Credit and Capital Markets, Volume 51, Issue 1, pp. 113–126
Scientific Papers

ECB-Eurogroup Conflicts and Financial Stability in the Eurozone

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Abstract

This paper examines the impact of conflicting ECB and Eurogroup narratives over the nature of the Eurozone crisis and the proper strategy for exiting it. While the Eurogroup prefers a simple austerity-focused policy to ensure distributional outcomes benefiting Northern Europe, the ECB advocates a carefully sequenced combination of growth-enhancing, budget balancing and structural adjustment policies. The confrontation over ECB measures to stabilise the Eurozone through monetary policy is partially and temporary relieved by Commission leniency, and partly through informal German accommodation. A formal adjustment of Eurogroup policy is unlikely, however.

Eurogruppe und Europäische Zentralbank im Konflikt und Finanzstabilität im Euroraum

Zusammenfassung

In diesem Beitrag werden die Auswirkungen von widersprüchlichen Narrativen der Europäischen Zentralbank (EZB) und der Eurogruppe über die Ursachen der Krise in der Eurozone und die richtige Ausstiegsstrategie untersucht. Während die Eurogruppe eine einfache, auf Sparpolitik ausgerichtete Politik bevorzugt mit der gewährleistet wird, dass die Verteilungsergebnisse Nordeuropa bevorzugen, befürwortet die EZB eine sorgfältig aufeinander abgestimmte Kombination aus wachstumsfördernden, Budgetausgleichs- und Strukturanpassungsmaßnahmen. Die Konfrontation über geldpolitische Maßnahmen der EZB zur Stabilisierung der Euro-Zone wird teilweise durch die Nachsicht der Kommission gegenüber den Mitgliedstaaten und teilweise durch eine informelle deutsche Anpassung erleichtert. Eine formelle Anpassung der Politik der Eurogruppe ist jedoch unwahrscheinlich.

Keywords: ECB, Eurozone, EMU, structural adjustment, macroeconomic policy

JEL Classifications: E4, E5, E6, H6

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I. Introduction

Ten years after the Great Financial Crisis, EU efforts to break the doom loop between banks and sovereigns has failed. Eurogroup demands to retrench public deficits and bank balance sheets have weakened financial stability acutely in Southern Europe (*Matthijs* 2014) and threatened contagion to the North. ECB monetary easing, coupled with TARGET II surpluses and deficits that have not been brought into balance, has reduced the likelihood of the doom loop leading to collapse. Meanwhile, the ECB has worked on piecing together a recommended mix of policy initiatives to exit the crisis sustainably.

Rather than recalibrate their demands to reflect a North-South compromise, the Eurogroup has reconfirmed its position (*Hodson* 2016; *Donnelly* 2018). An end of the ECB-Eurogroup confrontation is not in sight. It is characterised by a clash of ideas about how to combine economic growth with financial stability. For the Eurogroup, austerity – retrenchment of public deficits and debt, structural reforms and reduction of "excessive" private lending that could lead to asset bubbles are first-order priorities that will generate growth and employment down the road. For the ECB, structural reforms and retrenchment are best undertaken after measures to ensure sufficient growth to support employment and positive attitudes toward reform.

This paper contributes to the literature dealing with the political economy of Eurozone governance (*Howarth*/*Quaglia* 2016; *Donnelly* 2014; *Dyson* 2010), the role of (macroeconomic) policy ideas as weapons and coalition-building tools in public policy debates (*Blyth* 2013; *Quaglia* 2008; *Moravcsik* 1998), and in the agency of supranational EU institutions more generally (*Thatcher*/*Stone-Sweet* 2003; *Pollack* 2003; *Groenleer* 2009). In this paper I upgrade the role of the ECB as an independent institution that can intervene within limits in the intergovernmental conflict and redistributive power politics that permeate the Eurozone. It thus treats the ECB as a significant supranational actor.

The rest of this paper is organised as follows. Section 2 outlines the politics of the Eurogroup, Section 3 of the ECB, and Section 4 discusses how Commission leniency and informal German accommodation have relieved the deadlock without resolving it. Section 5 concludes.

