Austerity Europe, Keynesian Europe: The Politics of Debt and Growth in the European Union

Cornel Ban

The Frederick S. Pardee for Global Studies
Boston University

Austerity Europe

A rich body of literature associates the European Union institutions with self-defeating austerity policies enforced through increased surveillance, legalization of decision marking and a rich menu of coercive measures (Blyth 2013; Ladi and Tsarouhas 2014; Heinz and de la Porte 2015; Pavolini et al 2015; Ban 2016; Bengtsson and de la Porte 2017). Extensive empirical research demonstrated the pernicious effects of the EU management of the crisis on all social services and particularly on health (Reeves et al 2014; Greer 2014; Kentikelenis et al 2014). As a special issue on the topic concluded, austerity represents "a radical alteration of EU integration, whereby the EU is involved in domestic affairs to an unprecedented degree, particularly with regard to national budgets" (Heinz and de la Ponte 2014). Before long, as social investments were all but neglected, the EU faced a political backlash associating its crisis governance with the undermining of a social acquis painstakingly built over many decades in European societies (Matthias and Blyth 2017).

Other scholars have pointed out that Europe's crisis is compounded as much by institutional design issues (the well known poverty of the EU-level fiscal capacity) as it is by two costly political choices. The first is the failure to generate sovereign debt pooling mechanisms such as the ill-fated eurobond, due to contingent political dynamics in the creditor states (Matthijs and McNamara 2015; Matthijs 2016; Moschella 2017). The second costly choice was the absence of a lender of last resort for sovereigns, which further constitutionalized austerity at the EU level (de Grauwe and Ji 2013; Blyth 2013; Gabor and Ban 2015; Gabor and Ban 2016).[1]

This paper argues that this emphasis on austerity Europe in corpus of literature on the EU governance of the crisis begs for two consequential nuances. Since 2013 the Eurozone

[1] This choice is both self-defeating and financially costly for the EU institutions involved. As Paul de Grauwe showed that "failure to provide lending of last resort in the government bond markets of the monetary union carries the risk of forcing the central bank into providing lending of last resort to the banks of the countries hit by a sovereign debt crisis and this lending of last resort is almost certainly more

(albeit not the EU as a whole) has a full-fledged lender of last resort function for sovereigns (European Stability Mechanism) and since 2015 it also acquired a Keynesian face in the form of a countercyclical lending fund (European Fund for Strategic Investments). However, the paper finds that the first function comes at the cost of imposing pressures for pro-cyclical fiscal policies on countries facing sovereign debt issues that are in excess of those demanded by the IMF. Furthermore, the countercyclical lending fund has had a patchy record at delivering demand-side support to the countries that needed it the most and even when it did (as in the case of Italy) the amounts approved for disbursement barely make a dent in the massive needs of the economy.

The first section provides a succinct overview of the position of the EC and ECB as the "usual suspects" of the scholarship on austerity and ends with the formulation of specific research hypotheses. The next two sections make up the bulk o the paper and examine in detail the cases of the ESM and EFSI.

Austerity Europe and Beyond: the EC and the ECB

After a Keynesian interlude, in its June 2009 *Quarterly Report*, the EC asked all EU governments to "prepare a credible strategy for fiscal policy so as to be able gradually to withdraw the stimulus," stressing, however, that the withdrawal should take place only gradually, once the recovery takes hold, and avoid "excessively tight budgetary policies choking the nascent recovery" (25). In October, the call to withdraw the stimulus grew a bit louder, but it was only in the March 2010, after the EU heads of state meetings in the European Council failed to produce a strong response to the Greek debt crisis, that the EC argued austerity should be pursued "urgently." It was also in the March report that the EC defined its solution to the predicted increase in unemployment in countries showing high current account deficits: harsh and immediate "internal devaluation" packages executed through extensive spending cuts and structural reforms.

The doctrinal turn to austerity was translated into practice via a combination of nudging, legalistic, and coercive governance modes of governance. The coercive mode was first activated when the Commission embedded its ideas in bailout agreements concluded in

2008 and 2009 with the crisis- ridden countries in the eastern "periphery" (Lütz and Kranke 2014). The legalistic mode kicked into gear in 2010, when the Commission pushed for the adoption of an even stricter set of fiscal rules than the Stability and Growth Pact that essentially outlawed discretionary fiscal policy by shifting compliance with an enhanced SGP away from peer pressure and toward outright sanctions and fines for public debt and deficits out of line with new, more demanding numerical targets (Hodson 2011, 242). The stress on rules-based and eventually constitutionally hamstrung fiscal policy was unprecedented and was steeped in the Commission's own research apparatus (Deroose et al. 2008; Iara and Wolff 2010).

In 2010 the Commission published a research paper based on a "unique data set," which found that "stronger fiscal rules in euro area member states reduce sovereign risk" (2010 EC Economic Paper 433, 1) and "the legal base turns out to be the most important dimension for the perceived effectiveness of the rules" (1). In the same year, the Commission also initiated the European Semester, a framework that combined nudging and coercion. Every year since 2011, the Commission has written a report for each member state detailing its position on domestic macroeconomic and structural reforms to be adopted, naming and shaming rule- breakers along the way and applying sanctions on member states found in violation of deficit targets.

If the EC had a relatively gradual transition from stimulus to austerity, the ECB went for austerity early on. An overarching picture of the European Central Bank's fiscal policy standpoint between 2009 and 2012 can be pieced together by looking at the views expressed in the ECB *Monthly Bulletin* reports. A year before the Greek fiscal scandal erupted and the Commission's about- face, the ECB was already on offensive against expansionary fiscal policy. Indeed, as early as January 2009, the ECB's Governing Council demanded the reversal of the fiscal stimulus measures adopted by EU member states in the fall of 2008, arguing that "if not reversed in due time, this will negatively affect in particular the younger and the future generations" (ECB 2009, 7).

