Chapter 4

Risk or Opportunity? Institutional Change and Europe’s Financial Crisis, 2008-2012

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The authors wish to thank the organizers and participants of the Workshop on ‘Regional Governance and Global Crises’ held at University of Warwick, UK, June 18, 2012, for their constructive comments and suggestions.

Crises have long been used as a motor of European integration (Jo, 2007). ‘Europe will be forged in crises, and will be the sum of solutions adopted for these crises’, pronounced Jean Monnet to highlight the importance of crises in shaping policy change. Most narratives have focused on how periods of turbulence are used as opportunities to overcome old enmities and political opposition to change policies and institutions (Kühnhardt, 2009). However, crises can also be occasions for decline. Leaders may not draw the ‘right’ lessons and may ultimately create institutions that fail to adequately address the causes and effects of the crisis. What factors explain the institutional reforms observed during the Europe’s financial crisis? Institutions are defined as formal and informal rules of behaviour that govern EU macroeconomic and monetary stability.

We amend and clarify the argument put forth by Salines et al. (2011) to explain institutional resilience and change under crisis conditions. We use the typology of changes proposed by Mahoney and Thelen (2010) – layering and displacement – and clarify the mechanisms of institutional ‘reproduction’ hypothesized by Lindner (2003) – bargaining power and interdependence among policy sub-fields. Two episodes are analysed to explain institutional change, taking into account both external and internal shocks: the onset and mutation of the Irish banking crisis into a sovereign debt crisis (2008-2012) and the sovereign
debt crisis in Greece (2009-2012). We argue that despite similar institutional settings within the Eurozone, tackling the financial crisis has produced divergent results. On a theoretical level, our contribution links mechanisms to particular outcomes, specifying the conditions under which institutional change may occur. On a policy level, evidence shows that institutional innovation was helpful in Ireland: increased bargaining power of the anti-change coalition and fewer feedback interactions (lower interdependence) led to layering as a mechanism for change. Lower bargaining power of the Greek anti-change coalition and higher interdependence led to institutional displacement, which, under pressure by supranational actors, had disastrous effects.

Change has increased tension between member states and international institutions and between EU voters and global investors. Has Europe’s financial crisis been an opportunity to propel Europe forward as political leaders often remark, or is it a case of missed chances that collectively have failed to impress voters and investors alike? The chapter amends theories of institutional change and questions the capacity of institutions as instruments of regional governance to shield their members’ economies or respond effectively to external or internal shocks. Despite supplying substantial expertise and resources, regionally formulated innovations disturb domestic political coalitions and may provoke legitimation crises that end up exacerbating the very crises they are supposed to address.

4.1 Institutional Stability and Change

In an insightful essay, Salines et al. (2011) use institutional analysis to trace the evolution of EMU. Arguing that despite the current crisis, EMU is more likely to change through small, incremental changes rather than a complete reform through a ‘clean slate’ approach, they link the various institutional changes observed since 1999 to mechanisms of institutional change. After dividing the time frame into periods of stability (1999-2007) and crisis (2007-2010)
they identify the changes that have occurred. They claim that the onset of the financial crisis has changed the dynamics of institutional development by accelerating the pace of change.

While their argument’s insight lies in linking institutional changes to mechanisms within EMU, we take it several steps forward to further clarify and improve it. First, using the same theoretical approach, we posit links between specific mechanisms and changes. They leave this area unexplored. They, too, employ Mahoney and Thelen’s (2010) typology of institutional changes to categorize specific changes observed in EMU and Lindner’s (2003) mechanisms to explain the changes. We partially replicate their analysis and hypothesize there are specific mechanisms that make some changes possible but not others.

Second, their approach is similar to ours but their research question is not. They use institutional structure as a mediating variable to ‘condition the crisis response’ and ‘shape national interests to the benefit of the common European interest’ (Salines et al. 2011, p. 7). Instead, we use changes in structure as a dependent variable. Concepts such as national preferences, bargaining power, and opportunity costs are treated as independent variables (see below).

