Audun Forbregd Lykstad

Bachelor's thesis

The COVID-19 crisis and the 2007-2012 debt crises:

Why different outcomes?

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Abstract
The research paper aims to explain why the 2007-2012 financial crises (FC) and 2020 MFF budget discussions had different outcomes. The empirical study reveal that FC had huge implications on the eurozone prompting EU member states (MS) to coordinate response. The lack of reform initiated a sovereign debt crisis in 2010 and macroeconomic policy change from fiscal expansion to austerity. In contrast, the 2020 MFF budget discussion resulted in a giant fiscal stimulus package. The study argues that key variables (i) Nature of the Crises, (ii) Demand for fiscal reform and (iii) Superior crisis-assessment explain why the 2007-2012 FC and 2020 MFF budget discussion led to different outcomes. The COVID-19 crisis affected MS evenly, while the 2007-2012 FC revealed that MS saved their own banks. Only when the EMUs survival was at stake the MS acted. The EU of 2020 was more resilient with the addition of ESM and revision of the SGP and activation of its escape clause. It is revealed that EU lacked in 2007-2009 superior crisis-assessment by not letting ECB lend of last resort, and assuming symbolic leadership where comprehensive action was a necessity. The variables resulted in a positive snowball effect and positive rate-growth differential (RGD) for Greece.

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List of abbreviations

Acronyms	Definitions
BAR	**Brexit Adjustment Reserve**
CAP	**Common Agriculture Policy**
ECB	**European Central Bank**
EDP	**Excessive deficit procedure**
EU	**European Union**
EURIBOR	**Euro Interbank Offered Rate**
EMU	**European Monetary Union**
EP	**The European Parliament**
EGF	**European Globalization Adjustment Fund**
GDP	**Gross Domestic Product**
IMF	**International Monetary Fund**
MFF	**Multi Financial Framework**
MoU	**Memorandum of Understanding**
MS	**Member States of the European Union**
OECD	**The Organization for Economic Co-operation and Development**
PCS	**Pandemic Crisis Support**

PEEP	**Pandemic Emergency Purchase Programme**
SEAR	**Solidarity and Emergency Aid Reserve**
SGP	**Stability and Growth Pact**
SM	**Support Meassures**
SURE	**Support to mitigate Unemployment Risks in an Emergency**
TFEU	**The treaty on the functioning of the EU**
VSCA	**Voluntary specific cooperation agreements**

1 Introduction

The commission raised its growth forecast for the eurozone to 5 percent for 2021. The European Union (EU) economy is expected to grow 2.5 percent for 2023. The COVID-19 crisis has hit the EU hard causing economic recession, however despite this Economy Commissioner Paolo Gentiloni stated that the EU economy is moving from recovery to expansion. It suggests that the eurozone experience growth and fiscal expansion. In addition, the commission noted that EU deficits are narrowing down from 6.9 percent of its Gross Domestic Product (GDP) in 2020 to 2.3 percent in 2023. Meanwhile, debt-to-GDP is seen reaching 99 percent in the eurozone and 92 percent in the EU in 2021. It's expected to further decline to 89 percent in the EU in 2023. [1] This expresses a declining snowball effect contrary to the eurozone recession period from 2007-2012. The expansionary policy show sign of policy change in the EU. The ECB says that growth is resuming despite lockdowns in the eurozone. As example, the eurozone is expected to grow 4.1 percent in 2022. [2] This raises question if the eurozone is in total recovery from the global financial crisis and the eurozone sovereign debt crisis or it’s a temporary growth. In addition, if the shift in macroeconomic policy is related to lessons from the crises.

This chapter aims to review the existing literature on debt crises. It identified a gap in literature where scholars clarified the debt crises 2007-2012 and made a case for demand for reform in EMU, however scholars failed to provide categorization of the key variables for explaining the macroeconomic policy adjustments in an in-depth-analysis. Moreover, both disregard the nature of the crises and superior crisis-assessment as key variables to explaining different outcomes, it’s found that the variables have great explanatory power. The topic is macroeconomic policy, and the research question is *why the debt crises 2007-2012 and 2020 MFF budget discussion had different outcomes*. The issue that needs further study is which variable (i,ii or iii) hold most explanatory power to explain what caused the positive snowball effect.

The study compares the 2020 MFF budget discussion against the 2007-2012 crises. By using concepts on macro-economic policy, it explains why the outcomes was different. The paper concludes with *Nature of the Crises*, *Demand for fiscal reform* and *Superior crisis-assessment* were the key variables to why the 2020 MFF budget had a different outcome, moreover they explain macroeconomic policy shift to austerity in 2010 and fiscal expansion in 2020.

[1] Politico, Treeck, J. (2021, 11. November), Commission lifts 2021 growth outlook but warns of headwinds. POLITICO
[2] Politico, Treeck, J (2021, 30. April), Europe’s economy hit by coronavirus restrictions in early 2021. POLITICO

1.1 Literature Review

The topic of the study is macroeconomic policy in the EU. Literature on macroeconomic policy studies rate of economic growth and GDP in the Eurozone. The paper includes empirical study on debt crises 2007-2012 and the 2020 MFF budget discussion and an in-depth-analysis with goal of explaining why the outcomes were different. There are dominating economic schools of thoughts who have competitive views when explaining the Financial Crisis (FC). Neo-keynesians advocate towards greater government intervention to boost the economy and create real market competition. The neo-classical economists believe in pro-market and anti-government intervention. Lastly, the post-keynesians are believed to predict the FC and they believe in fiscal stimulus to improve the economy in financial recession. Arguably, Wyplosch and Baldwin subscribe to post-Keynesians ideals to have the national bank intervene against struggling EU member states (EU). While Drudi, Durre and Mongelli believe in neo-classical ideals as they make a strong case for price-stabilization and rationalize anti-intervention from EU. The paper leans more towards a post-Keynesian school of thought.