By September, the ECB asked for "a swift return to sound and sustainable public finances." This entailed higher- than- usual fiscal consolidation efforts that would "exceed significantly the benchmark of 0.5 percent of GDP per annum set in the Stability and Growth Pact" (ECB 2009, 7). Removing any doubt as to who should pay for all this, the ECB stated clearly that "the focus of the structural measures should lie on the expenditure side, as in most euro area countries tax and social contribution rates are already high" (ECB 2009, 7).[2]

By 2014, the conventional wisdom in the EC and ECB began to enter a more fissiparous stage. High-level figures in both institutions began to admit that austerity did not work and sought the loosening of fiscal adjustment packages. This became patently obvious in the Juncker Commission, where fiscal rules have been interpreted by stealth (Schmidt 2016) and whose top technocrats now admit the failure of austerity without hesitations.[3] Contrary to popular knowledge, in the ECB began to modulate its strong pro-austerity voice as well. In his 2014 speech before central bankers and private financiers at Jackson Hole pleaded that demand side fiscal policies play "a more supportive role" to the reflationary attempts of central banks (Draghi 2014). Moreover, as Manuela Moschella showed, even in the second Greek program both the EC and the ECB relaxed their opposition to debt restructuring and fiscal accommodation (Moschella 2016).

That said, no fundamental and systematically enforced change on agenda setting has taken place, with reorientation being a more apt word (Savage and Verdun 2016; Bauer and Becker 2014; Dunlop and Radaelli 2016). This is particularly the case in the Commission's "flexible austerity" paradigm (Seikel 2016: 1398). In this case, although the rules of the SGP upgraded the Commission's policy autonomy (Bauer and Becker

---

[2] The justification for this stance was anchored in the New Classical argument that places a heavy reliance on rules- based fiscal consolidation to be introduced immediately and paired with structural reforms to reign in public spending and reduce labor costs. To the extent that countries are judged to have "fiscal space" (no one other than Germany and Sweden was judged to have it), the ECB Governing Board encouraged them to allow existing levels of automatic stabilizers (mostly welfare payments) and new targeted reductions in corporate income taxes and in labor taxes to take effect. But even for these countries, the ECB cautioned against more "Keynesian" options such as government purchase of goods and services, public investment, and increased social transfers to credit-constrained households. In the view of the ECB, such measures were deemed to have rapidly fading impacts on economic growth. Even if one lived in the best of all fiscal worlds, what one should aspire to were Reagan- style tax cuts and the same levels of social spending, with the private sector remaining the hero of recovery.

[3] Author interview with Marco Buti, October 2016.

2016), structural power rests in the hands of creditor states (Seikel 2016). As a consequence, economic and social policies that conflict with budgetary discipline are subordinated to the primacy of creditor states. But, as Mark Blyth (2016) and Matthias Matthijs (2016) showed, for a variety of material and ideational reasons the preference of these states is austerity (Howarth and Rommerskirchen 2013; Blyth 2016; Matthijs 2016).

The next sections explore the argument that the latest arrivals in the hallways of EU economic governance opened up the domestic policy space for less procyclical policies. It is hypothesized that since the EFSF/ESM is effectively an institutional projection of the member states represented in the Eurogroup, the outcome can only be procyclical policy. In contrast, since EFSI was established by a Commission frustrated by the strong pro-austerity preferences of the creditor states, its lending policies should be countercyclical in word and in deed, with the final outcome mediated by the institutional capacity of the member states to absorb the EFSI loans and guarantees.

The ESM: Europe's Lender of Last Resort

From the EFSF to the ESM

The European Stability Mechanism (ESM) is an intergovernmental institution established in 2012 as a permanent bond market support mechanism ("bailout fund") for the Eurozone.[4] It mobilizes funding and provides stability support under strict conditionality to the benefit of contracting Member States[5] which experience, or are threatened by severe financing problems. The ESM intervenes to the extent that its funds are judged to be indispensable to safeguard the financial stability of the euro area as a whole and of its Member States. [6]

The origin of the ESM and of its predecessors reflects a compromise between the institutional constraints posed by hard-to-change treaties and domestic political possibilities. Institutionally the ESM exists in a 'Catch-22' – it is a bail-out policy

[4] For a comprehensive overview of its functions see Micossi, Stefano, Jacopo Carmossi, and Fabrizia Peirce. On the tasks of the European Stability Mechanism. Centre for European Policy Studies, 2011.
[5] Recital 7 ESM Treaty.
[6] Article 3 ESM Treaty.

instrument in a European Union treaty that prevents bail-outs. Article 125(1) of the Treaty on the Functioning of the European Union (TFEU) states that loans should not be provided to members that cannot honor their payments.

The logic here reflects the German position that members are not obliged to provide assistance to other members, which prevents moral hazard. But given that principal lenders are likely to be within the Eurozone the costs of a member state becoming insolvent and defaulting on their obligations are not only economic turbulence for the region but also the possibility of members leaving the single currency.[7] When the crisis hit, the European Union needed a mechanism to provide stability funding to members while not violating the treaty. In 2012, the Council established the European Financial Stability Facility (EFSF), a special purpose vehicle playing the role of a financial assistance instrument specially designed for Greece. These temporary sovereign bond market assistance funds were replaced in 2013 with the permanent European Stability Mechanism (ESM).[8] However, it is important to point out that the establishment of the ESM required the softening of the "no bailout" clause in the treaties and the addition of a third paragraph in Art 136 TFEU.