Third, we gain more analytical traction by focusing only on change under conditions of crisis. In other words, we conceptualize the dynamics of change under temporal, political, and economic pressure caused by external and internal factors. Crises loosen the grip of dominant coalitions onto institutional outcomes by forcing a re-examination of the latter’s structure and effectiveness. Change will not necessarily be the final outcome, but change will necessarily be on the agenda. As Gourevitch (1986, p. 17) observes, in hard economic times the ‘comfortable illusion’ of economic growth and prosperity disintegrates, producing reflection, political conflict, and change. The inadequacies of regional governance will be more obvious during crises likely leading to more observable and measurable institutional change. Crises open policy windows for change (Keeler 1993; Zahariadis 2003). They
empower alternative coalitions to frame problems in different ways and push for innovative solutions that would be less likely during periods of economic prosperity.

4.2 Linking Mechanisms to Institutional Change

Which factors explain the observed institutional change in EMU during the crisis years 2008-2012? We use the typology proposed by Mahoney and Thelen (2010) and Lindner’s (2003) mechanisms of change to link specific changes to particular mechanisms. Overall we postulate two hypotheses:

\[ H1: \text{Increasing bargaining power of the anti-change coalition leads to layering.} \]

\[ H2: \text{Higher interdependence between policy sub-fields leads to displacement.} \]

We probe their validity in two cases within two national contexts: Ireland and Greece.

We decided to drop Mahoney and Thelen’s (2010) redirection, depletion, and drift as categories of change for four reasons. First, brevity and analytical traction prevent a thorough investigation when the dependent variable takes so many values. Second, we view layering and redirection as somewhat equivalent types of changes. We understand that layering involves the creation of new institutions (see below) while redirection simply re-orient existing institutions but re-orientation alters the costs and benefits of current institutional arrangements and almost always leads to new configurations which involve marginally novel institutions. Third, depletion, which is defined as withering away of the institution, is clearly not the case in the EMU context; so from a methodological point of view we could not ascertain any mechanism of change. Fourth, drift is conceptualized in Mahoney and Thelen as a case where current institutional structures are overwhelmed by external shocks. Therefore, change results as institutions drift away from their original purpose toward a more stable and effective equilibrium. We believe drift spans many examples of change. In fact, we conceptualize it as a pre-cursor to change in all our examples. Pressures building in favour of
change must first show why the current system is unable to cope under present structures, essentially calling for demonstrating the presence of drift.

We also drop Lindner’s (2003) third mechanism of switching costs and fourth mechanism of accommodating pressure for change through minor adaptations for two reasons. First, we believe institutional change is likely to come as a result of failing to accommodate pressures through minor adaptations. This does not mean it cannot come in big, sudden reforms but minor adaptations are very difficult to measure as distinct from layering, which may involve minor innovations, or displacement, which reveals increased, gradual salience of one aspect of the system over time. Second, switching costs are almost always correlated with shifts in bargaining power because the desire to switch from one institutional venue to the other implies more bargaining power in the new environment. Therefore, the question of switching to a different institutional configuration must take into account possible future shifts in the distribution of costs and benefits.

To aid the process of replication, we re-examine many of the examples cited in Salines et al. (2011). We analyse the creation of the European Stability Mechanism (ESM) and its predecessor, the European Financial Stability Facility (EFSF), as examples of layering. We explore the salience of the European Commission during bank bailouts (and its relative absence during the sovereign debt crisis) and the infusion of liquidity through the ECB’s Long-Term Refinancing Operation (LTRO) as examples of displacement.

The dependent variable is institutional change and it comes in two forms (Mahoney and Thelen 2010). Layering is a change which involves a renegotiation of institutional arrangements where new institutions are developed and added on top of existing ones. In this way, participants may protect their institutional sunk costs and still allow for partial exploration of new ways to deal with old or new problems. The current distribution of costs and benefits is altered in significant ways to reflect the new distribution of power across
institutional actors. Applied to the EMU context, this change may be witnessed by the addition of a permanent fund such as the ESM on top of the temporary EFSF. *Displacement* takes place when one element of the institutional structure gains prominence over others. Such change takes place when the level of discretion in interpretation is high. The ECB provides an interesting case of displacement because its role has been very prominent during the crisis since 2008. It has (reluctantly in some instances) sought to ensure proper transmission of monetary policy and has adopted a more salient role in providing liquidity and conducting bank stress tests to restore credibility in Europe’s banking system.