Scholars in the macroeconomic research field are uniform in the acknowledgment of 2007-2012 EUs shortcomings. However what variables that led to EUs shortcomings vary. Some regard demand for reform as key variables like Drudi, Durre and Mongelli. Others address superior crisis-assessment like Wyplosch and Baldwin. The closest approach to my research question is Drudi, Durre & Mongelli and Ortiz & Cummings discussing macroeconomic policy adjustments from 2007-2012 and comparing it to the COVID-19 response.

The empirical study is based on Sapir and Pisani-Ferry assessment of the 2007-2010 debt crisis and complemented by Drudi, Durre and Mongelli assessment of 2010-present Eurozone debt crisis. Furthermore, Castellarin clarifies the tools and mechanisms EU took use of in the COVID-19 crisis. In the analysis Schramm discuss Germany support for COVID-19 crisis response, and he argue that EMU is based on the German model, moreover that Germany policy actions of 2007-2012 and COVID-19 response was based on protecting EMU. The source is important due to the papers unit of analysis is EMU and macroeconomic policy. Moreover, Baldwin and Wyplosch argue that the EU had its flaws in dealing with crisis-assessment during the sovereign debt crisis and introduce measures the EU could have implemented to hinder a positive snowball effect. Drudi, Durre and Mongelli argue the EU lacked reform and therefore failed in crisis-management and that the institutional adjustments of the present-EU were needed in 2007-2012. Van Rompuy argues that present-EU is more resilient today and that austerity measures are outdated. Ferragina and Zola argues that austerity is out, and fiscal expansion is the policy for EU MS, moreover their assessment shows the present-EU is far superior at crisis-assessment.

1.2 Methodology

The research was based on a qualitative method of analysis. The explanatory paper uses an inductive approach where an empirical study on the 2007-2012 crises and 2020 MFF budget discussion is used in an in depth-analysis. The gathered data is analyzed to identify the key variables that explain why the cases 2020 MFF budget discussion and 2007-2012 FC had different outcomes. The paper uses case studies as research method. As the complexity of the 2007-2012 FC and the 2020 MFF budget discussions is large and case study approach deal with such situations. By designing case study research, the research received extensive methods for data collection which supplements it by providing comprehensive overview over the topic of research. Where the unit of analysis is the EMU and macroeconomic policy. The study is adapted towards a historical paper as the researcher gather evidence of the past and compares it to the present socio-economic state. (i.e Covid-Europe). The first chapter introduces the research-question, lit review, methodology and conceptual framework. The second chapter is devoted to empirical study, the third chapter is an in-depth analysis with variables that explain variance and similarities between two cases, and the fourth chapter is summary and conclusion.

1.3 Conceptual framework of the study

To answer the research question framework on macroeconomic policy will be outlined. Macro-economic concepts help to explain the debt-increase in the eurozone and to explain shifts in macroeconomic policy. In addition, snowball effect is a key concept to examine the debt dynamics and sovereign sustainability of MS in chapter 3: the in-depth-analysis.[3]

The snowball effect is a process where a small situation becomes significantly greater as it builds on itself and can become catastrophically dangerous the greater its build and extent is. It is a constant increase that will blow up negatively or positively for the actors involved. Converted into macro-economic terms indicates that a debt ratio tends to rise if the GDP growth rate is lower than the interest rate paid on government debt. In other words, a negative snowball effect results in higher GDP and lower debt-ratio. [4]The effect is linked to the 'paradox of debt'. The paradox means any attempt to reduce the ratio of debt to gross domestic product (debt/GDP) by freezing or cutting public expenditure may end up increasing the weight of debt. Therefore, any change in the debt/GDP ratio are the result of the snowball effect. The government must pay the interest on its current debt, which means higher expenditure and fresh debt. In contrast if the economy is growing these payments represents a decreasing percentage of GDP and thus a negative snowball effect. The snowball effect therefore reduces the weight of public debt when the growth rate is higher than the interest rate, and vice versa. [5] It is used to explain adjustments in deficit-debt. The debt to gdp-ratio is determined by the primary balance and the difference between the interest rate and the GDP growth rate. If the interest rate-growth differential (RGD) is strictly positive, a primary fiscal surplus is needed to stabilize or reduce the debt-to-GDP ratio. Higher initial debt level means the primary surplus needs to be higher. Persistently negative RGD on government debt implies that debt ratios could be reduced even in presence of primary budget deficits. In these terms negative snowball effect equals negative RGD. Currently the eurozone experience negative RGD.[6]

A positive snowball effect results in fiscal contraction. Fiscal contraction in the context of spending cut implies austerity measures. The idea behind 'successful' austerity is when its lowering interest rates and reduce the snowball. As example Greece was in 2011 successful at trimming its deficit, the cost of rolling over its debt could stop it from

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[3] ECB. (2009). Monthly Bulletin September: *Economic and monetary developments*, Frankfurt, European Central Bank.
[4] Ibid.
[5] Álvarez, N., & Uxó, J. (2019, January 15). The 'paradox of debt'—or how to avoid austerity again. Social Europe.
[6] ECB. (2009). Monthly Bulletin September*: Economic and monetary developments*, Frankfurt, European Central Bank.

making progress on reducing its debt to GDP – ratio. As example austerity can as well be negative, when Greece last implemented austerity (1989-1994), the public debt level started at 64% of GDP (1989) and stood at 96% in 1994, highlighting the important point that achieving a primary balance surplus is not the same as reducing the debt-to-GDP ratio. The main difference is Greece had higher positive values on RGD, resulting in increased debt-to-GDP ratio. In contrast, Ireland and Portugal had less vaules of positive RGD so debt-to-GDP ratio wasn't excelling at the same rate as Greece.[7]

2 The empirical study

The study follows A. Durré, F. Drure & F.P Mongelli (2022) suggestion to split the 2007-2012 financial crisis (FC) in Europe to three distinctive parts, the financial turmoil, the global financial crisis and the European sovereign debt crisis. [8]

2.1 Financial turmoil (2007-2008)

The FC underwent two phases in which the first began in August 2007 to 2008 marked by a general liquidity strain to what gradually transformed into a crisis of securization and leverage.