II. Eurogroup Doctrine

Germany leads an advocacy coalition on EMU policy (*Howarth*/*Quaglia* 2016; *Quaglia* 2010), based on distributional interests and held together by ordoliberal ideas with concrete consequences for Eurozone member states. This narrative sees financial stability emerging through investor confidence and prudent public and private finances, which require downsizing public budgets (borrowing) and bank balance sheets (loans) in Southern Europe. This in turn means a deflationary reversal of Southern Europe's boom years of the early-to-mid 2000s (*Hall* 2017; *Perez/Matsaganis* 2017). These are mandated by increased attention to macroeconomic imbalances and public finances since 2011.

Eurogroup macroeconomic policy is characterised by a push for balanced budgets (*Moravcsik* 2016), plus methods to achieve it (frontloaded structural adjustment procedures and procyclical budget adjustments) and the establishment of institutions to increase technocratic control – most notably the European Semester and semi-automatic sanctions for exceeding deficit limits (*Sanchez-Cuenca* 2017). Growth is expected to follow through a combination of private investment allowing businesses to capitalise on increased international competitiveness. This supply-side approach involves no consideration for demand or how to combine economic policy initiatives, and contains no explicit focus on financial stability.

These preferences are held in place by institutional mechanisms. The Eurogroup's means of securing agreement on this policy rest on two institutions: the Treaty and Stability, Coordination and Governance (TSCG) and the European Stability Mechanism (ESM). The TSCG commits EU national governments to fiscal retrenchment and structural reforms to pursue competitiveness in line with the SGP and the European Semester, even though it is an international treaty outside of EU law. Signing the TSCG is a precondition to accessing emergency funding through the ESM. In this legal context, Eurogroup demands cannot be attacked, adjusted or watered down by Commission proposals to introduce North-South transfers, require Germany or the Netherlands to reduce their current account surpluses by importing more from Southern Europe (*Dombrowski* 2016), or be challenged by other parties before the ECJ.

The asymmetric source of these demands is posited by multiple sources. *Moschella* (2017) and *Matthijs* (2016), demonstrate that Eurogroup politics increase the importance of some national parliaments, belonging to the core group of austerity-minded countries, particularly Germany, and weakening that of others, for example Greece, Italy and much of Southern Europe. *Jones* and *Matthijs* (2017) contrast national vetoes by the German parliament with the powerlessness of southern European parliaments, and the lack of a commitment to solidarity in the north. This is seen in the coupling of ESM financial backstop measures with balanced budget demands by Germany and their view in much of the rest of Europe as a 'blackmail' conditionality (*Bosco/Verney* 2012; *Donnelly* 2014; *Matthijs/McNamara* 2015; *Crespy/Schmidt* 2014).

The balance of evidence suggests isolated instances of Eurogroup flexibility. *Moschella* (2016) argues that there is more flexibility from 2012 onward with regard to program countries (Greece specifically) after new EMU institutions are in place to manage the effect of a collapse. This can be seen in support for debt reduction and interest rate reductions on Greek financial assistance. However, *Hodson* (2016) notes that on balance, Eurogroup concessions were extremely limited.

However, on balance, the dispute between the Eurogroup, Commission and IMF from 2012 onward over the extent to which leniency should be exercised toward Greece suggests a different picture, that Eurogroup and Commission (and ECB) evaluations of the severity of the economic frailty of Greece and the necessity for further debt relief continued unabated. The Eurogroup's demands during the showdown of mid-to-late 2015 also suggest a hardening of its position, compared to softer Commission expectations under the Juncker administration (*Donnelly* 2016). As recently as 2017, the IMF continued to underline the necessity of the Eurogroup to ratchet back its austerity demands and to accept a reduction of Greek public sector debt to make its financial obligations sustainable.

This intransigence impacts financial stability. In the absence of considerable outside investment or fiscal transfers prior to retrenchment, this means an extended period of financial instability (through economic contraction) until a stable equilibrium point is reached (in which governments live within their newly modest means, banks lend more modestly and conservatively, and firms and households follow with more modest levels of employment/wages, consumption and production (unless intended for the external market, which these countries rarely do). In this context, the contrast of ECB policy ideas remains strong.

