations, based on tax data from OECD (2016) and current account data from IMF (2016)

The effect of this unequal distribution of the adjustment burden between deficit and creditor states on economic growth and employment prospects in these countries has been harsh. Figure 4 illustrates how unequally the costs of the adjustment have been spread across Eurozone countries and how different Eurozone countries have fared throughout the crisis, and traces their economic development between 2007 (noted by the line) and 2013 (noted by the dot). The large increases on the horizontal axis show that the five main Eurozone debtor-deficit countries—Ireland, Italy, Portugal, and, especially, Spain and Greece—witnessed massive increases in unemployment over the course of the crisis. Their GDP fell back to the levels of when the Eurozone was first founded in three of these countries (the respective 1999 levels are represented by the value of 100), and GDP decreased significantly in all five debtor states. In contrast, the economic costs of the crisis were much smaller or even nonexistent in the surplus states, such as Germany, Austria, and the Netherlands. Over the same period of unprecedented contraction in Greece, for example, the German economy grew, and unemployment fell. Overall, the European response to the crisis achieved the one common goal all Eurozone policymakers agreed upon: the prevention of the breakup of the monetary union. But the price to achieve this goal varied among the Eurozone members, as it was paid predominantly by the crisis countries.

Figure 4: Crisis cost for selected Eurozone countries

Note: Short vertical lines indicate 2007 values. Dots indicate 2013 values.
Source: World Bank (2016a, 2016b)

Yet to say that the costs of the crisis have been predominantly borne by deficit states does not mean that everyone in deficit states was equally hurt by the crisis. Instead, the impact of the crisis has varied considerably among social and economic groups in these countries. For example, unemployment has hit young people, men, and less educated the hardest (Gutiérrez 2014). Youth unemployment tripled in Ireland between 2007 and 2012, and between 2012 and 2014, more than half of economically active people under the age of 25 in Greece and Spain were without work.[12] Likewise, relative poverty rates for young people went up in Italy, Portugal, and especially in Spain and Greece, while at the same time declining considerably for the elderly. Interestingly, inequality has only increased in some countries (most notably, Greece), whereas crisis policies seem to have had no impact on equality in other countries, or an inequality-decreasing impact in some (Matsaganis and 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, deficit states were relatively quick to adopt austerity measures, whereas structural reforms were implemented more hesitantly. Given that the latter were often aimed at stripping privileges from politically influential groups, they were frequently implemented only under considerable external pressure, and even then, compliance has been spotty. Similarly, banks and other financial market participants have largely socialized their losses, rolling them over to taxpayers (Blyth 2013). As discussed above, debtor-country governments ended up assuming many of the bad debts of their banks, and thus converted private debt into sovereign debt. Entrenched insider-outsider structures (Bentolila, Dolado, and Jimeno 2012), strong resistance by vested interests (Featherstone 2015), and clientelistic politics (Afonso, Zartaloudis, and Papadopoulos 2014) have generally protected politically influential groups. As in earlier crises, governments have often shielded their own voter base from the crisis consequences as much as possible (Walter 2016).

The impact of the crisis among social and economic groups has also varied in surplus states. One of the most important distributive questions was how to deal with deficit country debts: Should surplus countries allow the deficit states to default and restructure their debts, thus requiring their own financial systems to absorb the costs of the crisis? Or should the costs of the crisis be transferred onto surplus country taxpayers by way of providing public funds to the debtor countries that would allow them to continue servicing their debts to financial institutions in the North? Surplus country governments generally opted for the latter option. For example, of the € 215.9 billion in taxpayer loans

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

provided to Greece in the first two bailout packages, only about 5% actually ended up in the Greek state budget. The rest was used to finance old debts and interest rates payments to private banks, a lot of which were located in surplus countries (Rocholl and Stahmer 2016; Thompson 2015).

Bad options, difficult choices

Why did deficit countries accept to implement unprecedented levels of austerity during the crisis? Why did surplus countries put together huge bailout packages but not allow any meaningful debt relief? Why did they not adjust their policies to share some of the crisis-resolution cost? Why has it been so difficult to find common ground on the European level for a sustainable EMU reform? And why did, despite of all this, no country leave the Eurozone?

To understand the unusual choices policymakers took to respond to the Eurozone crisis, it is important to understand the range of options available to them. As discussed above, the principal options in a debt crisis revolve around how to deal with accumulated bad debts—do debtor countries repay the outstanding debt, or do creditor countries grant debt restructuring, providing some relief to debtor countries? However, this only resolves the stock problem of accumulated debts, not the flow problem of growing debt levels. Because the Eurozone crisis is, at its root, both a debt and a balance-of-payment crisis (Baldwin et al. 2015; Baldwin and Giavazzi 2015; Johnston, Hancké, and Pant 2014; Wihlborg, Willett, and Zhang 2010), solving the underlying problems of the Eurozone in a sustainable manner requires more far-reaching economic adjustments designed to address the flow problem of continuing current account imbalances that fueled the debt problems in the first place.