Tensions on money markets grew regardless they if they had a few ups and downs. Moreover, there existed solvency problems regarding specific institutions however none had significant cross-border activities. All EU financial systems were affected but it wasn't financial fragmentation along national lines. BNP Paribas froze redemption for three investment funds where they referred to inability to value products that was structured. Counterparty risk between banks increased sharply and liquidity evaporated from the interbank market. As response central banks provided massive liquidity to their banking systems. ECB had unlike other banks wide range of collateral that they could accept in repo lending. It fine-tuned liquidity provision to the banking sector. Due to the tendency that general liquidity crisis turns int solvency crises the EFC ad hoc group launched their work. The EFC called for common analytical framework for assessment of crisis situations and conclusion of a new MoU (Memorandum of understanding) between all relevant authorities. The report committed all MS to a crisis of a pan-European financial institution as a 'matter of common interest'. The ECOFIN council further agreed on common principles to preserve financial stability.[9]

The outlined principles were not as effective as it left out incentives to cooperate. The Commission was invited to propose ways to clarify cooperation obligations for adopting by the end of 2009. Meanwhile the MS were simply encouraged to sign specific 'voluntary cooperation agreements' between relevant national authorities as soon as possible. As result the only true EU instrument for crisis management remained competition and state aid rules. During this period MS intervened with rescue measures to prevent insolvency of banks, none with substantial cross-border activities. State measures were managed by the EU competition authority, the European Commission based on standard rescue and restructuring aid rules. Another MoU was adopted in June 2008 which added specific procedures to improve cooperation within and between MS. An offensive was initiated by

[7] White, G. (2011, June 7). Societe Generale On "The Snowball Effect" That Could Stop Greek Austerity Success. Business Insider.
[8] Drudi, F., Durré, A., & Mongelli, F. P. (2012). The interplay of economic reforms and monetary policy: The case of the eurozone*. JCMS: Journal of Common Market Studies, 50(6), p. 881–898.
[9] Pisani-Ferry, J., Sapir, A., & Tille, C. (2010). Banking crisis management in the EU: an early assessment [with Discussion]. Economic Policy, 25(62), p. 341–373.

the ECOFIN council when it introduced to MS with common financial stability concerns which has presence of cross-border financial institutions to develop voluntary specific cooperation agreements (VSCA). Moreover, the creation of cross-border stability groups that facilitated the management and resolution of cross-border financial crises. [10]

2.2 The global financial crisis (2008-2010)

Second phase during the FC started in September 2008 and ended in summer 2009, this phase was generalized by a general loss of confidence and institution-specific solvency crises that affected some major cross-border banks. Financial fragmentation became present as example the increase of dispersion of Euro Interbank Offered Rate (EURIBOR) rates. The outcome of excelling snowball effect was a dramatic decrease in confidence among banks in mid-September when Lehman Brothers bankrupted. The affair greatly reduced an already deficient liquidity that were in various markets, however it created massive solvency problems in major European banks. The outcome was major rescue missions, on 27 September Fortis was rescued by Belgium, the Netherlands, and Luxembourg. The issue became cross-border as the same countries intervened to rescue Dexia. It demonstrated the use of state-aid as a support measure (SM).[11]

Ireland acted on guaranteeing all deposits and debts of six Irish bank, the result was putting other MS deposit guarantee schemes at a disadvantage. The result was several MS governments launching initiatives that could have cross-border implications and potential risks for the EU banking system. Therefore, the MS leaders of France, Germany and Italy met to discuss measures that could hinder spillovers. However, no measures were agreed upon. On the other hand, the MS ministers of finance met in the ECOFIN council and Eurogroup where they agreed upon a coordinated response at the EU level. Despite this, the only action was guaranteeing the increase of deposits to a minimum of 50,000 EURO. At last, The ECB initiated a counter-offensive against the debt crisis by changing the procedure for refinancing operations. It instated a fixed rate procedure with full allotment instead of the factor rate tender on 8 October 2008. This procedure gave certainty that banks could bid for liquidity satisfied with a rate set by the ECB. This removed uncertainty and lowered cost of liquidity. The list of assets eligible as collateral was temporarily expanded which meant that the ECB went much beyond the fine-tuning of existing procedures by introducing innovative operations. [12]

The 6 of October, markets throughout the world suffered one of their worst days in history. It prompted the French Presidency of the European Union to convene the first-ever meeting of the heads of state or government of the euro area. The emergency summit in Paris the 12 October was regarded as the turning point in efforts to bring about a concerted EU response to the FC. The Paris Declaration on a European action plan for the euro area countries was endorsed by all MS at the European Council meeting of 15-16 October. It provided a plan for concerted action. The plan included the commitment to further liquidity provision by the central bank, as well as commitment to public recapitalization of banking institutions in need of capital and public guarantees for bank borrowing. Moreover, it committed signatories to enhanced cooperation. It paved the way for three important Commission documents which provided consistent framework for rescuing and restructuring of EU banks aimed at minimizing negative spillover effects. The *'Banking Communication'* of 13 October 2008 focused mainly on

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[10] Ibid.
[11] Ibid.
[12] Ibid.

conditions that national guarantees covering bank liabilities must fulfil to follow EU state aid rules. '*Recapitalization communication'* of 5 December provided conditions that national funds would need to meet in recapitalizing banks to ensure adequate levels of lending to the economy. At last, the *'impaired assets communication'* of 25 February 2009 which provided the framework for the clean-up phase of financial institutions balance sheets by removing toxic assets and underperforming loans. Furthermore, the commission call of October 2008 to lift the minimum level of deposit guarantees was followed on 11 March 2009 by a Directive setting a new minimum level at 100 000 EURO and shortening the maximum payout delay from 9 months to 20 days. [13]