Viewing change as the absence of stability, Lindner (2003) elaborates on two mechanisms of institutional stability, what he terms reproduction. A breakdown in those mechanisms produces institutional change. He specifies the following independent variables:

- the bargaining power differential between the dominant coalition and the change coalition, and
- spill-over effects and the presence of supranational entrepreneurs.

Each variable is linked to a distinct mechanism. We improve on his argument by showing that each variable leads to a specific kind of change. The first independent variable provides the logic for change in producing layering. The second supplies the logic of the mechanism producing displacement.

**Bargaining Power**

Institutional change alters the cost/benefit ratio of current institutional arrangements. Any change must either increase or decrease the ratio relative to the status quo; otherwise actors would not expend political capital trying to change things. Changes may be brought by increases or decreases in bargaining power. Such power differentials arise because of external or internal factors, but in either instance such factors create dynamics that privilege some
governments and downgrade others. For example, exogenous factors such as the economic crisis may weaken the ability of a powerful member within the SGP if that member also leads a dominant coalition which opposes strict enforcement of the rules. If members accumulate debt as a result of the crisis, or if their debt servicing capacity comes under attack by market actors, the ability of that government to sustain lax enforcement rules of SGP-defined sanctions is weakened. Deteriorating finances over a period of time would lead to more gradual though equally perceptible shift in power. In contrast, governments that are able to improve their finances are in a better position to make their voices heard. Germany is a good example of a country whose finances have improved over time (even during the crisis years) to give it even more leverage than it previously had over SGP changes. German 2-year sovereign bond yields recently dropped to negative 0.012 per cent (though have since gone up), while 10-year bond yields hovered around 1.32 per cent. In contrast, Spain’s 10-year yield rose to 6.5 per cent and Italy’s yield rose to 5.73 per cent (Goodman and Jenkins 2012). All this implies there are financial winners and losers in the crisis whose bargaining power shifts accordingly.

We assume depletion is not an option and membership among change agents overlaps with status quo agents. Under such conditions, changes in bargaining power are more likely to coincide with institutional redirection. The reason is two-fold. First, the status quo coalition will try to fend off any changes even as its power is eroded from within. The end result is defection of some members at the margins. The idea is that shifts in bargaining power will not be wholesale but relatively small. Because agents are efficient users, political capital will be spent trying to reform existing arrangements rather than completely redesign them. This leads us to the second reason. Changes imply uncertainty. If members of the status quo coalition are implicated in the pro-change movement, the cost of overcoming the status quo may be greater than the cost of redirecting objectives to better serve the new status quo membership. In the
latter case, the defection of one or two members may be sufficient to tip the balance in favour of a new cost/benefit distribution with minimal cost. We measure bargaining power by reference to creditor versus debtor countries. The lower the public debt, budget deficits, and bond yields of sovereigns, the greater their bargaining power is likely to be.

4.3 Spill-over and Supranational Entrepreneurs

When institutional stability hinges on interdependence among policy sub-fields, any accumulated externalities may tip the balance by leading to more costs or benefits in one field rather than another. Actors accustomed to the status quo may view this as upsetting the balance and may therefore change institutional configurations to recalibrate costs and benefits. In other words, spill-over effects might cause reassessment of costs or benefits in ways that require a new coalition to redistribute costs and benefits. Lindner (2003) argues this is done in the presence of supranational entrepreneurs. When veto players are strong and discretion of rule interpretation is high, current institutional arrangements are easier to reconfigure to take into account new realities. New institutions are unlikely to be created because veto players do not want to see dramatic change. However, some actors might acquire new salience because they are deemed capable of responding to challenges within the current institutional configuration. The higher the level of interdependence, the greater the likelihood will be of damaging effects spilling over across national borders. More spill-overs generate the need for greater coordination, making the involvement of a supranational entrepreneur more likely and thereby increasing its salience.