Several options exist for resolving balance-of-payments imbalances (Algieri and Bracke 2011; Broz, Duru, and Frieden 2016; Frieden and Walter 2017; Walter 2013). In contrast to the conventional narrative that the solution for such problems lies with deficit countries—who have to cut back domestic consumption and to increase their competitiveness in order to reduce imports and to boost exports of goods and services as well as capital—both deficit *and* surplus countries can contribute to the policy adjustment necessary for rebalancing (Willett and Chiu 2012).[13] A so-called internal adjustment of domestic economic policies can be achieved by deflating prices in deficit countries and by boosting domestic demand in surplus countries. Adjustment can also occur externally through the adjustment of exchange rates. Finally, current account imbalances can be made more sustainable if surplus states cover deficit states' financing needs . Table 1 summarizes these different policy options that deficit and surplus countries have to resolve current account imbalances as well as their implications for the Eurozone.

Although these options differ in their implications for deficit and surplus countries, they all have significant downsides. These downsides form the basis for the distributional conflicts surrounding the resolution of balance-of-payments crises. Whenever current account adjustment is required to solve a crisis, regardless of whether the crisis was predominantly caused by financial flows or by flows of goods and services, policymakers face trade-offs and difficult choices with regard to these options.

The first option for rebalancing the current account is *external adjustment*. This strategy involves a change of the nominal exchange rate, which for Eurozone members means that Eurozone would have to be broken up in some sort of way. Deficit countries adjust externally by devaluing their

[13] Note that our distinction between surplus and deficit countries is based on whether they exhibit a current account surplus or deficit during the buildup and outbreak of a given crisis. In the short run this is relevant for crisis management, and the dynamics and relevant trade-offs will be different across deficit and surplus countries. This does not mean that surplus and deficit countries are so different that countries are structurally either always deficit or surplus countries. Rather countries' current accounts can change from a deficit to a surplus and vice versa (see figure 1.1 and Manger and Sattler 2019).

exchange rate, making domestic products more competitive internationally. As expenditure is switched away from the consumption of internationally tradable goods and towards the production and export of such goods, the current account rebalances. Because this means that less capital is needed to finance the current account deficit, capital inflows decrease and the capital account deficit equally shrinks. This adjustment strategy can benefit the export-oriented sector, but it hurts other groups because it also leads to a reduction of purchasing power, increased exchange-rate volatility, and rising debt service on foreign-currency denominated loans (Frieden 1991b, 2015a; Steinberg and Walter 2013; Walter 2008a, 2013). In addition, external adjustment is often associated with higher rates of inflation, and it creates contagion risks for states with similar problems. For surplus countries, external adjustment implies an exchange-rate revaluation, which makes domestic products more expensive relative to foreign products, thereby increasing imports and reducing exports, as well as capital outflows. Many of the effects of external adjustment in surplus countries mirror the effects in deficit countries: Currency appreciation hurts the export-oriented sector, whereas domestic consumers and holders of foreign-currency-denominated debt benefit. At the same time, holders of assets denominated in foreign currencies lose out. Exiting a fixed-exchange rate regime such as a monetary union creates significant additional costs for both surplus and deficit states, however. Not only does it increase significant volatility, but breaking up a monetary union leads to a loss of credibility that is likely to have long-lasting negative effects. By demonstrating the possibility of exit, it is particularly likely to encourage speculation, which is likely to travel to other member states of the currency union (Chang and Leblond 2015). The resulting contagion effects are likely to have negative consequences both in surplus and deficit countries. External adjustment is thus a particularly costly policy option in a currency union such as EMU. It is important to understand that this does not mean that external adjustment is impossible – after all, it was discussed as a serious policy option in Greece in 2015 and euro exit was a pledge in French presidential candidate Marine Le Pen's 2017 election campaign – but does mean that external adjustment is a much more costly policy strategy for members of a currency union than countries with other forms of exchange rate regimes.

Table 1: Policy options to resolve balance of payments 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	Eurozone breakup	Convergence of deficit and surplus countries	Permanent financing structures (e.g., fiscal federalism, automatic stabilizers etc.)

Source: Frieden and Walter (2017: table 1)

The second possible adjustment strategy is *internal adjustment*, in which relative prices are adjusted through domestic fiscal and monetary policy changes and structural reforms. In deficit countries, the aim is to engineer an "internal devaluation" that deflates domestic prices through productivity gains and a reduction in domestic demand. This makes domestic products more competitive, reduces demand for imports and foreign capital, and increases exports. Because this adjustment strategy requires austerity policies such as public spending cuts, tax increases, and structural reforms (e.g., measures designed to increase labor market flexibility or policies aimed at increasing competitiveness), it is typically associated with higher unemployment, lower wages, asset price deflation, and recession in deficit countries. Implementing such policies is politically difficult (Barta 2018). For surplus countries, internal adjustment implies policies and reforms that increase relative prices—for example, a loose monetary policy or reforms stimulating domestic demand, such as increasing public investments, cutting taxes, or increasing the minimum wage. These policies increase the price of domestic relative to foreign prices, which lowers exports and increases imports as well as domestic consumption.

Both the external and the internal adjustment strategy aim at the long-term resolution of current account imbalances. Policymakers also have a third option, however, which is to simply *finance* the current account deficit and not adjust. Deficit countries can do this by using their foreign currency reserves or procuring external funding from international actors or other countries.[14] Surplus countries, who tend to be the creditors of deficit countries, are often willing to support such funding—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 an important downside: it does not resolve the underlying structural problems and often even aggravates them. Thus, this approach carries the risk that eventual adjustment will have to be more extensive than if it had been implemented early on (Frankel and Wei 2004; Walter and Willett 2012). To avoid such a situation, official foreign funds, such as those given by the IMF, are usually only provided under strict conditionality which forces the recipient country to implement adjustment.[15] For surplus countries, the main drawback of the financing option is that they have to provide the necessary funds in a setting where it is unclear when or whether the recipient will pay back those funds.