EU authorities moved swiftly during the fourth quarter of 2008 and in 2009 to put in place a framework to respond to the crisis. From October 2008 to July 2009 the commission approved a total of over three and a half trillion euros of state aid to financial institutions, of which one and a half trillion had effectively been used. The support measures (SM) fall under four main headings: capital injections, guarantees on bank liabilities, relief of impaired assets and liquidity and bank funding support. Moreover, total approved measures amounted to 44per cent of EUs GDP which reinforces the statement that the crisis was solved by pumping assets into the banking sector. However, SM varies in MS where New Member States (NMS) get lower support due to them having banking sectors controlled by foreign banks. Moreover, SM had varied effects on MS economy as few MS had SM that accounted for 100per cent of their GDP like Ireland. In contrast MS such as Belgium, the UK, the Netherlands and probably Luxembourg had SM that ranged between 20-30per cent of their GDP. Lastly you have the 10per cent SM which is Germany, Sweden, Austria, and Latvia and the 5per cent SM which accounts to Spain, Denmark, France, Portugal, Hungary, Slovenia and Greece. The variation between MS can account for many factors however in the case of Ireland it can account to the nation relying heavily on international trade as their economy was tied up to wholesale markets over domestic deposits. (IMF, IRELAND). Moreover, Ireland focuses exclusively on state guarantees while UK used mainly liquidity and bank funding support. By contrast the Benelux MS made us of all SM. Furthermore, a variation can be explained due to healthier banks in other MS focused on raising private capital and replay government support. [14]

2.3 Eurozone sovereign debt crisis (2010-the present)

MS introduced in the aftermath of the Lehman Bankruptcy initiatives to support their banking sector through capital injections, loans and state guarantees. As well as countering slowdown of economic growth by stimulus packages. On the other hand, the SM made the market question the sustainability of public finances. [15]. The underlying reason was the SM didn't counter the positive snowball effect and it created grave consequences for Greece. Due to the MS not reporting correct numbers the Greek president George Papandreou became the 'tip of the iceberg' for the crisis to unfold. [16] The reveal of public finance created tensions in the sovereign debt market. The 10 May 2010 revealed that the ten-year yield spread between Greek and German government bonds reached the at the time historical high of about 1,000 basis points. Similar concerns rose in Italy, Spain and Ireland which impacted the market liquidity in the markets for new and existing sovereign debt negatively. A major source of systemic risk

[13] Ibid.
[14] Ibid.
[15] Ibid.
[16] Smith, H. (2010, February 2). Greece's Papandreou Makes TV Appeal for Unity over Financial Crisis.

for several eurozone economies was the risk of contagion of rising spreads on sovereign bonds. It meant that downgrades in sovereign debts in Greece, Ireland and Portugal was closely linked to rise of sovereign spreads of other MS with weak fiscal fundamentals. There was therefore a significant risk that these developments in the sovereign bond markets of a growing number of MS could possibly trigger market dynamics that could degenerate into a vicious illiquidity spiral for the sovereign debt markets of the whole eurozone. It proved the interdependence of EMU MS exposed a weakness in EMUs framework. The liquidity position of banks was affected by a feedback loop. A sequence of sovereign debt rating downgrades was accompanied almost in tandem by downgrades of most marketable securities issued by financial institutions headquartered in the countries that were affected by the sovereign debt crisis.17 This in turn also led to further downgrades across a broad range of assets in the private securities markets. The decreasing prices of these assets weakened the balance sheets of financial institutions, while their recapitalization appeared less and less likely given the fiscal consolidation needed in most countries to restore confidence in sovereign debt markets.[17]

In context to the developments the eurozone MS was allowed to have a deficit of 3per cent or less of their GDP to be members of EMU. This was a commitment trough the stability and growth pact (SGP). However, the EMU framework didn’t include strict budgetary supervision. Therefore, a natural cause was the Greek PM announcing that their previous government didn’t have a deficit of 5per cent as previously forecasted but 12per cent of GDP. Greece would have to loan from IMF and EU as they couldn’t loan from the marked due to its high interest rates. The result of Greece not being able to pay its national debt, was that the MS had to negotiate a 110 billion bailout under strict conditionality imposed by the ‘troika’ – consortium comprised of the European Commission, the ECB and the International Monetary Fund (IMF). Thus, since the deterioration of debt markets positive snowball effect was excelling in Portugal, Ireland, Spain, Cyprus, Spain and Italy. The result was implementation of austerity measures which included cut spending and increase revenue. Results were unsatisfactory as deficit wasn’t cut. The root to the still positive snowball effect after the bailout was the high RGD which caused the MS to not be able to pay its new debt. The debt was stretched for many years, and moreover since austerity doesn’t generate growth another bailout would need to be introduced for Greece to be able to finance itself to 2014.[18]

The FC trend was that each country was exposed to a loss of trust by financial markets resulting in the interest rates on their bonds (i.e. government debt securities) were pushed to unsustainable levels. This resulted in the prementioned negative RGD. The unsustainable deficit growth created fears that the MS exit of the EURO could become reality. Due to fears of an EMU breakdown the ECB pumped billions into the economy by buying government bonds throughout the eurozone resulting in financial stability. The crises made it clear EMU suffers from structural problems and the legacy from the crises is still present today such as Italy rising debt or Greece still large debt.[19]

2.4 The MFF 2021-2027 and COVID-19 crisis

The results of 2020 budget discussions is an ambitious COVID-19 recovery effort. The efforts to rebuild post-corona Europe is reflected in its objectives in the Recovery Plan.

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[17] Pisani-Ferry, J., Sapir, A., & Tille, C. (2010). Banking crisis management in the EU: an early assessment [with Discussion]. Economic Policy, 25(62), p. 341–373.

[18] Cameron, D. (2022). Yale Macmillan Center. Faculty Interview: David Cameron on the Eurozone Crisis.

[19] Pisani-Ferry, J., Sapir, A., & Tille, C. (2010). Banking crisis management in the EU: an early assessment [with Discussion]. Economic Policy, 25(62), p. 341–373.