Supranational actors might take an interest in an issue that was not previously under their prerogative (displacement) for three reasons. First, higher interdependence under crisis conditions maximizes spill-overs and cascading effects (Zahariadis, 2012). In this case, supranational entrepreneurs are activated to build coalitions for change. Second, a
supranational actor may have superior overall powers that eclipse the powers of any single actor. The ECB, for instance, has monetary power and an overall European perspective that eclipses that of any government. Third, when there is acute conflict among participants, the supranational actor might be the only actor most members can agree to take up the issue. Existing supranational actors already have legitimacy of action. In this sense, cooperation via the presence of the ECB is enhanced when there is a credible supranational authority to mitigate and adjudicate costs and benefits in ways that individual national actors cannot. We measure interdependence by the degree of cross-national holdings of debt. Consequently, increased salience is uncovered by supranational actors undertaking activities they did not previously do in ways that EMU participants had not deemed important.

Though not addressing institutional change, von Hagen’s (2009) work illuminates the difference between the two mechanisms. Cooperation among states under EMU rests on addressing two fundamental conflicts. The horizontal conflict arises from the uneven distribution of costs and benefits among EMU members. The vertical conflict stems from the possible abuse of resources and/or political power by either member states or the institutional centre of the Union. EMU rests on the ability to fine tune the balance between the two. Crises upset this balance and may lead to institutional changes that either make the distribution of costs and benefits even more uneven, and therefore, politically unacceptable or prevent abuses by stressing centralized power.

In essence, cooperation, according to von Hagen, is the ability of each member to incentivize the willingness to come together against the propensity to defect. If member governments believe they will gain from increased cooperation under EMU, they will likely accept the current distribution of costs and benefits despite its unevenness. If they believe they will benefit from defecting, i.e., deviating from agreed norms, they will attempt to change course. At times, the question is to make deviation so costly as not to pursue it. At other
times, the main question is how to distribute benefits and costs more evenly. The end result is a zero-sum situation where a more even distribution of costs and benefits leads to decentralization of power increasing the possibility of deviation and abuses. In contrast, increasing the cost of deviation creates the possibility of a more uneven distribution ratio.

4.4 EMU’s Institutional Design

At its core, Europe’s financial crisis since 2008 has brought back to the surface a political controversy that surrounds the design of EMU. Viewed as a collective action dilemma, a delicate compromise was crafted in the Treaty of Maastricht to accommodate national preferences to design a monetary system that would bring about the economic benefits of monetary integration without dealing with some of the political difficulties that surround the loss of national sovereignty implied by integration (Dyson and Featherstone 1999). Instead, the system was designed with several coordinating functions and soft modes of governance, such as the Stability and Growth Pact (SGP), to prevent the likelihood of free riding and/or abuses by national governments. It essentially decoupled EMU from political union (Jones 2002; Padoa-Schiopa 2004) leading scholars to argue for few spill-over effects, conflict, or disintegration (Enderlein and Verdun 2009). Indeed, Verdun (2000) argued the compromise was the result of no appetite for further integration on the part of national governments, essentially leaving a crisis as the only way to make the next steps desirable or acceptable. Despite increased criticism of various design flaws (e.g., De Grauwe 2006; Heise 2008), the system performed remarkably well for several years (Hodson 2009; Verdun 2010).

EMU has two major goals (European Commission 2012):

- to provide price stability through a sound, integrated monetary policy; and
- to create an environment fostering higher economic growth and more employment.

Apart from the obvious instrument of creating a single currency, EMU tried to accomplish
these goals by creating an independent central bank and coordinating fiscal and economic policies among member states. Governing the EMU system are several EU and national institutions. But it soon became apparent the system would run into trouble unless certain precautions were taken to deal with problems of collective action. The two main ones were shielding the central bank from political pressures to monetize national fiscal deficits and holding countries responsible for their own financial management. As a study from Deutsche Bank Research (2011) asserts, ‘To achieve the first objective, the ECB was prohibited to purchase government bonds in the primary market and given far reaching independence in the Maastricht Treaty that constituted EMU. To achieve the second objective, the Stability and Growth Pact was concluded with the aim to prevent [and discipline] governments from running up excessive fiscal deficits’. Despite reforming the SGP in 2005 to tailor the rules to specific national demands (Howarth, 2007) the system proved remarkably resilient and stabilizing (Hodson 2009). But beginning in 2008, things began to change.