The first international intervention jointly organized by the Eurozone member states and the IMF began in May 2010, at the request of the Greek government. The intervention was launched shortly before the launch by the European Council of the European Financial Stabilization Mechanism (EFSM). A public limited liability firm under Luxemburgish law, the EFSM had been tasked to provide financial assistance to the Greek government, reduce the country's foreign debt and bring Greece back on private sovereign bond markets.

The initial mission of the EFSF was to address the wider contagion of the sovereign debt

---

[7] Closa, Carlos, and Aleksandra Maatsch. "In a spirit of solidarity? Justifying the European financial stability facility (EFSF) in national parliamentary debates." *JCMS: Journal of Common Market Studies* 52.4 (2014), page 826.
[8] ESM, *Annual Report*, 2013.

crisis from Greece to other Euro area member states such as Ireland and Portugal.[9] Both institutions have emerged as large players in the Euro area sovereign bond market, with outstanding bond volumes similar to that of a small euro area economy.[10] Research suggests that the sovereign bond markets trusted the guarantee structure of the EFSF, treated it as core issuer of bonds and consequently reattached the periphery to the core, relegating Greece to a "special case" area of high risk.[11]

The scope of the ESM interventions includes macroeconomic loans (the most used with Greece, Portugal and Ireland), primary and secondary market purchases (developed but never used), precautionary programmes *a la* IMF (developed but not used), as well as direct and indirect bank recapitalization assistance (the latter was used for Spain).

Stability support loan	Direct loan from the ESM to an ESM member
Primary market support facility	Allows the ESM to participate in bond markets, buying bonds directly from the supported government, in auctions designed for private financial market participants.
Secondary market support facility	This works like the primary market support facility, but allows the ESM to purchase government bonds indirectly, on the secondary market, off other holders of the bonds.
Financial assistance for recapitalisation of financial institutions ('indirect recapitalisation')	A tool for crises due to a member's financial sector, with conditionality refocused accordingly. This was the instrument used in Spain.
Direct recapitalisation instrument (DRI)	An instrument to directly recapitalise banks, under highly specific and restrictive conditions, after all other instruments, including 'bail-in' and the Single Resolution Fund, have already been used. This instrument backs up the EU's Banking Union.
ESM precautionary financial assistance	Allows Member States to secure ESM financial assistance before incurring unsustainable refinancing conditions on financial markets. Conditionality is lighter and monitored via 'enhanced surveillance' by the Commission, rather than a full ESM macro-economic adjustment programme.

These interventions are financed by the issuance of bonds and other debt instruments on the capital market. In short, the ESM emerged as a lender of last resort for distressed

[9] Gocaj, L., & Meunier, S. (2013). Time will tell: The EFSF, the ESM, and the euro crisis. Journal of European Integration, 35, 239-253.
[10] Hillebrand, Martin, et al. European Government Bond Dynamics and Stability Policies: Taming Contagion Risks. No. 8. 2015.
[11] Hillebrand, Martin, et al. European Government Bond Dynamics and Stability Policies: Taming Contagion Risks. No. 8. 2015.

Euro area sovereigns and banks facing serious bond market pressures.

The ESM and the EFSF are managed by the same Managing Director and are operationally, albeit not legally, identical. The EFSF was a temporary bailout fund (June 2010-June 2013)[12] with *pari passu* ("equal footing") creditor status that was incorporated as a private company under Luxembourg law. In contrast, the ESM is a permanent (June 2012-) intergovernmental institution under public international law that can claim a preferred creditor status (after the IMF).[13] The EFSF's capital structure is backed by the guarantees of the Euro area member states while the ESM's is backed by the subscribed capital of €704.8 bn and the €80.5 bn in paid in capital of the Eurozone Member States. Both are bailout funds but the maximum landing capacity of the ESM is more than double (€500 bn) that of the EFSF (€192bn). Both institutions have had very high credit ratings.

Legally speaking, the ESM is an entity that emanates from the sovereign will of the Member States and delegates critical forms of intervention in the domestic policy arena of the program countries to the Commission and the ECB. Article 3 of the ESM Treaty reads:

> the Board of Governors shall entrust the European Commission – in liaison with the ECB and, wherever possible, together with the IMF – with the task of negotiating, with the ESM Member concerned, a memorandum of understanding (an "MoU") detailing the conditionality attached to the financial assistance facility.

Furthermore, article 6 (g) of the ESM Treaty stipulates that the BoG "gives a mandate to the European Commission to negotiate, in liaison with the ECB, the economic policy conditionality attached to each financial assistance."

[12] The EFSF assistance to Greece was extended to February 2015.
[13] The one exception is the ESM recapitalization of Spanish banks, for which the ESM could only claim pari passu status.

Yet despite being an emanation of the main EU subjects (the Member States), the ESM was placed by them outside the EU legal framework, a fact certified by CJEU in the *Pringle* case.[14] In effect, the EU created a private body that is controlled by the informal consensus of the ministers of finance of the Eurozone but which leaves the adjustment program design (the Memoranda of Understanding) and their enforcement to the Commission, the ECB and the IMF (the so-called Troika/the Institutions). In effect, "the Member States 'borrowed' the EU institutions for the use by the ESM"(Salomon 2015).

The ESFS/ESM as bond market fire brigade

The ESM's interventions in the Eurozone sovereign bond markets and the ECB's policy turn after Mario Draghi's "whatever it takes" moment can be credited with the first successful attempt to arrest a systemic sovereign bond market crisis in the Eurozone (Figure 1). Indeed, the fact that the ECB and ESM acted in tandem was critical for this success (Jones et al 2016).