The Multi Annual Financial Framework (MFF) wants to be an instrument in the recovery of European Economies. It's a giant stimulus package which around 2,018 billion Euro allocated to rebuild post-corona Europe. Not only does it want recovery, but it also seeks to change the nature of EU in its own regard by making it digitalized, greener and resilient. The MFF budget is combined with the NextGenerationEU which was adopted by the EU in 2020 and is a reconstructing fund on 750 billion EURO to support MS affected by the corona pandemic. The fund was financed by the commission taking up loans in the market. The EU with the new MFF wants to strengthen the flexibility mechanisms to gain capacity on meeting the demands of tomorrow. The last steps to ensure the MFF was taken in 17. December 2020 and the budget is tailored reality and an uncertain future. Half of the budget will go to modernizing Europe by funding science and innovation through horizon Europe. A fair climate policy and digital turnover through the fund for Fair turnover and program for digital Europe. Lastly contingency, recovery and resilience through the rescEU and EU4Health. These SM is considered to recover Europe and transform MS economies. The other half of the budget goes to modernization of existing policies as Common Agricultural Policy (CAP) and EU Cohesion policy. Furthermore, combating climate change with 30per cent of EU-funds and protecting biodiversity and promoting equality between genders. [20]

The EUs collective response includes several mechanisms. The first important mechanism is direct support to public health and humanitarian aid. The commission announced in March 2020 several measures to directly support public health and humanitarian aid. The G20 leaders made a global initiative to counter the pandemic and part of that the research programs of EU were funded. The overall aim is to facilitate universal access to COVID-19 treatments, tegsts and vaccines. EUs economic reaction to COVID-19 response is multi-layered. Substantially, not all economic measures have direct financial implications for the EU. The Temporary Framework for State aid have not financially implications for EU but for the MS as it guides them. Moreover, the commissions guidance on foreign direct investment screening has no implications for the EU budget at all. The treaty on the functioning of the EU (TFEU) and the activation of the general clause of the SGP have been detrimental to the successful response. Although the main measures rely on MS, the mentioned measures have made MS adopted massive budgetary responses to COVID-19. This includes liquidity SM and fiscal stimulus worth around 20per cent of EUs GDP. The ESM is as well adamant as its newly established Pandemic Crisis Support (PCS) supplies credit up to 2per cent of each MS to support domestic financing of direct and indirect healthcare. Moreover, cure and prevention-related costs due to the COVID-19 crisis, with very low interest rates and fees. The Pandemic Emergency Purchase Programme (PEEP) is ECBs offensive against the COVID-19, moreover it is the largest financial element of the EUs response. The EU announced trough several communications to devote funds towards improving research, and packages amounting to around 540 billion in packages. These communications were transparent, and the goal was to defeat COVID-19.[21]

The EU also activated three financial instruments for allowing financial flexibility in the new 2021 MFF budget. Those include the Solidarity and Emergency Aid Reserve (SEAR), the European Globalization Adjustment Fund (EGF), and the Brexit Adjustment Reserve

[20] Europakommissionen. (2022, May 4). Genopretningsplanen for Europa.

[21] Castellarin, E. (2020). The European Union's Financial Contribution to the Response to the Covid-19 Crisis: An Overview of Existing Mechanisms, Proposals Under Discussion and Open Issues. *European Papers-A Journal on Law and Integration*, *2020*(2), p. 1021-1044.

(BAR). Together they free up 6,3 billion that the EU can enjoy in their budget. SEAR is used to help tackling emergency situations due to major natural disasters or public health crises in MS and accession countries. GEF help to reintegrate into the labor market workers who lost their jobs due to globalization. EGF is played when a large number of workers are laid off in a particular sector. BAR help to counter the effects of BREXIT and its implications on MS and sectors worst affected by it. [22] This proves the new 2021-2027 is well adapted towards unforeseen events and circumstances.

3 Why different outcomes?

3.1 Nature of the Crises

A key variable to why the outcomes was different is the nature of the crises. The 2007-2010 FC began due to a deteriorating financial market, and the successive period 2010-present FC were its legacy. In contrast the nature of the COVID-19 crisis was responding to a virus that affected all MS evenly domestically. Moreover, the COVID-response was in larger degree based on MS managing their budget by allocating resources from other sectors to the health sector to combat the COVID-19 virus. Since the COVID-19 crisis is life threatening MS took responsibility by taking leadership and seeking cross-border cooperation. Lessons from 2007-2012 FC had in no doubt great effect on policy-decisions. Instead on borrowing directly from the market, MS receive healthy loans raised by the commission. Moreover, indirectly support to various public sectors through grants. Due to large scale public schemes firing labor wasn't the outcome. A rapid increase in unemployment could have disastrous effects and activate positive snowball effect by hindering growth. Although public schemes were costly the cost of potentially deteriorating liquidity could stall the growth and economic stimulation of MS. In contrast, firms, and labor in 2007-2009 were reliant on failing financial institutions therefore they were unable to have good liquidity. In 2020 the MS provided liquidity to the firms through rescue packages, moreover financial institutions were properly capitalized. [23]

The EU's financial response to the COVID-19 crisis has been diverse, as it includes grants, loans and guarantees. As usual for EU programmes and funds, co-financing with MS is common and several mechanisms aim at leveraging much bigger amounts of private capitals. The Commission estimated that the €540 billion first package of economic and social measures will mobilize investments for €1,290 billion, and that Next Generation EU and the 2021-2027 MFF should generate investments for €3.1 trillion. This means that the EU has leverage to deal with economic recession without hindering prospects for growth unlike the EU of 2010-2012 that imposed austerity measures. The SM introduced by the 2020 EU can make markets regain confidence in MS. Moreover, the solidarity by fiscal-burden sharing can recover periphery MS like Greece and Portugal.[24]

The outcome of the 2020 MFF budget discussion was a MFF that was grant-based and heavy-debt financed, arguably it was a highly unlikely outcome. As Germany, a net-payer MS in the EMU is also the champion of EU policymaking. The outcome of 2008-2010 response wasn't grant based, moreover funding was based on borrowing from a vulnerable market. The grant-based budget stood in sharp contrast to the traditional MS

[22] European Commission. (2022, February 3). Flexibility and special instruments.