What factors explain the institutional changes observed in Europe during the financial crisis since 2008? We look at the effects of the banking crisis that first occurred in Ireland, and then turn our attention to the sovereign debt crisis, which first started in Greece.

4.5 Ireland and the Banking System’s Meltdown

The case of Ireland contains a paradox. Despite the country’s exemplary economic performance prior to 2007 and its ability to sustain low public debt and even record fiscal surpluses since its entry in the Eurozone (McCarthy, 2012), Ireland was forced into an EU/International Monetary Fund (IMF) austerity program. In fact, Ireland was always performing well within the SGP agreed at the Eurozone level. The Irish problem was not due to the structural design of the Euro as a common currency, but rather to the exposure of Irish private banks to toxic assets as well as the reckless lending practices of its national banking
system. It was the global financial crisis that sparked with the bankruptcy of Lehman Brothers in 2008 that sharpened the focus on Irish bank debt. EMU proved institutionally, politically, and economically unable to shield the national economy from impending catastrophe. In order for the banks to stay afloat the government was forced to undertake this private debt transferring it to the general public. Hence, the private banking meltdown mutated into a sovereign debt crisis. The presence of EMU simply regionalized Ireland’s problem.

On 28 November 2010, the Irish government requested and received financial assistance to cover €85 billion in the coming three years, through the newly created EFSF mechanism. Albeit a landmark decision for the success of the EFSF, it was also a significant test for the new institutional architecture of the Eurozone and whether the application of this mechanism brought some stability to the Irish economy.

The Irish problem began towards the end of 2008 when the Irish government introduced a guarantee scheme to cover six of the bigger banks in the country of €400bn. This scheme included the troubled Anglo Irish Bank which on 21 December was recapitalized by the government with €1.5bn. Amidst plummeting shares, the government nationalized the bank later in January 2009 (Honohan, 2009). Amidst strong allegations of fraudulent activities and risky stock deals, the headquarters of the bank were raided by investigators in February 2009 and by the end of March 2010 the bank reported a corporate loss of €12.7bn, the biggest in Irish history (Honohan, 2010). At the same time, the government, responding to the global financial downturn, produced a budget with projected savings of €4bn and initiated measures to cut public expenditure by increasing pension age by one year in the public sector by the end of 2009. Despite the nationalization of Anglo Irish Bank, the bank continued to report losses to the tune of €8.2bn by June 2010 (Clarke and Hardiman, 2012). By the end of the summer, all major rating agencies had cut Ireland’s creditworthiness with negative outlook. In September 2010, the government initiated a new round of bailing out Anglo Irish alongside
two more banking institutions, Allied Irish Bank and Irish Nationwide. Ultimately, the new bank bailout cost the government dearly as it raised the budget deficit to 32% of GDP (Lane 2011, p. 69).

After the EU Summit of 29 October, Germany’s reaction to the restructuring of Eurozone debt pushed the government’s bond spreads – the difference between yields in Irish bonds and the benchmark German bonds – to 6.65% (11 November 2010) making borrowing for the Irish government impossible. According to the Wall Street Journal, the Irish Finance Minister Brian Lenihan recommended to his government that the country should formally request a bailout package from its European partners and the IMF, since the liquidity of the Irish state was reduced due to the high costs of the bailout of the banking system. Taoiseach Brian Cowen made the announcement on 21 November 2010. The problem then transformed from being a private sector inability to finance toxic assets to an inability of the government to bail out the country’s financial sector. The problem itself was quite simple; it involved tackling the private debt and containing the underwriting of the government’s debt. Yet in order, to achieve more savings, the government had to implement tough austerity measures. Failing to contain outrage from politicians and voters alike about using public funds to finance private follies, the Irish Government was shocked by the withdrawal from the coalition of the Green Party which caused general elections to be called earlier than expected. In February’s general election a coalition between Fine Gael and the Labour Party replaced the Cowen administration, under the promise of renegotiation of the bailout terms and an alternative to the submission to foreign lenders.