What does this mean for the politics of the Eurozone crisis? Because the crisis occurred within a currency union, some policy options would play out differently in this context than in the context of regular BOP crises. Most importantly, in a monetary union, external adjustment implies a breakup of the union, in this case the Eurozone. Although declared as highly unlikely by many observers (Eichengreen 2010), historical evidence shows that currency unions can and do break up (Cohen 1993). Different variants of such a breakup are thinkable—from the exit of a single country to the formation of two or more currency blocs or the introduction of parallel currencies (e.g., Brown 2012; Crafts 2014; Kawalec and Pytlarczyk 2013; Watts, Sharpe, and Juniper 2014). But whatever its form, external adjustment would mean that the Eurozone would cease to exist in its current form. This would carry huge costs for everyone involved, with consequences ranging from widespread defaults, over bank runs, and massive economic turmoil in the European economy.

For this reason, the external adjustment path was quickly ruled out by virtually all Eurozone policymakers who worried that, as Angela Merkel put it in a famous speech, a failure of the euro would lead to a failure of Europe.[16] In contrast, internal adjustment was seen as a desirable outcome because it would ultimately lead to a convergence of Eurozone economies. From its start, many observers have doubted the feasibility of a currency union in the European context because it clearly does not constitute an optimum currency area, with heterogenous member states that are subject to asymmetric vulnerability to shocks, a lack of labor mobility, and an absence of sufficient fiscal stabilizers (Bayoumi

[14] This explains why deficit countries are typically in a worse bargaining position about the burden sharing of adjustment than surplus countries. Reserve sales are often not enough to stop the crisis (Walter and Willett 2012).

[15] Though both the extent of these conditions (Copelovitch 2010; Dreher and Vaubel 2004) and the compliance with conditionality vary significantly (Stone 2008)

[16] https://www.bundestag.de/dokumente/textarchiv/2010/29826227_kw20_de_stabilisierungsmechanismus/201760

and Eichengreen 1992; Hall and Franzese 1998; Johnston 2016).[17] Internal adjustment, especially when undertaken not just in terms of fiscal policy but through structural reforms of labor and product markets, is designed to let the Eurozone countries converge more closely to one another. The idea was that this would not only serve to solve the short-term pressures of the Eurozone crisis but also lead to more long-term stability in the Eurozone. The political reality, however, has put the onus of achieving such adjustment squarely on the shoulders of the deficit countries, whereas surplus countries have done little to adjust their economic policies, let alone their economic growth models (Hall 2014; Matthijs 2016b; Willett and Chiu 2012). Finally, a long-term financing of European current account imbalances would require the creation of a set of institutions designed to facilitate the permanent transfer of funds from surplus to deficit states—such as a fiscal union, a banking union, and/or the establishment of a larger, more permanent transfer mechanism to replace the European Stability Mechanism. Many economists have called for such structures (e.g., De Grauwe 2013; Lane 2012; Pisani-Ferry 2012), yet political progress towards establishing such long-term financing structures has been limited.

Overall, this discussion shows that crises that require balance-of-payments adjustment, such as the Eurozone crisis, confront policymakers with a list of unattractive options. The general approach taken in the Eurozone crisis has been one of internal adjustment in debtor states, coupled with temporary financing (bailout packages) and expansionary monetary policy implemented by the ECB. Large bailout programs were set up, but crisis countries were forced to implement austerity and structural reforms in return, and no major debt relief was granted. Deficit countries largely accepted surplus countries' refusal to grant debt relief as well as their insistence that they should mostly shoulder the burden of internal adjustment alone, even though this resulted in deep recessions and record levels of unemployment in the deficit countries, whereas creditor countries were much less affected by the crisis.

The argument in brief

This book argues that distributive concerns are important for understanding not only Eurozone crisis politics but also the ongoing difficulties to substantially reform EMU. Distributive concerns, both within countries and among countries, always influence the politics of resolving debt and balance-of-payment crises. Research on the politics of past balance-of-payment crises—such as the breakdown of the gold standard (Eichengreen 1992; Simmons 1994), the Latin American Debt Crisis (Frieden 1991a; Nelson 1990), or the Asian Financial Crisis (Pepinsky 2009; Walter 2008b, 2013)— emphasizes the important role that distributive struggles played in these crises. At the international level, countries with current account surpluses and deficits fight over who should implement the policies necessary to reduce the current account imbalances and who should take responsibility for the accumulated debts (Willett and Chiu 2012).[18] Within countries, firms, interest groups and voters fight to shift the costs of crisis resolution away from themselves (e.g., Alesina and Drazen 1991; Fernandez and Rodrik 1991; Gourevitch 1986). Much research on the Eurozone crisis has zoomed in on these struggles in deficit countries, which have been at the center of the crisis (e.g., Afonso, Zartaloudis, and Papadopoulos 2014; Armingeon and Baccaro 2012b; Culpepper and Regan 2014; Fernández-Albertos and Kuo 2016; Kurer et al. 2018; Picot and Tassinari 2017). However, because both deficit and surplus countries can contribute to resolving the crisis, it is important to also analyze crisis politics in surplus countries and how the distributive struggles and concerns within these countries has shaped their response to the

[17] Based on the criteria set forth in the canonical studies by Mundell (1961), McKinnon (1963), and Kenen (1969).