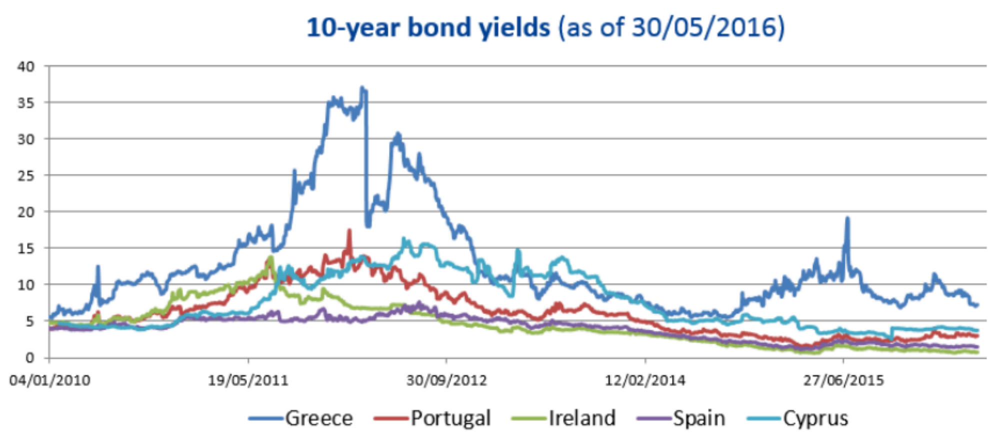
Some scholars noted that at the time the EU could have given the ESM a "banking license," so that it could leverage its working capital more aggressively to bail out larger member states but this option was rejected because "European Commission officials worried quietly that any attempt to rely on EFSF or ESM financing would soon reach the limits of resources available and so lack credibility in the markets. And the German government was unwilling to allow the ESM to obtain a banking license because any increase in leverage would impose unacceptable risk on ESM capital and because having the ECB as a liquidity backstop looked too much like the monetary financing of

[14] This legal arrangement was challenged in CJEU almost as soon as the ESM was established. Thomas Pringle, an Irish national, asked Irish courts to clarify of the ESM Treaty was incompatible with the Irish constitution and whether a referendum was not required to validate Irish ratification. Critically, Pringle argued that the Troika conditionalities could have an adverse effect on the rights guaranteed by the Charter. The Irish High and Supreme courts rejected the claim but asked CJEU for clarifications regarding the legal status of the ESM: (2) whether the Council's amendment to Article 136 TFEU to include a reference to a stability mechanism, was legal and (2) whether the ESM Treaty itself was not in fact incompatible with the existing Union Treaties. CJEU passed its judgment on the merits on November 27, 2012 (case C-370/12). CJEU ruled that (1) the establishment of the ESM was procedurally and substantively legal, that (2) the ESM is not an EU body and (3) the Member States that constitute it do not implement EU law when making decisions in the ESM. Therefore, the European Court decided that the Charter is not applicable to the ESM and the Member States acting in the ESM (and therefore outside the EU). This interpretation was based on article 51 (1) of TFEU requiring EU Member States to observe the Charter "only when implementing EU law." Since ESM was outside the EU law, the conclusion was as stated.

governments."

At the height of the crisis, in 2012, funding was insufficient to address all critical needs in the Eurozone, with emergency funds for Greece, Ireland, and Portugal in play, while Italy and Spain wobbled without dedicated support (Lane 2012). All in all, today, four of the five countries that received ESM assistance can borrow at sustainable rates and have exited their programmes.

Figure 1: Select sovereign bond yields at critical junctures of the crisis



Source: ESM

Faced with ongoing bond market panic, the ESM showed flexibility in its lending practices. It abandoned the EFSF's initial and stricter, high margin, relatively short maturity (5-12 years) IMF-style sovereign lending paradigm used mostly in Ireland and Spain and transitioned instead to a low-margin, long-maturity one (32 years) that greatly facilitates the repayment for the programme country concerned. The Financial Times cited private sector evaluations showing how drastic the consequences of this change were. Relying on long-term maturity allows a much slower cycle of debt refinancing, meaning that Greece has to raise fewer funds in the coming decades in order to refinance bonds that have to be repaid.

When calculating the repayment risk on a given bond, investors will not focus on the overall stock of outstanding debt. Rather, they will need to know how much of the debt needs to be repaid within the timeframe of the bond whose risk investors are seeking to assess, i.e. a focus on flows. If this methodology were applied to the case of Greece, it would lead to an estimation of "gross balance sheet debt of €118bn at the end of 2015 (67 per cent of GDP), rather than €314bn (178 per cent of GDP) as reported by the International Monetary Fund (IMF) or €311bn as reported by Eurostat. Almost all of this roughly €200bn in debt reduction had occurred by the end of 2012." Further lending to Greece by the ESM reduced Greece's balance sheet debt by another €17 billion. The changes in lending terms "effectively reduced the Greek government debt burden by about 49 per cent of the country's 2013 output, or about €88bn." These dramatic changes in the Greek outlook show the relevance of methodological tweaks and lending terms.

The transatlantic conflict over debt restructuring and austerity

In October 2015 the ESM's Managing Director gave a long interview to Financial Times[15] in which he defended the case against a debt writedown (or nominal debt haircut, in technical terms) for Greece that would be on the scale that the IMF (in their June and July debt sustainability analyses) and the Greek government preferred. Regling clarified that the difference was a different timescale for looking at Greek debt, with the IMF asking for their money back within ten years and the ESM reducing the burden of debt thorough agreeing to much longer maturities (32 years) and lower interest rates that the Fund.