III. ECB Ideas as Expertise

The ECB, though not unsympathetic to the economic policy prescriptions the Eurogroup favours regarding sound public finances and structural adjustment, sets limits to how far they can be pushed. Unlike the Eurogroup, it factors in deflation as a destabilising factor for national economies, the euro zone economy as a whole and for financial stability in particular, where it has a self-assumed mandate protected by the ECJ. Its view that Eurogroup policies perpetuate these fragilities implies that the quantitative easing policies it has used to hold the Eurozone together (LTRO, SMP, OMT announcement, negative interest rates) will persist. Indeed, the ECJ has raised this likelihood by rebuffing challenges to OMT through the German Constitutional Court. This institutional reinforcement of ECB independence allows the ECB the freedom to continue articulating and acting on its vision of proper policy.

In essence, the ECB links up retrenchment policies (which the Eurogroup pursues without limits) to macroeconomic policies (which impose limits on the extent and nature of retrenchment) in ways that the Eurogroup does not. This is because the Eurogroup's demands are based on distributional conflict (*Dyson* 2010) designed to prevent a fiscal union rather than (sound) macroeconomic policy. The ECB, in contrast, keeps expertise in the foreground about the mix of policies required to keep a currency union functioning and counteracts the worst side effects of the EG's policies and institutions.

The ECB articulated financial stability as a core task alongside price stability in 2008 (meaning stability of financial markets), and economic stability as well by 2010 (meaning avoiding deflation). Quantitative easing became one more program to pursue that goal. Financial stability includes the capacity of national governance to borrow (and if not on capital markets, then eventually through the ECB and its balance sheet). ECB Financial stability reports take four factors into consideration when determining whether extensive intervention is required: external factors (negative impacts or uncertainties emanating from the global economy); internal banking sector factors (weak profitability coupled with flat economic growth and significant NPLs); internal non-banking sector factors (weak income of non-bank sector coupled with flat economic growth and significant debt); and investment sector stress (amplifying problems and establishing contagion to further parts of the economy). Critical conditions threatening financial stability occur when these four factors reinforce one another.

ECB thinking in its Financial Stability Reports also reveals that it is not insensitive to the demand of the Eurogroup to address debt levels and engage in structural adjustment programs. However, the Financial Stability Review (2016) and other ECB documents indicate additional concerns: with addressing liquidity shortages and the continuing collapse of the interbank lending market (dating back to 2008); followed by a shift toward anaemic growth and a rise in non-performing loans and exposures. The latter concerns not only dominate risks to the Eurozone, but also complicate a definitive exit from the consequences of the Eurozone crisis.

With the imperative of restoring growth and preventing deflation in mind, the ECB has remained firm in combining quantitative easing with calls for the Eurogroup to change its policies, despite political pressure by the Eurogroup. By 2012, and continuing into 2017, the ECB had been confronted with accusations that it had strayed from its intended mission of pursuing price stability, as laid out in the Maastricht Treaty by engaging in quantitative easing. Its response to this was that price stability means preventing prices from rising too much too quickly, but also from falling too much too quickly, which gives it a mandate to put a safety net under the European economy. Eurogroup demands to prevent the ECB from deploying quantitative easing would therefore undermine its legal mandate to ensure price stability (*Coeuré* 2016).

Furthermore the ECB pushed back against Eurogroup doctrine by attacking the sequencing of structural adjustment programs during economic downturns, and across sectors in a pro-cyclical fashion, a view that built on OECD advice from 2013 (*Cournède* et al. 2013), and as recently as 2017 (OECD 2017). *Coeuré* (2016) drew particular attention in 2016 to the impact of labour market reforms (particularly the increase in unemployment) on the success of and willingness to implement other (product and market) structural adjustment programs that are required to generate new economic development. But he also called for broader consensus at the EU level on what policy moves are necessary, and in which order, backed by political legitimacy.

A better policy response would include coordination between monetary, fiscal and other policies: ensuring that demand-side policies support growth in each Eurozone country alongside supply-side policies; promoting strategic investment in promising sectors; and sequencing policies to avoid internal devaluation effects. *Coeuré* hoped that the new Juncker Commission and the European Council would support such a shift (*Coeuré* 2014). Instead, the Eurogroup spent most of 2015 polarising against the Greek government and hardening its position even further (*Hodson* 2016). But *Coeuré* underlined that front loading labour market reforms (pushing price competitiveness) instead of other productivity-enhancing market reforms first leads to lower growth and interest rates, as structural blockages in the market prevent regeneration. It had to be rejected.