The new coalition continued to receive negative outlooks for its economic plans and therefore was forced to maintain the same austerity route, establishing essentially a pro-stability attitude, and quickly signed off to the new austerity cuts throughout 2011 and 2012. It broke its campaign promises quickly leading to more protests due to new property taxes,
university fee increases and others, while Taoiseach Enda Kenny refused to admit that Ireland would need a second bailout package from three international lenders, collectively known as the Troika – the European Commission, the ECB, and the IMF (McDonald 2012). According to our argument, the new government in Ireland changed overnight from a pro-change actor (i.e. following an alternative, a different route) to an anti-change coalition meaning that it chose to follow the path of stability that the proposed austerity measures and bailout packages entailed. Therefore, it was forced to support the institutional framework the EU proposed through the EFSF. The institutional innovation offered by the EU seemed appropriate for Ireland: the new government, despite the rough start, agreed to new financial mechanisms and surveillance dictated by external lenders; the problem was relatively simple and interdependence was low. Hence it was layering that worked as a mechanism for institutional change rather than displacement.

4.6 Greece and the Sovereign Debt Crisis

It is quite interesting to compare the Irish bailout agreement and austerity package with the one of Greece, as the two cases present us with differences that can help explain which mechanism produced what change in the Eurozone’s new institutional architecture. The Greek sovereign debt crisis involved high public debt that followed a long period of cheap borrowing by a highly corrupt and clientelistic state that utilized money to fulfil electoral promises rather than create sustainable growth and investment (Manolopoulos, 2011). At the same time, when Greece first sought external help to tackle its debt, there was no institutional framework or prior experience with confronting such issues. Hence Greece was tiptoeing on a stretched cable without a safety net. The EFSF was launched in June 2010, whereas the Greek Prime Minister requested assistance on 23 April 2010.

Tracing back the case study not from the time of Papandreou’s assumption of office in
November 2009, but rather from the point when financing the Greek state became unsustainable without external help, we can identify the key junctions that lead to further complications in the austerity programme. The problem for Greece was quite different from that of Ireland as the banking sector was not initially affected by the global financial crisis, in the sense that Greek private banks had minimal exposure to toxic assets. Yet, the public sector was on the verge of collapse; there simply was not enough money to finance services, operations, salaries and pensions without external borrowing. As George Papakonstantinou, then finance minister starkly claimed: ‘In less than two weeks, a 9 billion-euro bond comes due and the state coffers don’t have this money’; borrowing from foreign markets was prohibitively expensive so the only option was to accept the rescue plan (quoted in Featherstone 2011, p. 203). The Greek Prime Minister initiated but slowly implemented some reforms, securing a first deal with the EU and the IMF in exchange for further budget cuts. Amidst growing public opposition the Greek parliament approved the austerity measures accompanying the bailout package on 6 May 2010. At the same time, the plan raised questions of accountability. Not only did it prompt blame (Vasilopoulou, Halikiopoulou and Exadaktylos, 2014) and recriminations domestically but because the terms were agreed in principle by the government without a vote, questions arose of sovereign economic governance (Chrysogonos, 2010).

From that moment on, the government grudgingly capitulated to international lender demands. However, Greece was plagued by failed reforms because of strong opposition by several of the government’s own party members, the social partners and various social groups. Despite herculean efforts to streamline public finances – in 2010 Greece accomplished the highest reduction in general government deficit in the Eurozone by 5 percent of GDP – the government simply came up short (IMF 2011). Austerity bred more austerity, and despite a feeble attempt to commence a privatization programme worth €50 billion, rating agencies
continued to lower Greek creditworthiness which reached the lowest rating in the world by June 2011. It is interesting to note the Greek bailout remained outside the new EFSF institutional architecture although it, too, was funded by bilateral and multilateral loans and guarantees.

The government was desperately trying to stick to the plan even after going through a reshuffling of the cabinet and a vote of confidence in favour of a revised but harsh five-year austerity plan. Yet, this was not enough to calm Greek nerves or bring back credibility and financial stability, forcing the Greek government to seek a second rescue package that would now involve losses by private bond holders. A major precondition of this package was adoption of a restructured austerity programme passed in May 2011.