[18] Our analysis focuses on Eurozone member states and their domestic politics. Others have emphasized the role of international (such as the IMF) and supranational institutions (such as the European Commission or the ECB), who also pursued their own agendas during the Eurozone crisis (Copelovitch and Enderlein 2016; Lütz and Hilgers 2018; Lütz, Hilgers, and Schneider 2019; Moschella 2016).

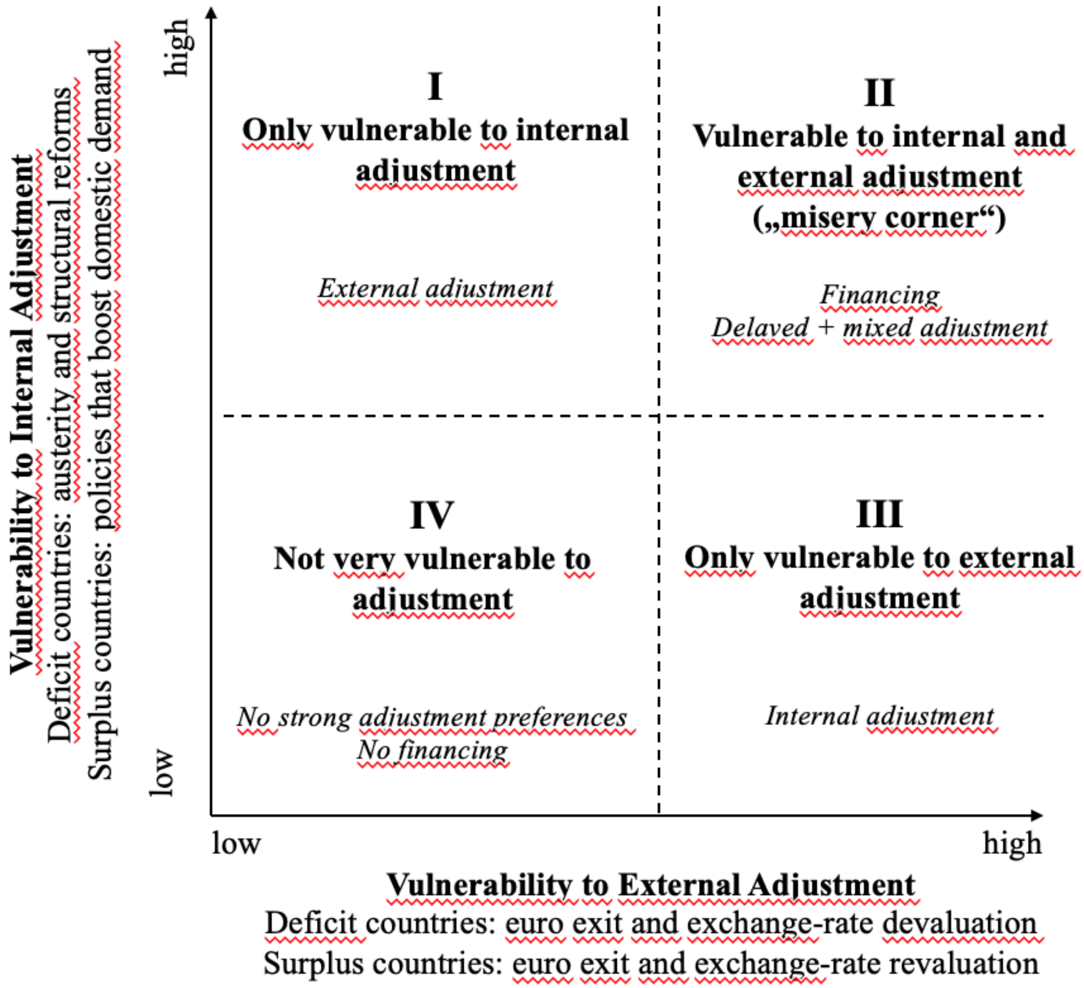
Eurozone crisis. We argue that the distributive struggles surrounding the politics of the Eurozone crisis in surplus and deficit countries are distinct but related, and that they should be analyzed in a unified framework.

This book, therefore, analyzes the distributive struggles shaping Eurozone crisis politics in a comprehensive manner, which gives equal attention to crisis politics in deficit and surplus countries and considers all available options, including those that were not chosen. As we have seen, balance-of-payments crises confront policymakers with a list of unattractive, bad 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. We argue that these vulnerabilities—and the trade-offs they present for individuals, interest groups, and national governments—strongly influence the politics of balance-of-payment adjustment in the wake of a financial crisis both within countries and at the international level. The puzzle of why deficit countries agreed to unprecedented austerity, which has taken such a heavy toll on their economies, becomes less puzzling, for example, if one considers that the alternatives facing deficit countries were Eurozone exit and/or unilateral debt default. Likewise, many have puzzled over the reluctance of surplus countries to boost domestic demand at home. We argue, and show, that this decision is less puzzling if one considers that such a rebalancing was unpopular domestically and that surplus countries had a viable alternative: bailouts with strict conditionality.