[23] European council. (2022, May 4). Covid-19: The EU's response to the economic fallout. Retrieved May 7, 2022, from https://www.consilium.europa.eu/en/policies/coronavirus/covid-19-economy/

[24] European Commission - Press corner. (2020, March 20). Questions and answers: Commission proposes activating fiscal framework's general escape clause to respond to coronavirus pandemic.

national interest. As its MS national interests to avoid fiscal burden sharing. As in case of 2010, MS were leaning towards saving their own or cross-border banks over transferring funds to periphery MS. The risk of burden sharing was higher in 2008-2012 than presently. Arguably, the sharing of debt, and transferring of finances between MS respected a higher policy goal, the defense of EMU. On the other hand, defending the EMU is less costly than a fragmentation of it. The ESM offers loan with low interest rates; therefore, the risk of positive snowball effects is lower. [25] The lower risk of financial collapse offers Germany flexibility to pursue its policy goal of defending EMU In contrast when dispersion of EURIBOR rates increased or confidence in Greek bonds fell to an all-time low the risk was high. The nature of the crises reveals greater financial risk in 2007-2012 than in 2020.

The EU itself recognize that the 2008-2010 crisis highlights the lack of tools to preserve the critical functions provided by failing financial institutions. Moreover, it demonstrated the absence of frameworks to enable cooperation and coordination amongst authorities in MS to ensure the taking of swift and decisive action. Without the tools and in absence of cooperation and coordination frameworks, MS were compelled to rescue financial institutions using taxpayer money to stem contagion and reduce panic.[26] If the EU had the tools in hand, then as it has now, the handling of the crisis would perhaps be different. In addition, the large parts of 2020 grants raised were through private capital instead of taxpayer money. It relieved the financial stress on the consumer economy. The response was in higher degree solidaric to all MS compared to 2007-2012 FC. MS like Portugal, Ireland, Spain and Greece were the epicenter of recession in comparison to more fortunate MS like Germany, France and Netherlands. The COVID-19 included a common, uniform, and fair response with universal financial implications for all MS economies.

To further understand the role of Germany, France and Netherlands in their opposition to greater fiscal risk-sharing the prospect of burden-sharing must be discussed. In late 2008 when the French presidency gathered the MS to design an action plan, it was in their national interest to achieve fiscal stability. Sharing burden have high financial implications for the MS but a breakdown of EMU has higher risks for all. Bailing out Greece over a Greek EURO opt-out is favorable. Efficient EMU maintenance of EMU results in fiscal stability. In the case of Germany, it is more inclined than other MS to maintain EMU as its built on the German economic model. The German fiscal contribution goes to that extent that the government in the past proved ready to endorse greater EU fiscal risk-sharing in the form of bailouts or new institutions only when the costs of EMU breakdown were considered prohibitively high. In that regard the policy-goals of Germany and therefore EU were aligned in both 2008 and 2020, as in protecting the EMU. In 2008 by bailing out Greece and now by opting for grants to reduce MS debt. Therefore, preventing positive snowball effect and a potential financial crisis in EMU. The only exception to protecting EMU for MS is when they limit their fiscal contribution by refusing their budgets to guarantee other MS expenditures.[27] Despite this, the nature of the crises show that MS don't favor fiscal burden-sharing unless a breakdown of EMU is

[25] European Stability Mechanism. (n.d.). How we work.

[26] e.g. Regulation (EU) of the European Parliament and The Council. 2021/2023 of 16 December 2020 on a framework for the recovery and resolution of central counterparties and amending Regulations [2022] OJ L22/1

[27] Lucas Schramm (2021): Economic ideas, party politics, or material interests? Explaining Germany's support for the EU corona recovery plan, Journal of European Public Policy, DOI: 10.1080/13501763.2021.1985592, p. 1-6.

possible and the lack of fiscal burden-sharing in the early stages 2007-2010 created debt crisis for MS in 2010.

3.2 Demand for fiscal reform

Lack of fiscal discipline were paramount to the Greek failure. The tightening of framework surrounding Eurozone membership means that MS can't activate domino effects or snowball effects by running budgetary deficits. A primary reason to the upheaval of rigid fiscal discipline in the eurozone is related to MS receiving more reasonable loans while also receiving supervision. This in practice results in negative RGD which the eurozone currently experiences. The 2010-present FC was as consequence of false budgeting in Greece. Presently the same premises for false budgeting isn't present and therefore a positive snowball effect can be avoided. The revision of the SGP agreement limits MS from having deficits and activation of the excessive deficit procedure (EDP) scares MS from accumulating debt. In view of this, the SGP escape clause create further budgetary flexibility for MS to increase their budgetary flexibilities. By contrast in FC 2007-2009 the necessary reforms weren't put in motion and acts such as agreements were symbolic and principal. Although, the MS of the day wasn't made aware of the Greek debt until 2010. However, scholars argue the EMU required reform long before the crises[28]. In sharp contrast, EU assumed leadership in April of 2020 to implement reforms needed to counter COVID, as mentioned in chapter 2, section 4. The results is hindering a positive snowball effect.

The prospect of economic recovery was small during the 2007-2012 FC due to MS lacking fiscal consolidation to recapitalize financial markets. The MS took use of SM where they provided state-aid to financial institutions which stabilized the situation for the more rigid MS. Through, capital injections, guarantees on bank liabilities, relief of impaired assets and liquidity and bank funding support the MS to rescue their banks. The periphery MS like Greece and Portugal didn't have the luxury to have healthy banks. Moreover, Greece had foreign banks and therefore got lower SM. Whereas, healthy banks could raise private capital, Greece couldn't as it didn't have the conditions, nor did it have a market with confidence in the MS. The result was negative spillovers for the MS, inherited from the imposed austerity measures. The conditions for SM in 2020 was universal and solidaric. As example the 750 billion fund is assessable to all MS recovering for COVID-19. Compared to 2007-2010 the MS rescued their own banks, or cross-border banks in the case of Dexia as it had implications of national interest. The communications the commission put forward between 2008-2009 put together a framework for rescuing EU banks. However, it failed to achieve the goal of rescuing MS from positive snowball effect. Instead, in the case of weak MS such as Greece – it only made it harder to receive the SM it desperately needed. The imposition of strict fiscal discipline on Greece could only work if the country had strong financial institutions that could raise private capital or the MS running a primary fiscal surplus.[29]

The EU during the global recession 2010-2020 introduced austerity measures. In contrast, the EU presently goes back to the 2007-2009 years by pursuing fiscal expansion. Previously MS governments pursued austerity measures by abandoning fiscal expansion and embracing expenditure contraction. The reason to the budget adjustments

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[28] Pisani-Ferry, J., Sapir, A., & Tille, C. (2010). Banking crisis management in the EU: an early assessment [with Discussion]. Economic Policy, 25(62), p. 341–373.