The IMF's prioritization of the overall debt burden ("stock") in their debt sustainability reports was not applicable to Greece, he argued, because Greek's annual debt payments ("flows") were low relative to almost all other European countries. In effect, the argument went, over the long-term horizon, the ESM member states gave Greece debt restructuring without reducing the nominal value of Greek debt. In the same annotated interview he reassured the public that the IMF's view were beginning to converge with the ESM's.

[15] https://www.ft.com/content/f5de7464-8d83-3ee8-83bc-8a749c9f479a

A year later it became clear that the IMF was reluctant to buy a less talked about aspect of the ESM's view: the size of the primary surplus expected in exchange for this long-term financial assistance that acted as a de facto debt restructuring. In December 2016, Maurice Obstfeld, the chief economists and Poul Thompsen, Director of the IMF's European Department of the IMF took the unusual step of disagreeing in public (on the IMF's blog) with this long term view of the ESM in December 2016. The two senior economists insisted that the primary fiscal surplus of 3.5 percent Greece had to achieve by 2018 " would generate a degree of austerity that could prevent the nascent recovery from taking hold," proposing instead a lower primary surplus of 1.5 percent in 2018.

According to Obstfeld, this higher bar set by the European institutions entailed the adoption of additional austerity measures than those agreed initially, with the Greek government agreeing with the European institutions (and against the advice of the IMF) to cut spending further. Furthermore, "cuts have already gone too far, but the ESM program assumes even more of them, with an increase in the primary surplus to 3.5 percent of GDP achieved through further cuts in investment and discretionary spending (…) if Greece agrees with its European partners on ambitious fiscal targets, don't criticize the IMF for being the ones insisting on austerity when we ask to see the measures required to make such targets credible."[16] ESM representatives expressed dismay at this unorthodox practice and hope for a "return to the practice of conducting program negotiations with the Greek government in private."

Such ideas reflected a dramatic shift on fiscal policy that had started with Dominique Strauss Kahn and Olivier Blanchard and had become the norm with Lagarde and Obstfeld. An older emphasis on maintaining states' credibility with financial markets remained the primary goal of policy, but this goal now had to cohabit with greater acceptance of discretionary fiscal stimulus programs and an emphasis on gradual fiscal consolidation where fiscal space for stimulus was limited. Also, unlike the pre-2008 period, the IMF now advocates more balance between revenue and spending measures in the approach to fiscal consolidation (Ban 2015). After some initial resistance to reconsider the Fund's traditional hostility to debt restructuring, by 2014 change was

[16] https://blog-imfdirect.imf.org/2016/12/12/the-imf-is-not-asking-greece-for-more-austerity/#more-15842

under way and it became part of the Fund's doctrinal revisionism, affecting areas as wide as capital account regulation and financial regulation (Gallagher 2015; Ban et al 2016).

This open conflict between the two institutions brings to the fore questions about the different fiscal philosophies of the world lender of last resort for sovereigns and its European counterpart while highlighting the more conservative fiscal theory of the latter. The fact that the ESM attributes strict adherence to rules-based fiscal consolidation to the preferences of sovereign bond market is puzzling in the light of the fact that "the alleged preference of financial market participants for stricter fiscal rules is based on a handful of articles whose generalizability and validity can be questioned" (Rommerskirchen 2015). As the next section shows, the Juncker Commission has attempted to compensate for this austerian face of Europe with a countercyclical lending fund: the European Fund for Strategic Investments. To date, the results have been mixed.

Keynesian Europe

Demand-side policy, EU-style

The European Investment Bank is the world's largest public multilateral bank and brands itself "the EU's bank." Despite this, to date it has stayed below the scholarly radar. Following a slow recovery from a deep economic crisis, the EIB has received two capital increases, emerging as a central actor in delivering much-needed investment to the European economy, which remains below pre-crisis levels. It has taken on ever more roles on behalf of the Union, leveraging limited EU budget funds on financial markets via investment vehicles such as the Project Bonds Initiative, a 2012 initiative designed to promote investment in European infrastructure.

What is more, in 2014, The EIB was chosen to deliver President Juncker's landmark investment initiative, the European Fund for Strategic Investments (EFSI), which the Commission recently declared a success and doubled in time and money. Set under the EIB umbrella, the European Fund for Strategic Investments (EFSI) was established in 2015 as part of the Investment Plan for Europe (the so-called Juncker Plan). Its establishment reflected concerns with stagnant investment, a prolonged recession followed by a weak recovery, high unemployment (especially among the young) and legal-political constraints that ruled out the general stimulus favoured in 2008-09.

In practice EFSI is an EIB-operated body. The involvement of an independent Investment Committee and its prerogative to provide a project with a loss-absorbing EFSI guarantee (based on the fulfilment of the requirements of the EFSI regulation) are the critically new elements in what is largely an EIB-staffed operation.[17]

EFSI is intended to crowd-in additional investment to the tune of EUR 315 bn7 over the next three years. The funds to be leveraged stem from the EU budget (EUR 8 bn) and the European Investment Fund (EUR 5 bn for SME financing). The funds are meant primarily for (i) transport, energy and the digital economy; (ii) the environment and resource efficiency; (iii) human capital, culture and health; (iv) research, development and innovation; and, (v) support to SMEs and mid cap companies.8 For example, EFSI funded health care research in Spain, the expansion of Croatian and Slovakian road and airport infrastructures and the technological updating of steel rolling in Italy. EFSI is not only being promoted as a successful initiative to incentivise investment in a depressed economic climate. It also has a higher standard in terms of transparency and accountability to EU institutions. The main reason for higher standard of accountability to the EU institutions is EFSI's use of the EU budget. Given strong prior Member State and Commission involvement, the novelty is a key role for the European Parliament.