Faced with a serious BOP crisis, such as the Eurozone crisis, voters, interest groups, and national policymakers vary in their preferred crisis response, since the two main strategies for rebalancing the current account, external and internal adjustment, vary in how costly they are for each of these actors. If one adjustment path (say Eurozone exit) clearly imposes more costs than the alternative (say internal adjustment), then the latter alternative will be clearly preferred. Oftentimes, however, both adjustment paths will be costly, and it is in those instances when preferences will be less clear, when the politics of crisis resolution will become more difficult, and when financing turns into an increasingly attractive third alternative. These are also the instances when attempts to eschew the burden of adjustment by pushing the burden of adjustment on other states will be most pronounced. Eurozone crisis politics, thus, cannot be understood without considering the trade-offs and costs associated with each of the three main alternative options: internal adjustment, external adjustment, and financing (including debt relief).

The preferred choice of crisis-resolution strategy, then, depends on the potential costs that external adjustment would impose on an actor, relative to the potential costs of internal adjustment. In short, crisis-resolution preferences are informed by an actor's "vulnerability profile" (Walter 2008b, 2013, 2016) in both deficit and surplus countries. Figure 5 presents a stylized overview of the four ideal type vulnerability profiles that voters, interest groups, and, in the aggregate, societies can exhibit, as well as the preferred policy response associated with each of these profiles.

Figure 5: Classification of vulnerability profiles and preferred policy response



This classification suggests that there are four types of vulnerability profiles. Actors with a vulnerability profile I are predominantly vulnerable to internal adjustment—austerity in deficit countries and an expansion of domestic demand in surplus countries—and they are, therefore, more likely to prefer resolving the crisis through external adjustment. Actors with a vulnerability profile III also have a clear-cut preference, that is, internal adjustment, because they are much more vulnerable to external adjustment—devaluation in deficit countries and revaluation in surplus countries—than to internal adjustment. When the costs of one adjustment strategy clearly outweigh the costs of the alternative (vulnerability profiles I and III), the choice is thus relatively straightforward: quick implementation of the less costly adjustment strategy.

Voters, interest groups, and policymakers face a much more difficult situation when both internal and external adjustment are costly (vulnerability profile II). Actors who find themselves in this "misery corner" would ideally prefer no adjustment; they are, therefore, most amenable towards addressing the current account imbalance through financing. Finally, actors for whom the costs of both internal and external adjustment are low (vulnerability profile IV) are unlikely to have strong preferences about the type of adjustment strategy, although they are likely to be opposed to the financing option because this would stand in the way of a crisis resolution in deficit countries or would likely come at the expense of taxpayers in the surplus countries. Because these scenarios do not result in a clear preference for one adjustment strategy, however, crisis politics in settings with vulnerability profiles II and IV will be more amenable to preference shaping, that is it offers domestic and international political elites an opportunity to shape policymaking and societal preferences about crisis management and their preferences and ideas. In these instances, moreover, ideology is likely to take a more prominent role in guiding policymaking. As such, our explanation complements existing accounts that highlight the importance of ideas for crisis politics both in the Eurozone crisis (e.g., Carstensen and Schmidt 2018; Matthijs 2016a; Matthijs and McNamara 2015) and beyond (e.g., Blyth 2013; Chwieroth 2009; K. McNamara 1998; Morrison 2016).

The vulnerability profile is a useful heuristic for analyzing Eurozone crisis politics because it sheds light on the distributive concerns regarding the trade-offs between different policy options in both deficit and surplus countries. First, it can be used to examine which crisis responses countries opt for overall. Countries for which one type of adjustment strategy is significantly more costly than another have strong incentives to implement the less costly strategy in a swift and decisive manner. Countries more vulnerable to austerity and structural reforms than external adjustment (vulnerability profile I) are more likely to respond with a swift devaluation of the exchange rate without much financing. Finding an example of a Eurozone country with this vulnerability profile is difficult because all Eurozone member states are highly vulnerable to a Eurozone breakup, but such vulnerability profiles have not been unusual in past BOP crises. Likewise, countries with a vulnerability profile in quadrant III also are more likely to clearly opt for one type of adjustment over the other; in this case, governments will opt for internal adjustment and exchange-rate stability. In terms of financing, countries with both vulnerability profiles I and III should show little enthusiasm for long-term, low-conditionality financing facilities such as Eurobonds, but they should be more open to financing measures that smooth rather than avoid adjustment in economic policies. The situation is more difficult in countries that are vulnerable to any type of adjustment (the "misery profile" II). Here, any adjustment is unpopular and politically difficult to implement. Given the country's high exposure to both domestic reforms and Eurozone exit, these countries should be more intent to receive (deficit countries) or be more willing to grant (surplus countries) different forms of financing instead. In the process, deficit countries should try to keep the conditions attached to the external funds to a minimal level, favoring Eurobonds and debt haircuts for international investors over bailouts. Surplus countries with this vulnerability profile should push for high-conditionality types of financing that transfer the burden of adjustment onto the deficit countries in exchange for foreign funds.