Amidst violent protests the government approved more austerity measures in a variety of policy areas while by the end of October 2011 a new plan was drafted in an EU summit with a 50% haircut of privately-held Greek debt. The new set of loans as part of the second package shifted to the new EFSF mechanism alongside €34.4 billion remaining from the previous Greek Loan Facility spread in instalments and pending reform progress. The ruling socialist party was unable to sustain a pro-stability coalition in parliament and was forced to enter into a coalition government with two neoliberal opposition parties, effectively replacing Papandreou as the prime minister and appointing the technocrat, former ECB vice-president, Lucas Papademos in November 2011.

The specific mandate of the coalition government was to adhere to the reforms and measures spelled out in the new bailout package, negotiate and complete the haircut of debt held by private sector bondholders, pass through parliament the austerity budget for 2012 and generate primary surpluses to tackle the deficit. Despite the honest efforts of the new government as well as the newly installed financial arsenal at the EU level, Greek macroeconomic conditions and outlook worsened in the last few months of 2011 (Manifava,
2012), improved somewhat in the beginning of 2012, and crashed again in April-June as a result of elections and political instability (Tsolis, 2012). In a perilous game of negotiations among social partners and pressure by external lenders who threatened to withhold the bailout instalments unless specific conditions were met, the Greek parliament ratified further austerity measures. After finalizing the haircut and negotiating the bailout package, parliament was dissolved and new elections were held on 6 May 2012. Because they produced no clear winner or the possibility of a ruling coalition, fresh general elections were called for 17 June 2012, bringing to power three coalition partners: the conservative New Democracy, the Socialists, and the newly established Democratic Left.

There were two problems operating at both the Greek and EU levels (Zahariadis, 2013). First, there was no clearly identified sector that was problematic. All financial problems (private or public) were tied to the structural deficits of the Greek state and the inability of the Greek government to carry out many agreed-upon reforms. Therefore, the degree of problem interdependence was quite high. Second, confronted with a unique problem and in light of previous experience with loose interpretation of Eurozone rules and lack of consequences, Greece’s partners proved unable to react promptly. They had no prior experience with tackling such a complex issue within the established institutional architecture of the common currency area. The solution agreed between the Greek government and the Troika predated any serious attempt to tackle the sizable sovereign debt of many Eurozone countries. The Greek government had to confront a rather strong pro-change (i.e., against austerity) coalition formed by domestic political parties, competing social groups as well as internal factions within the governing party. In this way, the decreasing bargaining power of the anti-change (pro-stability) coalition failed to build on the existing institutions of the Eurozone, effectively failing to promote institutional change within the country and take ownership of the austerity programme.
By the end of the period, Troika demands took precedence over the necessities and preferences of the Greek state and society. The lack of domestic consensus and the strong pressures from abroad forced a mechanism of displacement to be triggered leading to (a) a new bailout package in March 2012 and (b) more importantly to even greater financial, political and social instability. Confirming our hypothesis, higher interdependence between policy subfields in Greece led to institutional change characterized by displacement rather than layering.

**Concluding remarks**

What factors explain the institutional reforms observed during Europe’s financial crisis? Drawing on work from Mahoney and Thelen (2010) and Lindner (2003), we assessed the empirical viability of two hypotheses: (1) increasing bargaining power of the anti-change coalition leads to layering; and (2) higher interdependence between policy sub-fields leads to displacement. They were tested through the Greek and Irish bailout packages to explain differences in the challenges they presented to the institutional architecture of the common currency area. From an institutional perspective we build upon and contribute to conceptual linkages of specific mechanisms to particular types of institutional change. Amending Mahoney and Thelen we show their taxonomy can also be used to explain crisis-driven, short-term institutional change. But not all change is necessarily productive or appropriate.

Despite similar institutional settings within the Eurozone, tackling the financial crisis in Greece and Ireland has produced thus far divergent results. We found that the bailout arrangement was quite appropriate for Ireland, but the one agreed for Greece was not. Crises challenge this EMU presumption in two ways. First, the decoupling of economic and monetary union is strongly contested. Second, efforts to address one set of problems end up exacerbating others (Zahariadis, 2012). The point is that crises may lead to institutional
innovations, but these innovations will not always be productive. Leaders may not draw the right lessons, especially in regards to Greece, because of the huge interdependence between sub-fields. In other words, a simple solution was applied to a very complex problem. It worked for Ireland but it failed for Greece, given that Ireland’s problem was less complex, and it involved a prior history of fiscal discipline and restructuring of the state.