[29] Drudi, F., Durré , A., & Mongelli, F. P. (2012). The interplay of economic reforms and monetary policy: The case of the eurozone*. JCMS: Journal of Common Market Studies, 50(6), 881–898. https://doi.org/10.1111/j.1468-5965.2012.02290.x

was as reaction to the 2010 sovereign debt crisis as MS were forced to address debt and fiscal deficits. From 2007-2009 the MS governments had introduced fiscal stimulus programs and ramped out public spending however this didn't in the case of some MS hinder a positive snowball-effect. This proves the EU was weaker in crisis-assessment. MS on average expanded, spending from 2008-09 around 3.3 per cent of GDP. In contrast when austerity was introduced MS experienced on average a 2.3 per cent contraction from 2009-2010. This means a severe change in fiscal position for all MS. [30] These severe changes in fiscal position means that the deficits were larger than in 2020. The covid-response represents this, France implemented emergency policies like the furlough scheme in which allocated 6.6 billion hours of pay to citizens. The International Monetary Fund (IMF) and The Organization for Economic Co-operation and Development (OECD) recommended that wealthy countries increased public spending. Moreover, a shift from pro-austerity stance. [31]. In other words, the claim that the debt-to-GDP ratio were larger in 2007-2012 has momentum, moreover the severity of the 2007-2012 FC compared to COVID-19 crisis. In sharp contrast to 2020, from 2010 and onwards the IMF called for large-scale fiscal adjustment. This inclined fiscal adjustment in the lines of structural reforms in public finance to be initiated immediately in all countries recovering from FC. Pensions and health were reformed towards adapting to spending cuts. On the composition of fiscal adjustment, it was advised that most of it could come from unwinding the previously adopted fiscal stimulus packages. As example it had to be avoided a rise of spending as a share of GDP. This meant less entitlement towards health and pension to adapt to spending-cuts. Moreover, containment of other spending by means of eliminating subsidies and tax revenue increase. [32]The grant-based response from 2020 strengthen that 2020 EU is richer, and 2007-2012 crises were more severe.

3.3 Superior crisis-assessment

Herman Van Rompuy argues that the EU now knows were to cut and where to invest, moreover the threshold for introducing austerity is high. Moreover, the impact of national measures packages was great as it was coordinated at a European level. Furthermore, the ECB acted through expansionary policy to reduce inflation. In contrast to the austerity policies of 2010-2020 to reduce debt. EU now has a safety net comprised of the pan-European guarantee (fund of European Investment Bank) meant to support businesses falling out after COVID-19. Safety net for workers Support to mitigate Unemployment Risks in an Emergency (SURE) and ESM Pandemic Crisis support line. All these measures are issue specific to improve quality for businesses, MS and workers affected by COVID-19.[33] Arguably issue-specific measures are sharp contrast to previous management of FC. As example in 2007-2008 EU responded by agreeing on symbolic agreements, to 2009-2010 where they pumped over 3 trillion as state aid into MS financial institutions. This proved not enough as other MS still had a debt-ratio increase. Moreover, it proves that EU is now more careful in crisis assessment, which in turn

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[30] Ortiz, I., & Cummins, M. (2021). The Austerity Decade 2010-20. *Social Policy and Society, 20*(1), 142-157. doi:10.1017/S1474746420000433

[31] Emanuele Ferragina & Andrew Zola (2022) The End of Austerity as Common Sense? An Experimental Analysis of Public Opinion Shifts and Class Dynamics During the Covid-19 Crisis, New Political Economy, 27:2, 329-346, DOI: 10.1080/13563467.2021.1952560

[32] Ortiz, I., & Cummins, M. (2021). The Austerity Decade 2010-20. *Social Policy and Society, 20*(1), 142-157. doi:10.1017/S1474746420000433

[33] Van Rompuy, H. (2020, April 16). Covid-19: A turning point for the EU? COVID-19: A turning point for the EU? Retrieved May 8, 2022, from https://www.epc.eu/en/Publications/COVID-19-A-turning-point~317a04

results in issue-specific measures that hinder a positive snowball effect and spillovers from FC.

There was no other developed country elsewhere who faced a debt crisis during the troubled FC period. Which means during the FC there might be flaws with the Eurozone. Ireland as example had great fiscal discipline before the FC. Portugal had poor fiscal discipline and its growth rate was likely to be meagre. However, it wasn't in a worse situation than Japan, Italy, or USA. The likely causes are multiple equilibria, in which the markets turned its attention on some specific MS while disregarding other countries. The difference between the MS and Japan or USA is that MS don't have their own currency and national bank which can lend of last resort for their governments by buying large amounts of the public debt. It was believed ECB was forbidden to rescue national debt which reveals the incompetence of policymakers in EU at the time. Moreover, EURO is foreign currency to MS, making it difficult for them to counter FC. MS not hit by the crisis rejected large-scale purchases of public bonds and issuance of Eurobonds. They feared moral hazard and prompted for sharing debt if a MS were to default. This was example of inferior crisis-assessment as Ireland, Cyprus, and Spain had urgent necessity to bail their banks out. Had ECB acted as lender of last resort it could provide some of the necessary fund and prevent positive snowball effect. But the European Parliament (EP) provides answers to why the EU failed to decrease debt-ratio by arguing that Greece experienced positive snowball effect due to weak political ownership and administrative systems, lack of investor confidence, larger-than-expected fall in economic output and unexpected deterioration in the external environment. What ended the acute phase of the crisis was ECB buying as much crisis MS public bonds as necessary to bring down interest rates. [34]. In 2020 the EU had SGP as well as willingness to take higher fiscal-burden to avoid another economic disaster. For instance, it provided grants, instead of having MS loan with high interest which resulted in MS implementing fiscal expansion over austerity. This strengthen that the EU is now far superior in crisis-assessment.