Mario Draghi's take on Eurozone challenges in 2016 reflected similar concerns: a need to engage in structural adjustment programs, but in a way that directly attacked low growth and high structural unemployment, particularly in Southern Europe, which had not rebounded as well as the North from the Eurozone crisis. Investment, research and education needed to be increased priorities in public spending for all governments, buttressed by structural and tax adjustments to incite private investment as well. Country-specific recommendations in the European Semester need to be followed up on. Finally, EMU required completion and reform in line with the Five Presidents' Report of 2015 so that risks are both reduced (individually) and shared (collectively). Otherwise EMU would remain fragile and individual countries vulnerable to shocks. (*Draghi* 2016)

Speaking already in 2014, *Draghi* countered Eurogroup doctrine with a critique of its broader negative impact on Southern Europe. In the absence of a fiscal union, attempts at stabilising EMU took away macroeconomic stabilisers at the national level. Front-loaded budget retrenchment and reductions in public service, education and healthcare employment from early 2011 onward led to declines in GDP, rises in (long-term, structural) unemployment, and reduced resources to (re)train workers in industry and construction for jobs employers seek. Financial access problems for governments and banks also meant that monetary policy accommodation was not passed through to the real economy.

Finally, uncertainty for investors about the likelihood of losses through deflation-related debt restructuring would prevent recovery (*Draghi* 2014).

Instead, *Draghi* advocated a balance of demand-side measures to reduce unemployment (at the European and national levels) and supply-side measures at the national level. Regardless of the asymmetric, pro-cyclical impact of front-loaded reforms, structural factors at the national level still mattered, but were beyond the ECB's control. While adjustment in Ireland took place through price levels, in Spain price rigidities in the labour market meant that it took place through job cuts, and given the dual market between protected and unprotected contracts, adjustment took place on the backs of younger workers (*Draghi* 2014). Sequencing recovery therefore required attention to boosting aggregate demand first and then tackling structural adjustments afterward. Stagnant growth and inflation in the Eurozone, and the ineffectiveness of fiscal policy had little to do with debt overhang (in contrast with the Eurogroup's position), but with the inability of the central bank to back a centralised fiscal policy as in the United States and Japan. That means that fiscal policy adjustments couldn't be backloaded in the Eurozone, as they were in those countries.

The ECB's position should not be understood as advocating a fiscal union without national structural adjustment programs, however. For *Coeuré*, the ECB's positions were not about abandoning the SGP – which he indicated would be 'self-defeating'. The European Semester and Macroeconomic Imbalances Procedure both recognised that not only monetary but also broader ex ante economic policy coordination was an important part of making EMU work properly by reforming to promote recovery (*Coeuré* 2016).

Coeuré depicted structural adjustment programs in particular as a key practical obligation of good governance in the Eurozone, a critical component of economic rejuvenation, and a political prerequisite for a functioning EMU, but not a legal obligation under the European Semester. In his assessment, the problem was that member states had actually implemented as little as 4 % of country-specific recommendations in 2015. In order to ensure that factors of production can be redeployed, SAPs remained vital, but they needed to be comprehensive, and sequenced (or accompanied appropriately with fiscal stimulus). This meant that governments would have to unroll SAPs to liberalise product and service markets, typically defended by powerful lobbies, to attract investment before labour market adjustment programs. Minimising pain could further be accomplished by undertaking reforms when the economy is in an upswing, or when macroeconomic management is stimulating economic growth. The Eurogroup's problem was reversing the sequence, imposing structural adjustments during downturns, leading to an increase in unemployment and a reduction of consumption. The combined drag on the economy and politicisation was disastrous (*Coeuré* 2016).

In the absence of such change, the ECB has dug into its position to take extraordinary monetary policy measures within limits set by the European Court of Justice (ECJ), which itself was prompted to set limits by the German Constitutional Court. The ECJ approved the ECB mandate to provide for financial and economic stability as implied powers of a central bank, but also with limits: extraordinary measures are only permissible under conditions of emergency: one that implicates the doom loop (ECJ 2015).