Second, vulnerability profiles help us understand who supports and opposes different policy options domestically. Vulnerability profiles can be conceptualized for individuals, interest groups, and societies overall. Individuals matter for crisis politics as voters. Interest groups represent larger segments of society: business and employer associations represent certain types of firms and economic sectors, trade unions represent certain types of workers, and groups such as taxpayer associations or pro-poor groups represent certain groups of individuals. These groups are more likely to have a direct voice in the policymaking process and are, therefore, important for shaping overall crisis politics. We argue that individuals and interest groups also form their policy preferences on the basis of their vulnerability profiles. For example, deficit country homeowners who have mortgaged their home in euros but have very secure employment are highly vulnerable to an exit from the Eurozone, but they are much less exposed to internal adjustment than to external adjustment. Voters and interest groups with such clear-cut vulnerability profiles (I and III) are likely to share a strong preference for the type of adjustment to which they are not very vulnerable. Moreover, they should see financing predominantly as a means to smooth adjustment. Interest groups whose members are very vulnerable to both internal and external adjustment (vulnerability profile II) are in a more difficult situation. For them, any adjustment in micro- and macroeconomic policies will be painful, which is why these groups would likely oppose any significant policy reforms. Surplus country interest groups in this category are most interested to make sure that adjustment is undertaken elsewhere, but they are most willing to support deficit countries' efforts in this direction through bailout packages. Deficit country interest groups in this category are in a more difficult situation, but they are also expected to most favor receiving financing support from abroad. Given that these interest groups have much to lose from an adjustment of policies, the expectation is that they will be very vocal and combative in the political process.

Finally, examining vulnerability profiles can shed light on why crisis politics are more contested in some countries than in others. Political conflict is likely to be particularly high in countries with a vulnerability profile II. Such a vulnerability profile arises either when politically influential groups are very vulnerable to both internal and external adjustment or when politically important groups vulnerable to internal adjustment are equally prevalent as groups vulnerable to external adjustment. In such a setting, any type of adjustment will inevitably hurt at least one set of domestic interests. Especially in deficit countries in this category, crisis politics should be characterized by political turmoil, low levels of political stability, divisions within governments, and debates about the appropriate policy response to the crisis. Since deficit countries cannot easily push adjustment costs onto surplus countries, these distributional conflicts tend to revolve around how the cost of adjustment is to be distributed among different societal groups. But surplus countries with this vulnerability profile should also experience elevated levels of contestation, centered mostly on struggles over how financing should be provided to deficit countries in an effort to avoid adjustment. In contrast, in countries exhibiting any of the other three vulnerability profiles, crisis politics will be less conflictual, especially when the country's aggregate vulnerability profile also reflects the vulnerability profile of the country's politically most influential interest groups. Crisis politics in these countries should be characterized by lower levels of opposition and a less tumultuous political environment than in countries where policymakers impose significant costs on influential groups.

Taken together, answering these three questions provides us with a solid understanding of the distributive struggles that have led to the unequal burden sharing in the Eurozone crisis and the continued difficulties to achieve meaningful EMU reform.

Plan of the book

Our book examines why the Eurozone crisis was so difficult to resolve and argues that distributive conflicts both among and within Eurozone countries lay at the core of these difficulties. It explores the importance of considering trade-offs and alternative options for both deficit countries (part II) and surplus countries (part III). For each of these sets of countries, the book explores how vulnerabilities to different crisis-resolution options shaped crisis politics both on the country level and among interest groups and voters within countries.

Putting the Eurozone crisis in context: Country-level vulnerability profiles

Each set of analyses begin with an analysis if country-level vulnerability profiles to set the stage by putting the Eurozone crisis in comparative perspective. Rather than treating the Eurozone crisis as a *sui generis* event, as much existing work has done, these chapters (chapters 2 and 5) explore the similarities and differences between the Eurozone crisis and earlier well-known financial crises, such as the 1992 Crisis of the European Monetary System (EMS) or the 1997 Asian Financial Crisis. Chapter 2 focuses on deficit countries and lays out in detail the trade-offs that crises requiring balance of payments adjustment create for deficit country policymakers. It argues the relative costs of external vs. internal adjustment will shape crisis politics, including the willingness of these countries to accept harsh conditionality in return for external financial support. The chapter develops measures to compare national vulnerabilities to internal and external adjustment and analyzes the crisis responses for a sample of 142 crisis episodes that occurred in a sample of 122 countries between 1990 and 2014. Our analysis shows that the vulnerability profile is a useful tool for analyzing crisis responses across a wide variety of BOP crises. It also demonstrates that the Eurozone crisis is unusual because all crisis countries were located in the "misery corner": deficit country vulnerabilities to both internal and external adjustments were exceptionally high, and vulnerabilities frequently increased over the course of the crisis. In such a setting, quick and decisive crisis solutions are hard to find.