The case studies demonstrate that institutional innovation put forward by the European partners and the IMF was appropriate for Ireland: the anti-change coalition—despite coming to power under the platform of renegotiating austerity—succeeded to the new financial mechanisms and the tacit consensus gaining increased bargaining power over the pro-change (anti-austerity) partners. The problem of the Irish state was staying afloat and tackling liquidity drought due to the undertaking of the private bank debt – nothing more. Thus, the reduced complexity of the issues at stake was not sufficient to trigger displacement; rather institutional layering worked well as a mechanism for change.

In contrast, there was no political consensus in Greece largely because there was no consensus on what precisely the problem was and who was to blame (Vasilopoulou, Halikiopoulou and Exadaktylos, 2014. The government faced strong opposition by (a) the political parties in parliament, (b) the social partners affected by the institutional change and (c) by its own parliamentarians and ministers. Therefore, any bargaining power of the anti-change players was diminished. The Greek government could not put its own stamp on reform programmes (layering). At the same time, Greece’s problem was a lot more complex than simple government debt. Given the high interdependence amongst policy subfields, the new externally imposed institutional architecture took prominence under the pressure of supranational actors, leading to disastrous implementation and intensifying instability in financial, political and social terms. Essentially, displacement shifted the process and direction of change for Greece, but at the end of the day there was little consensus as to what
that direction was or should be. Increased confusion and resistance to change coupled with strong-arm tactics by external lenders created a toxic political environment that decisively lowered the effectiveness of these institutional innovations.

Crises have proven fertile ground to construct new institutions of governance in the EU. Our study echoes the observation made by van den Noord et al (2008, p. 63) that ‘the governance structure in EMU builds on a strong tradition of subsidiarity, which leaves policy responsibilities to the Member States wherever this is feasible’. The institutional rules of SGP as well as initial EU responses to the financial crisis clearly demonstrate the willingness of national governments to solve (unsuccessfully) their problems and the reluctance of EU actors and other governments to intervene robustly to fix those problems. However, the study also shows the limits of collective responses to national problems. Article 121 of TFEU views economic policy as a matter of common concern and coordination. Nevertheless, the ability to address economic problems is limited by national concerns and political timetables as demonstrated by the ‘no-bail out clause’ (Article 125 of TFEU). As a result, similar institutional innovations are used to generate solutions to quite diverse problems. The Fiscal Compact and the nascent (and still feeble) banking union further illustrate the benefits of regional institutional changes undermined by national preferences and bargaining power (Dehousse, 2012; Frankel, 2013; Fox, 2013). EMU was originally conceived as an institutional innovation that would bring financial stability and growth to European economies in light of increasing globalization. However, this pooling of economic risk also masked growing complications in dealing with systemic crises; national problems easily overwhelmed national capacities and became systemic problems. Responses addressed some problems reasonably well (Ireland) while leaving several problems with Greece unresolved while not effectively addressing deeper structural issues with financial institutions.

Some national governments consider more European integration as the solution to
issues of size. Cognizant of the inverse relationship between national economic effectiveness and growing globalization, small economies can have power in an increasingly global world only if they act collectively. The study undermines this argument by questioning the capacity of institutions as instruments of regional governance to shield their members’ economies or respond effectively to external or internal shocks. Systemic crises affect economies in very different ways. Solutions drawn on experience to deal with a set of problems in one economy cannot be transferred to another and be expected to work reasonably well. Global crises trigger national crises which may in turn exacerbate regional crises. This reverberation of problems across layers of governance complicates diagnosis and response. Democratic accountability focuses national attention to domestic problems, while international investors demand solutions that may cut across sovereign boundaries. Regional institutional changes aiming to deal with such contradictions must link these two levels in positive-sum rather than zero-sum ways. Addressing problems at one level should not be at the expense of creating problems at a different level. Regional governance is both the solution and the problem in periods of crisis. In the absence of a democratic, federal Europe, the answer to its financial crisis may not be more rule-based governance but more flexible institutional innovation.