In short, the EFSI is intended as an institution that increases lending in recessions and weak growth economic cycles, when private banks retreat (countercyclical lender) and as a public venture capitalist for high-risk special activities that must be 'additional' in the

[17] As the administrator of EFSI, the EIB is a hybrid international financial institution: First off, it serves as the public bank for the EU. As such, its main policy mandate has been to support socioeconomic convergence within the Union, compensate for the effects of trade liberalization and facilitate the functioning of an increasingly integrated market, mostly via integrated cross-border infrastructure. Secondly, the EIB was designed to act as a commercial bank in its day-to-day operations. This means it had to make choices that maintain its credit rating on international financial markets to keep lending costs low. The tension between its policy and commercial identitity means that for a project to be financed by the EIB, it has to be both financially sound and integrated into the policy objectives of the day, as defined by the EU's political institutions. The EIB resembles international development banks, but it has to strike a balance between its status as a public EU body making it accountable to a wide array of EU institutions, and its need to refinance itself on financial markets.

sense that "they point to a market failure or suboptimal investment situations and therefore would – in principle – not have been financed in the same period by the EIB without EFSI support, or not to the same extent."

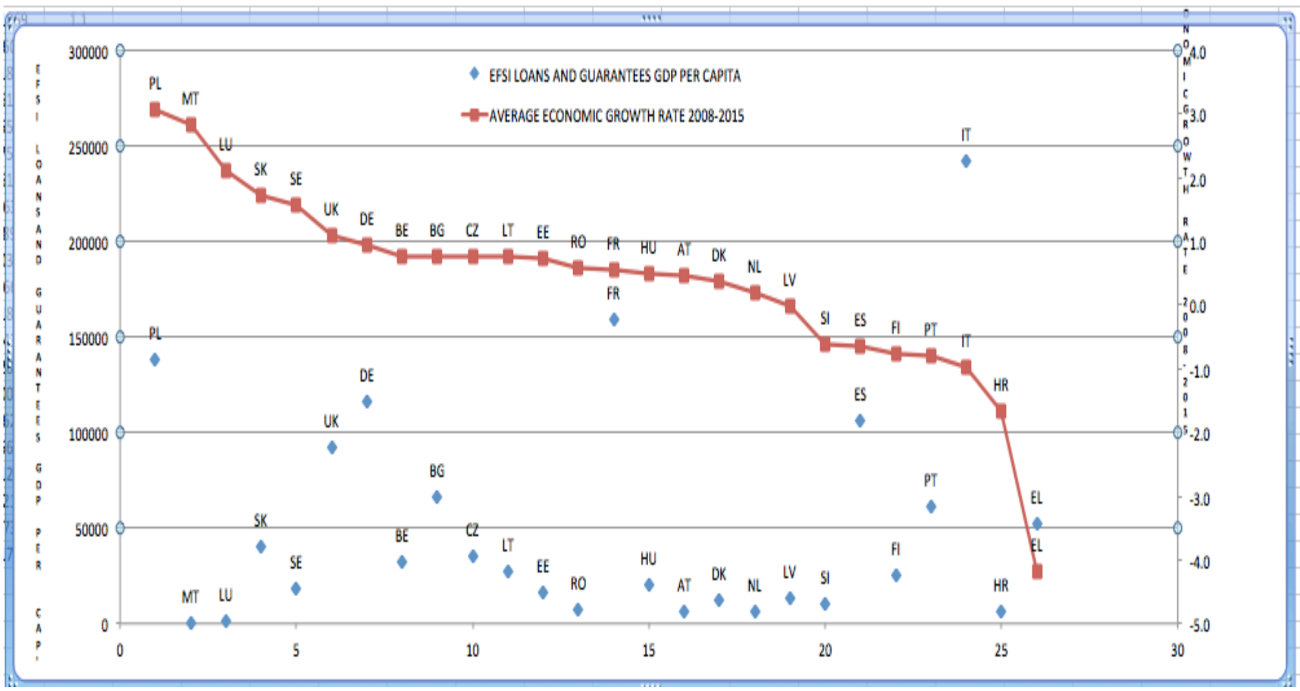
Given its critical importance and initial success in reaching the pre-set targets in terms of speedy takeup of investment volumes, the Commission decided in September 2016 to double its duration and financial firepower, extending EFSI until 2020.10 The bulk of EFSI's daily operations such as information gathering on projects, due diligence, informing EFSI governing bodies about the applicability of the EFSI guarantee, are run by EIB staff. Given the EIB's expertise, as well as the pressure on the Commission President to deliver on an election promise without developing new structures, the EIB was chosen to leverage the EU's limited budgetary commitment into a meaningful investment programme.

In addition to EFSI, the EU's Keynesian arm includes the European Investment Fund. Established in 1994, and co-owned by the Commission and the EIB, this financial institution acts as a risk and venture capital agent for the EIB. EIF is part of EFSI via the latter's SMR Window, which is set to provide 75 bn in capital and loans guarantess to SMEs. For example, it provides guarantee facilities, credit enhancement securitisation, social impact funds and equity to Business Angels and other non-institutional investors for the financing of innovative companies. EIF also raises funds from investors to provide risk capital to growing SMEs. Via its recent EIF-NPI Equity Investment Platform, the EIF offers national promotional banks the possibility to match the total investment budget of the EFSI SME Window on a 1:1 basis.

How Keynesian has EFSI been?