Likewise, the second part of the book (chapter 5) identifies and examines 272 episodes of substantial current account surpluses for the same set of countries during the same time period and compares country-level vulnerability profiles in those episodes to those of the five Eurozone surplus countries. Contrasting the Eurozone experience with the same countries' experience in the 1992 EMS crisis, for example, shows that European surplus countries exhibited a much higher vulnerability to both types of adjustment at the outset of the Eurozone crisis. They were very vulnerable to the breakup of the Eurozone, but they also shared high levels of vulnerability towards internal adjustment. Our analyses also show that whereas all Eurozone surplus countries were located in the misery corner during the Eurozone crisis, other European surplus countries such as Switzerland or Sweden were not confronted with such a difficult vulnerability profile. Chapter 5, thus, provides evidence for why surplus countries had an interest in making financing the main crisis response and in pushing the adjustment burden onto deficit countries, and why they were able to form a unified coalition in negotiations at the European level.

Overall, the country-level analyses show that the Eurozone crisis shares many features of previous debt and balance-of-payment crises, but is also distinct in that societies in both deficit and surplus countries exhibited an unusually high vulnerability to both internal and external adjustments—a vulnerability profile in the "misery corner" that makes crisis resolution politically difficult. The Eurozone's predicament is, thus, unusual because its setting within a monetary union significantly increases the costs of external adjustment. Moreover, the rigid nature of many European economies makes internal adjustment costly, and the high level of interdependence between Eurozone economies increases the costs associated with a debt default.

Interest group vulnerability profile and crisis resolution preferences

The book then moves to the interest group level and explores in much detail how domestic economic and social interest groups viewed their vulnerabilities to the crisis, which types of policies they preferred, and how they assessed the difficult trade-offs that the crisis presented them with. Focusing on the role of economic interest groups as important intermediaries in the political process, we argue that interest group vulnerability profiles influence their preferences regarding crisis resolution.[19] A growing literature emphasizes the importance of societal interests, varieties of capitalism, and growth models in shaping the politics of the Eurozone crisis (Armingeon and Baccaro 2012a; Frieden 2015a; Hall 2014; Moravcsik 2012; Schimmelfennig 2015; Tarlea et al. 2019). Much of this literature builds on assumptions about the preferences of core economic interests, but treats these preferences largely as a "black box" (Baccaro and Pontusson 2016: 200-1). Our book contributes to this debate by "looking into the box": It presents the results of a broad, systematic and theoretically guided original data collection effort on interest group vulnerabilities and preferences regarding Eurozone crisis management based on original survey data from 716 interest groups in both deficit and surplus countries, that allows us to empirically validate many of these assumptions.

Chapter 3 focuses on interest groups in deficit countries and explores why policymakers in crisis countries implemented unprecedented austerity and painful structural reforms, even though public opposition to these measures was considerable. Empirically, the chapter leverages data collected through surveys among 359 interest groups in Spain, Greece, and Ireland. The data show that although a vast majority of interest groups in deficit countries viewed internal adjustment negatively, they still preferred it to a breakup of the Eurozone, especially when pressed to choose. Nonetheless, interest groups varied considerably in their assessment of specific internal, external, and financing policies. Overall, we find that despite some variation in vulnerability profiles and the large variation in the

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evaluation of specific crisis policies, most groups valued avoiding a Eurozone breakup more than avoiding austerity, a finding that explains why deficit country governments could implement this strategy.

Whereas much scholarly attention has focused on deficit countries, much less is known about the politics of adjustment in surplus countries, especially beyond Germany. Chapter 6, therefore, examines interest group preferences in three surplus countries: Germany, Austria, and the Netherlands. It explores to what extent the reluctance among surplus countries to engage in internal adjustment—that is, policies aimed at boosting domestic demand—can be explained by pressure from special interests. We present on original survey data collected from 357 socioeconomic interest groups in the three surplus countries. Our analysis shows that as in deficit countries, vulnerability profiles played an important role in informing preferences about different crisis strategies and political strategies. Our key finding is that surplus country interest groups are not against internal adjustment in principle. Although general support for expansionary economic policies among interest groups in all the three countries was surprisingly high, however, domestic actors disagreed about which specific policies should be implemented to achieve this goal. Together with a broad consensus to avoid a breakup of the Eurozone (though some variants, such as a Greek exit, were viewed as less detrimental), this polarization turned financing into the politically most attractive strategy. The persistent surplus country resistance against internal adjustment, thus, seems rooted, at least partly, in distributive struggles about the design of possible adjustment policies among interest groups.

Crisis Politics

Policymakers need to balance the demands from special interest groups with those from their voters. The third set of analyses in the book, thus, looks at how interest group preferences influenced the politics of Eurozone crisis management in each of the three deficit and surplus countries, and how they interacted with the preferences and ideas of other domestic and international actors.

In deficit countries (Chapter 4), the analysis centers on how the preferences of interest groups shaped the design and contentiousness of crisis policies, and how external actors influenced crisis responses. For this we draw on a combination of primary and secondary sources including newspaper coverage, voter public opinion data, interest group position papers, sovereign bailout documentation as well as original qualitative evidence from 17 in-depth interviews with national interest group representatives in Ireland, Spain and Greece. We find that there was a large consensus among both interest groups as well as voters across all three countries that external adjustment – that is, unilateral euro exit – should be avoided at all cost. This left financing and internal adjustment as the only options, and significant conflicts flared up in all three countries about how the costs associated with internal adjustment (and to a lesser extent financing) should be distributed. Within the confines set by the Troika, which effectively narrowed down the range of options available to deficit countries, interest groups pushed for reforms to which they were least vulnerable: Business interests, for example, generally supported adopting comprehensive spending-based consolidation measures and labor market reform. Conversely, labor unions and social policy groups actively supported policies that would entail stronger burden-sharing between firms and workers. Overall, internal adjustment policies adopted across all three cases generally reflected the preferences of employer associations more than those of workers, but especially in Spain and Greece, this was associated with considerable political upheaval.