What constitutes an emergency is indeterminate, which broadens the potential scope of ECB activity. It could be defined narrowly as the imminent threat of financial collapse (crashing of financial markets and institutions, introduction of capital controls and the potential unrolling of an emergency support package by the Eurogroup through the ESM), or broadly as the persistence of flat or negative economic growth that results in a chronically unstable banking system and general economic instability. In the latter instance, the ECB's capacity to act independently to keep interest rates low and liquidity high ultimately depends on whether the Eurogroup's strategy for restoring economic and employment growth to the Eurozone succeeds or not.

It also means that there is a possible room for rapprochement from the side of the ECB. Once a strategy is found on the Eurogroup side, the ECB can taper quantitative easing and should be expected to do so, both from the perspective of maintaining price stability (when once again the risk the ECB considers most pressing is containing inflation rather than deflation) and from the perspective of maintaining the integrity of the legal cover the ECJ has extended to the central bank.

IV. Policy Impact and Institutional Independence

The impasse between the ECB and the Eurogroup that started in 2012 and reached a climax in 2015/6 has balanced itself out in its impact on the European economy. The means by which the Eurogroup demands that EU, particularly Eurozone member states make their own efforts for financial stability vary from country to country. But a significant part of the effort within the Excessive Deficit Procedure and the European Semester has a deflationary effect through front loaded budget retrenchment. Efforts at tackling sources of instability in the banking sector within Banking Union and the Macroeconomic Imbalances Procedure (both of which place downward pressure on loans in certain countries like Italy) place a similar drag on economic growth and development. These developments are alternatives to some sort of fiscal transfers or expanded use of the ESM as a time-saving device that might allow program countries to back load deficit reforms as they invest positively in structural reforms and infrastructure development. The Eurogroup-Greece standoff of 2015 (and ongoing) revolved around these issues and set a decisive precedent in favour of rejecting such alternatives.

Nevertheless, once the precedents have been set, there is room to change 'by stealth' according to *Schmidt* (2016). One form of adjustment below the radar is German behaviour rather than rhetoric: a reduction of the German balance of payments surplus, increased consumption and rising inflation provide more room for deflation and trade deficit-ridden countries in Southern Europe to revive economic output through exports and shift from balance of payment deficits to surpluses. Italy and Spain have done this, while Portugal and Greece have not. This is some indication that the critique levelled at Germany and the Netherlands for booking such large surpluses during the crisis has had some effect in Germany (even if the direct link cannot be proven). The Dutch surplus is as large as it ever was, but so is Dutch intransigence in its attitude toward Southern Europe, to go by the statement of the Dutch Finance Minister (*Khan*/*Maclean* 2017).

Another form of adjustment, if a less sustainable one, is the Juncker Commission leniency in enforcing the Stability and Growth Pact. This has come in the form of refusing to pursue the Excessive Deficit Procedure (EDP) for France 'because it is France' (*Guarascio* 2016), to providing smaller countries with the room to provide state aid to banks without counting it toward government spending (and borrowing) under the SGP rules (*Donnelly* 2017). In the case of Portugal, which was rebuked by the Council as recently as July 2016 for failing to observe budget rules (European Council 2016), this Commission leniency created the room to avoid EDP sanctions and to exit the procedure in 2017 (*Brunsden* et al. 2017).

This increased flexibility provides a stay of execution for Europe's more fragile economies by giving more room to macroeconomic stabilisers in the short term, in return for structural adjustments in the medium term. This absorbs some of the deflationary pressure that the Eurogroup pushes for. But it does not fundamentally solve the ECB-Eurogroup conflict.

V. Conclusions

This paper looked at the conflictual dynamics of ECB policy initiatives to hold the Eurozone economy together through monetary easing (QE, SMP, OMT, ELA, etc.) on the one hand; and on the other – Eurogroup initiatives to retrench debt and deficits, and reinforce national state liability for bank failures through changes to European economic governance. It also looked at the extent to which the conflicts were insurmountable or capable of bridging. It argued that two different policy narratives are at play in the deadlock between the two sides: between a Eurogroup that uses ideas as weapons in a distributional battle between

North and South; and an ECB that is seeking the optimal mix and sequence of policies to improve long-term financial, price and economic stability across the Eurozone. While Eurogroup austerity and SAP demands are intended to force the cost of crisis adjustment onto the Eurozone's weakest states, and accept internal devaluation as a core component, the ECB's has crafted a sequencing of policies that provides for adjustment without significant deflation.