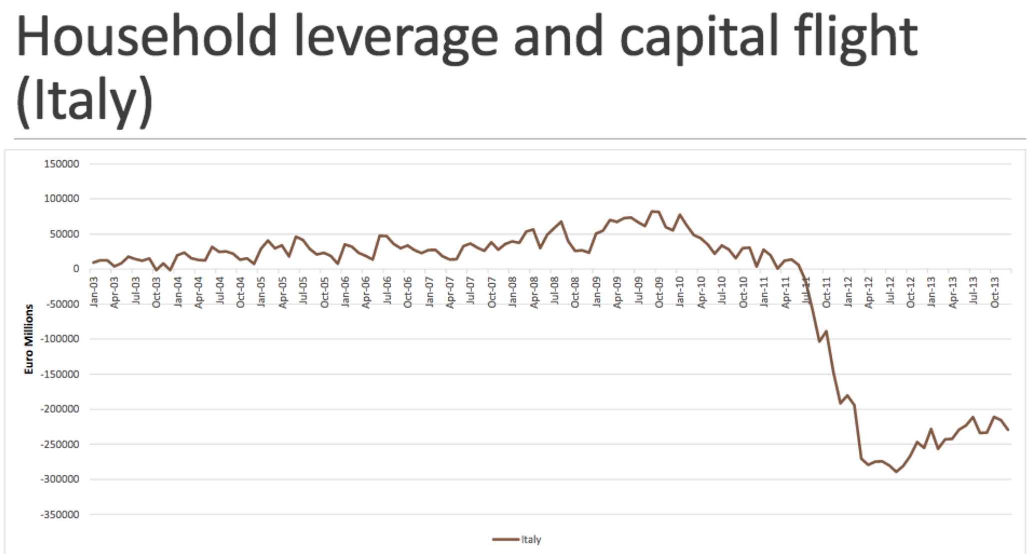
Figure 2 shows that two countries with steep recessions (Italy and Spain) a country with average performance (France) and two countries with strong growth (Poland and Germany) got the most EFSI loans and guarantees, as adjusted per capita. Member states battered by steep recessions (Finland, the Baltics, Hungary, Romania) get dramatically less. In sum, the countercyclical pattern looks quite patchy. Yet one clear pattern emerges: Indeed, France, Spain, Italy, Germany, but also Poland have national promotional banks whose key role in mobilizing EFSI funds was praised by the Commission.

Figure 2: EFSI loans and guarantees (adjusted by per capita GDP)



Source: Eurostat, EFSI and author's calculations

But even in the case of Italy, the needs far exceed the supply of credit by EFSI and EIB. As the graph below shows, capital flight from Italy far exceeded the total lending firepower of these two institutions.



Source: Jones (2015)[18]

Of the operations already signed, approved and pre-approved under EFSI in December 2016, most went to old EU Member States with promotional banks. A large number of EU countries, most of them from Eastern Europe, have not secured similar levels of EFSI funding. The EFSI Secretariat noted that the number of eligible investments is naturally higher in larger Member States and economies. In terms of EIB Group financing relative to GDP, the breakdown is said to favour smaller EU countries. In the case of EFSI, Estonia, Spain, Lithuania, Slovenia and Slovakia are expected to see the highest investments. As of October 2016, EFSI funds administered by the EIB and the EIF amounted to 361 projects in 27 out of the 28 member states, with 44% of the 315 bn euros already used.85 This can count as a success.

However, if the European Investment Fund operations through the SME window are subtracted, a different picture emerges. Half of the EU's Member States have five or less EIB administered projects each (loans, guarantees and equity type operations). A small

[18] https://institute.eib.org/2014/10/getting-the-story-right-how-you-should-choose-between-different-interpretations-of-the-european-crisis-and-why-you-should-care/

number of Member States received a much larger number of funded projects. Although some of the winners are countries that struggle with an extreme dearth of investment (Italy, Spain, Portugal), or are generally larger economies with far more projects eligible for EFSI financing (Germany, France), it is nevertheless an issue that the new Member States are grouped towards the low end of the spectrum.

While this situation has complex causes, one could argue that it could have been be remedied by a more developmentalist mindset in Luxembourg. This means that the EIB could have deployed not only conventional, targeted and sustained efforts to ensure availability of information in these states but also through the provision of expertise for the establishment of national promotional banks.

The EIB is the equivalent of a development bank at the EU level, while promotional banks are the equivalent of development banks at the domestic level. To the extent that the Commission currently favours the establishment of national promotional banks for the delivery of EFSI funds across the EU, the EIB should ensure that its expertise and best practices are made available in the setting up of "sister" institutions to national authorities. The EFSI has detailed guidelines on how to avoid geographical and sectoral concentration, but nothing stands in the way of structurally well-positioned (and lower-risk) applicants from wealthier Member States to lodge successful applications.

Moreover, beyond gross flows of loans and guarantees, it is difficult to probe deeper into the effects of EFSI as a prop for aggregate demand. This is because the EIB does not make publicly available on its website information relating to all EFSI financing and investment. A Transparency International report shows that this should include information regarding financial intermediaries (financial institutions whose names are made publicly available by the EIB) and information relating to the manner in which EFSI financing and investment decisions contribute to the general objectives set out in the Regulation. There are good reasons to be wary. For example, existing research by the NGO Bankwatch asserts that in Eastern and Central Europe, "many intermediaries appear to be making very few allocations to SMEs despite the fact that they have often received the entire global loan amount and have had, in some instances, over two years to find SME beneficiaries."

Conclusions

The conventional wisdom is that since 2010, austerity has been the dominant policy coming from established EU institutions. This paper shows that that entry of the ESM and EFSI in the governance mechanisms of the crisis has put some wrinkles on this common perception.