For the surplus countries (Chapter 7), the analysis focuses on the puzzle that although bailouts were a politically expedient option in light of the distributive struggles among surplus-country interest groups, the surplus-country governments remained hesitant towards bailouts and alternative financing measures, such as debt relief or the introduction of Eurobonds, and tied the provision of any financial support to strict and strong conditionality. Leveraging public opinion data, qualitative evidence and information gathered in 30 interviews with policymakers, we show that popular resistance against interstate financing constrained governments' appetite for more generous financing approaches.

Whereas surplus-country voters generally supported the goal of safeguarding the Eurozone, most remained skeptical about the provision of financing. This broad-based skepticism, together with the high salience of the issue, provided few electoral incentives for policymakers to consider more far-reaching financing alternatives. Being caught in-between interest groups blocking internal adjustment and voters opposing generous interstate financing, governments, thus, opted for the path of least resistance—piecemeal financing combined with high conditionality. Overall, our analysis shows that given the broad opposition of both voters and interest groups, external adjustment never became a politically viable option for surplus countries. Vocal and clear opposition from voters in all three countries blocked the route towards more encompassing financing approaches. Finally, more accommodating economic policies were pursued only in Austria, where the salience of the state of the domestic economy made expansionary policies electorally expedient and led the government to force economic interest groups to accept domestic reforms.

This final set of analyses once more demonstrate the importance of jointly analyzing the (un)popularity of all possible crisis-resolution alternatives, including those not chosen by policymakers. It provides insights into how the distributive concerns of voters, special interest groups and policymakers interacted with ideas, economic constraints, and international political pressure to shape the unusual crisis response to the Eurozone crisis.

The final chapter (Chapter 8) concludes by discussing discuss the insights that these three perspectives have yielded and summarize the book's main findings in the process. Because the bulk of our analyses have focused on domestic distributive struggles, the conclusion then turns to the question to what extent our approach is useful for understanding the distributive struggles on the European level as well. For this purpose, we examine how surplus and deficit states positioned themselves with regard to the core EMU-related issues and reforms that were discussed in the European Council during the Eurozone crisis (Wasserfallen et al. 2019). Our analysis shows that on policy issues related to questions of adjustment and financing, deficit and surplus countries aligned in opposing camps. Moreover, creditor-surplus countries managed to secure policy decisions in line with their preferences on almost all adjustment-related policy issues, which meant that deficit countries had to carry the bulk of the adjustment burden. In contrast, they showed more willingness to compromise on issues related to financing. We conclude with a discussion of the policy implications of our findings and an agenda for future research.

Conclusion

Overall, this book contributes to our understanding of the Eurozone crisis and the politics of crisis management more generally. First, it puts the Eurozone crisis in a comparative perspective, both in theoretical and empirical terms. Acknowledging that the Eurozone crisis is neither a normal recession nor a *sui generis* event, allows us to draw on the rich set of theoretical approaches and empirical investigations of past crises to tease out the similarities and differences of the Eurozone crisis. Empirically, this book is the first major study to quantitatively examine the Eurozone crisis in comparison to earlier crises. As such, it situates the Eurozone crisis in the context of other financial crises that required balance-of-payment adjustment and the problem of global imbalances more generally.

Second, the book considers both deficit and surplus countries, whereas the majority of studies of the Eurozone crisis (and financial crises more generally) have focused exclusively on crisis politics in the deficit and debtor countries. Although surplus countries have been instrumental in shaping the European crisis-resolution framework, little research so far exists on their interests and domestic political constraints, especially when it comes to surplus countries beyond Germany. Our book is one of the first to present such an analysis in a systematic manner. The book provides an encompassing and unified framework, which shows that the distributive struggles surrounding the politics of the

Eurozone crisis in surplus and deficit countries are distinct, yet they also revolve around common themes and are intricately linked. This allows us to better explore the interdependencies and dynamics of crisis politics in the Eurozone.

Finally, the book presents the results of a large data-collection effort on interest group vulnerabilities and policy preferences in six Eurozone economies. This data allow us to test both our argument and competing explanations in much greater detail, but they will also serve as an important resource for future scholars. The data and replication packages for all analyses presented in the book can be found online.[20] In sum, our book generates an encompassing picture of the distributional politics of the Eurozone crisis and a better understanding of the constraints under which policymakers have operated in their attempts to solve the crisis.

More generally, the book argues and shows that it matters whether policy options are considered in isolation or in the context of trade-offs. As such the book contributes to the wider emerging literature in political economy that highlights the importance of trade-offs in social and economic policymaking (Busemeyer and Garritzmann 2017; Emmenegger, Häusermann, and Walter 2018; Häusermann, Kurer, and Traber 2018; Jacobs 2011). These trade-offs are ubiquitous and confront political actors with difficult decisions but also create space for creative options in the design of policies. Our book demonstrates that some policy choices that seem puzzling at the outset are much readily understood once the alternatives are considered.

[20] Link to website/dataverse

Bibliography