The key to explaining different outcomes is the lack of comprehensive action from eurozone policymakers. It was questionable to impose fiscal restraints during a severe recession. As example Greece were forced to trade loan from EU and in return receive austerity. The borrowing from EU was a bad deal as it in turn meant increasing government spending that resulted in higher interest rates in the eurozone. The government spending was done to adjust the budget towards repaying the old debt but since the government were imposed austerity the economy didn't grow, and therefore the new debt couldn't be repaid. This continued the positive snowball effect trend. In contrast, Italy took use of expansionary fiscal policy instead of austerity measures, which hindered a positive snowball effect for the MS. [35] This proves austerity was a death sentence for Greece, arguably like Italy it was saved by the ECB declaring itself lender of last resort. Moreover, the positive snowball effect in Greece created another issue spillovers. The excessive debt it had was judged unsustainable therefore destroying confidence which scared away investors. It would avoid its excessive debt if ECB acted to buy its public bonds to bring down interest rates. Moreover, if EU gave it loans with low interest rates through the ESM it could avoid the positive snowball effect. [36] This proves

[34] Baldwin, R., & Wyplosz, C. (2012). The Economics of European Integration (4th ed.). McGraw-Hill Higher Education. P. 486-492

[35] Dinan, D. (2014). Europe recast a history of European Union (Vol. 6, Ser. The European Union Series). Palgrave Macmillan.

[36] Nello, S. S. (2011). The European Union: Economics, policy and history. McGraw-Hill.

the efforts proved too little and too late, had EU reformed its fiscal policy the spillovers could be hindered. This strengthen that the previous EU didn't make a strong case for superior crisis-assessment compared to 2020 EU.

4 Main findings and conclusion

To summarize, the Snowball effect is used to explain adjustments in deficit-ratio. And its legacy fiscal contraction. 2007-2008 FC went from a crisis of general liquidity strain to what gradually transformed into a crisis of securization and leverage. The second phase 2008-2009 was generalized by a general loss of confidence and institution-specific solvency crises that affected some major cross-border banks. The Paris declaration included a concerted action plan for FC response. Response included tightening of framework to receive state-aid, stricter condition for national funds to lend, and removing toxic assets and underperforming loans to improve financial institutions balance sheets. At the same time, MS implemented SM to recover. 2010-present FC began due to Greece accumulating large debt and losing trust in financial markets. The MS took loans from IMF and EU but couldn't reduce a positive snowball effect. Resulting in its bailout and imposition of austerity measures. The results of 2020 MFF budget discussions are a giant stimulus package. The activation of the escape clause of SGP created budgetary flexibility. The MS implemented liquidity SM and fiscal stimulus worth around 20per cent of EUs GDP. To explain different outcomes nature of crisis is important. The 2007-2010 FC began due to financial deterioration while 2020 COVID-19 crisis began by a virus spreading evenly across MS. As result, MS took responsibility by taking leadership and seeking cross-border cooperation. MS provided liquidity to firms and capitalized the banks. This proves the EU has leverage to manage economic recession without hindering prospects for growth, resulting in confidence in financial markets. The national interest of MS is to avoid fiscal burden sharing. Therefore, the 2007-2012 FC the MS saved their own banks over transferring funds to other MS. The overarching goal, protecting EMU meant that even the less FC affected MS pursued fiscal burden sharing. However, in 2020 FC the risk of burden sharing was lower than in 2008-2012 due to ESM offering loans with low interest rates and other tools that allow flexibility. As EMU is built on the German model the MS is inclined to aid it. Moreover in a extent where it would endorse greater fiscal risk than it would otherwise done. The policy-goals of the MS is aligned in 2020 and 2008 in protecting EMU. Lack of fiscal discipline was paramount to the Greek failure. Tightening of framework created a rigid EMU that hindered MS to run budgetary deficits and activating snowball effects. MS in 2020 received reasonable loans and supervision. Resulting in negative RGD. SGP scares MS from accumulating debt through EDP. The escape clause creates budgetary flexibility the 2007-2009 EU needed. EMU needed reform long before the FC. The 2007-2012 lacked fiscal consolidation to recapitalize financial markets. Greece and Portugal didn't have the luxury to have healthy banks and as result received less SM. In 2020 all MS could access the 750 billion fund for recovery. Imposing strict fiscal discipline on Greece could only work if it had strong financial institutions. MS in 2020 implemented large public schemes proving the EU was richer than 2008 EU. IMF and OECD call for a pro-austerity stance shift. Proving that 2007-2012 FC were more severe than in 2020. The EU of today know where to invest and cut, as result the threshold for introducing austerity is high. Issue-specific measures proves the 2020 EU had superior crisis-assessment. Moreover, its quick assumption of leadership compared to the symbolic leadership of the 2007-2008 EU strengthen this claim. Portugal wasn't worse off than USA. However, due to multiple equilibria and lack of lender of resort the outcome was harder financial hits. It reveals incompetence of policymakers had ECB acted upon buying national bonds it could avoid positive snowball effect. The 2020 EU had necessary reforms and willingness to take higher fiscal-burden to avoid another economic disaster. The key to different outcomes is lack of comprehensive action from eurozone policy makers. It was questionable to impose fiscal restraints during a severe recession. In addition to not letting ECB act as lender of last resort or implementing necessary reforms.

In short, the study concludes that *Nature of the Crises*, *Demand for fiscal reform* and *Superior crisis-assessment* were the key variables to why the 2020 MFF budget, they explain macroeconomic policy shift to austerity in 2010 and fiscal expansion in 2020.

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