This means that the gap between the ECB and the Eurogroup is real, but capable of being bridged. The ECB is looking for the Eurogroup and the EU to develop its coordinated economic policies further so that structural adjustment programs are pursued further, but in a sequenced way so that the remaining prime threats to financial, economic and price stability (chronically flat economic growth, threats of deflation, high unemployment and fragile financial systems) are overcome. German behaviour within the Eurozone has adjusted already (though it remains uncertain how long this will continue). But no threats to the current course appear on the horizon. Further, the political demise and replacement of the Eurogroup's hawkish chair, Jeroen Dijsselbloem, harbours well for a potential rapprochement. Only the move toward formal changes in the near future appears unlikely: given upcoming elections in Germany in 2017.

The Eurogroup's demands are difficult to back down on, even when some of its leaders might be willing to compromise. They are based on an advocacy coalition of national governments surrounding Germany, with the intent of preventing fiscal transfers as an aid (if not a solution) to securing financial stability in Europe, buttressed by a paradigm for austerity that is difficult to compromise without damaging the coalition, or damaging elector prospects for some of its members (*Donnelly* 2017b). Given the centrality of Germany within this coalition and the ideational leadership it provides, Eurogroup change would require an adjustment of German politics favouring a more relaxed view on EMU rules. However, Germany's domestic politics make it difficult to imagine a clean break from its previous demands, despite a willingness to adjust. This can be seen in societal actors digging in their heels on the issue of low interest rates that the ECB continues to uphold rather than rethinking their commitment the the Eurozone's policy to date. The dominant complaint is that low interest rates not only punish saving (and therefore a range of prudent practices that promote growth and development without asset bubbles – such as saving for purchasing a house instead of full-price mortgages and saving for retirement and providing deposits that can be channeled into loans for communities and SMEs and general economic development), but that they also coerce savings banks into increasingly risky behaviour in asset management and financial speculation for lack of other opportunities to make money (*Bindseil* et al. 2015). The role that increasingly risky investments played in bringing down German Landesbanken in 2008 and Spanish camas afterward (*Deeg*/*Donnelly* 2016), provide fuel to German steadfastness, particularly in the politically important public savings bank sector (Sparkassen). The result is that financial stability remains undersupplied in the Eurozone.

The paper also demonstrated that although the impasse is real, a compromise remains possible, but for political reasons, an informal one that leaves the rules and institutions imposed by the Eurozone intact. In this context, the Eurozone economy appears to have bottomed out and stabilised at a fairly low level. That it did not collapse entirely can be attributed to a reluctant ECB providing various forms of monetary accommodation. This does not mean an unreflective monetary policy intended to relax pressure for structural adjustment programs, however. It appears to follow the formula laid out by *Daniel Gros* (2012) – in which the ECB seeks to ensure that (excessive) credit flows to the periphery followed by a sudden stop are not repeated in a follow-up crisis – and in which the ECB provides (just enough) liquidity to buy governments time to undertake reforms. The Juncker Commission has avoided a Council showdown between the Eurogroup and the Southern periphery through lenient application of rules, but a Council compromise on sequencing along ECB-proposed lines remains elusive.

In sum: the incomplete nature of EMU is seen by some as the absence of a fiscal union, and by others as the lack of obligatory structural adjustment programs and deficit retrenchment. The internal politics of the Eurogroup have witnessed the establishment of a dominant narrative to ensure the interests of its northern members are the official line. In its zeal to push adjustment costs on its weaker members, it accepts internal devaluation and deflation as components of recovery. The ECB sees a more nuanced combination and sequencing of reforms that focuses on product and market liberalisation first, followed by labour market reforms and public spending reforms once growth has started to recover. While it cannot substitute for the perceived necessity of a fiscal union, it's expertise-based policy ideas promise better exit strategies than the current alternative. While the Commission's leniency toward national governments in the Excessive Deficit Procedure has bought them time from this impasse, it has not resolved it. However, the ECB has a formula that could work without a fiscal union, and that might prove acceptable eventually to the Eurogroup in a future crisis.

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