The evidence suggests that the ESM has proved to be a lender of last resort whose creative reduction of the debt burden over long time horizons for debtor states has been matched by its insistence on contractionary fiscal policies that exceed those of the IMF. In that sense, the ESM has been a rescue operation for a version of the Washington Consensus that the Fund has grown out of since the Great Recession.

As in the Janus of legend, the EU's flexible austerity face represented by the ESM was joined to the EU's Keynesian face represented by EFSI, which was designed to be a countercyclical lender and booster of aggregate demand in countries facing steep recessions. However, in addition to making available loans and guarantees that are far below the needs of Europe's national economies, this institution managed to fulfill its mandate only in countries with strong public development banks, irrespective of their output performance.

Bibliography

Ban, Cornel. *Ruling Ideas: How Global Neoliberalism Goes Local*. Oxford University Press, 2016

Ban, Cornel. "Austerity versus stimulus? Understanding fiscal policy change at the International Monetary Fund since the great recession." *Governance* 28.2 (2015): 167-183.

Ban, Cornel, Leonard Seabrooke, and Sarah Freitas. "Grey matter in shadow banking: international organizations and expert strategies in global financial governance." *Review of International Political Economy* (2016): 1-33.

Bauer, Michael W., and Stefan Becker. "Absolute Gains Are Still Gains: Why the European Commission Is a Winner of the Crisis, and Unexpectedly So. A Rejoinder to Eugénia da Conceição-Heldt." *Journal of European Integration* 38.1 (2016): 101-106.

Bengtsson, Mattias, Caroline Porte, and Kerstin Jacobsson. "Labour Market Policy under Conditions of Permanent Austerity: Any Sign of Social Investment?." *Social Policy & Administration* 51.2 (2017): 367-388.

Blyth, Mark. *Austerity: The history of a dangerous idea*. Oxford University Press, 2013.

Blyth, Mark, and Matthias Matthijs. "Black Swans, Lame Ducks, and the mystery of IPE's missing macroeconomy." *Review of International Political Economy* 24.2 (2017): 203-231.

De Grauwe, Paul, and Yuemei Ji. "Self-fulfilling crises in the Eurozone: An empirical test." *Journal of International Money and Finance* 34 (2013): 15-36.

Gabor, Daniela, and Cornel Ban. "Banking on bonds: the new links between states and markets." *JCMS: Journal of Common Market Studies* (2015).

Gabor, Daniela, and Cornel Ban. "Europe's toxic twins." *The Routledge Companion to Banking Regulation and Reform* (2016).

Greer, Scott L. "The three faces of European Union health policy: Policy, markets, and austerity." *Policy and Society* 33.1 (2014): 13-24.

Howarth, David, and Charlotte Rommerskirchen. "A panacea for all times? The German stability culture as strategic political resource." *West European Politics* 36.4 (2013): 750-770.

Heinz, Elke, and Caroline de la Porte. "The sovereign debt crisis, the EU and welfare state reform." *Comparative European Politics* 13.1 (2015): 1-7.

Iara, Anna, and Guntram B. Wolff. "Rules and risk in the euro area: does rules-based national fiscal governance contain sovereign bond spreads?." *Rules and Institutions for Sound Fiscal Policy after the Crisis* (2010): 277.

Jones, Erik, R. Daniel Kelemen, and Sophie Meunier. "Failing forward? The euro crisis and the incomplete nature of European integration." Comparative Political Studies 49.7 (2016): 1010-1034.

Kentikelenis, Alexander, et al. "Greece's health crisis: from austerity to denialism." *The Lancet* 383.9918 (2014): 748-753.

Lane, Philip R. "The European sovereign debt crisis." The Journal of Economic Perspectives 26.3 (2012): p. 60.

Ladi, Stella, and Dimitris Tsarouhas. "The politics of austerity and public policy reform in the EU." *Political Studies Review* 12.2 (2014): 171-180.

Lütz, Susanne, and Matthias Kranke. "The European rescue of the Washington Consensus? EU and IMF lending to Central and Eastern European countries." *Review of International Political Economy* 21.2 (2014): 310-338.

Matthijs, Matthias, and Kathleen McNamara. "The euro crisis' theory effect: northern saints, southern sinners, and the demise of the eurobond." *Journal of European Integration* 37.2 (2015): 229-245.

Matthijs, Matthias. "Powerful rules governing the euro: the perverse logic of German ideas." *Journal of European Public Policy* 23.3 (2016): 375-391.

Moschella, Manuela. "Negotiating Greece. Layering, insulation, and the design of adjustment programs in the Eurozone." *Review of International Political Economy* 23.5 (2016): 799-824.

Pavolini, Emmanuele, et al. "From austerity to permanent strain? The EU and welfare state reform in Italy and Spain." *Comparative European Politics* 13.1 (2015): 56-76.

Reeves, Aaron, et al. "The political economy of austerity and healthcare: Cross-national analysis of expenditure changes in 27 European nations 1995–2011." *Health policy* 115.1 (2014): 1-8.

Rommerskirchen, Charlotte. "Fiscal rules, fiscal outcomes and financial market behaviour." *European Journal of Political Research* 54.4 (2015): 836-847.

Savage, James D., and Amy Verdun. "Strengthening the European Commission's budgetary and economic surveillance capacity since Greece and the euro area crisis: a study of five Directorates-General." *Journal of European Public Policy* 23.1 (2016): 101-118.

Seikel, Daniel. "Flexible Austerity and Supranational Autonomy. The Reformed Excessive Deficit Procedure and the Asymmetry between Liberalization and Social Regulation in the EU." *JCMS: Journal of Common Market Studies* 54.6 (2016): 1398-1416.

Salomon, Margot E. "Of Austerity, Human Rights and International Institutions." *European Law Journal* 21.4 (2015): 521-545

.