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Trier, 7 October 2014

A Resilience Framework for Analyzing the Euro Area Crisis

(very first draft, please do not cite or quote!)

Paper presented at the international workshop "Five Years of Crisis – Lessons Learned and Paths Towards a Resilient European Monetary Union"
University of Trier, October 9th-10th, 2014

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Introduction: Resilience –buzzword or fertile theoretical concept?

This workshop aims at taking stock of the European Monetary Union's (EMU) deep crisis that started roughly 5 years ago, looks at its evolution over time and assesses the lessons policy makers had to learn the hard way. The papers to be discussed cover a broad range of important issues, from immediate reactions to the crisis in term of "fire extinction" to longer-term governance reforms developing new instruments and institutions serving "preventive fire protection" purposes. A recurring theme to be debated – in this workshop and beyond – is the degree of the euro area's recovery from a state of existential crisis and an assessment of its vulnerability to future shocks.

One way to approach these "big questions" is to adopt a resilience perspective that allows for an integrative view on a highly complex subject area. The purpose of this paper is to provide some elements for this and to show that resilience thinking is a promising route towards this end.

According to Brasset and Holms (2013) „Resilience is fast becoming a policy mantra across governance domains". Policy-makers dealing with natural disasters, pandemics, terrorist threats, the protection of critical infrastructure against cyber-attacks or other disruptive threats developed a resilience discourse (especially in the UK) and strategies of to cope with threats and vulnerabilities. The concept – or buzzword? – of resilience rapidly gained in importance not only among policy makers but also in academia where it comes close to a growth industry. It is currently making a career in several social science disciplines, from the sociology of risk and catastrophes to the political science literature dealing with the stability of political systems or fragile states and especially in security studies. Contributions in economics using the resilience concept deal with issues such as financial market stability and macroprudential policy and regulation. In this policy field, resilience language clearly entered into the discourse of policy makers and expert networks (cf. Financial Stability Forum 2007 and Basel Committee on Banking Supervision 2009).

What are the commonalities to be found in resilience research across such diverse disciplines and fields of study?[1] And what makes it a promising perspective to look at the EMU's crisis and the way policy-makers dealt and deal with it? Leaving aside the use of the concept in individual psychology, resilience usually refers to reactions of complex and tightly interconnected adaptive systems or social units to highly disruptive events or shocks and to their capacity to assure their own survival under conditions of extreme stress.

In a classical first generation definition of resilience in his research on ecological systems, Holling defined the concept as being "a measure of the ability of these systems to absorb changes of state variables, driving variables, and parameters, and still persist" (Holling, 1973: 17). In his understanding, resilience is more than only a system bouncing back to a state of equilibrium after a perturbation, referred to by Holling to as "engineering resilience".

[1] For a literature review covering several disciplines, see Martin-Breen and Anderies 2011.

One widely used second generation definition refers to resilience as “the capacity of a system to absorb disturbance and reorganize while undergoing change so as to still retain essentially the same function, structure, identity, and feedbacks” (Walker et al. 2004: 4). In yet another definition, resilience is conceived of as “the capacity of a social system (e.g. an organization, city, or society) to proactively adapt to, and recover from, disturbances that are perceived within the system to fall outside the range of normal and expected disturbances” (Comfort, Boin and Demchak 2010: 9). The latter definition seems well suited to our field of inquiry as it stresses not only the highly unexpected nature of the disturbance, but also covers *proactive* measures of adaption, not merely *reactions* to an observed critical event. In the same line of thinking, Walker and Cooper refer to resilience as an “anticipatory form of governance” (Walker and Cooper 2011). However, the underlying paradigm of resilience thinking is not one of prevention. Rather, it is one of uncertainty, of living with risks, of anticipating severe shocks and finding ways to cope with them and to raise one’s level of preparedness instead of sticking to the idea that such disruptive events, shocks and deep crises can be completely prevented. One prominent example of this kind of thinking in economics, even though not couched in resilience language, is Reinhart and Rogoffs seminal work on international financial crises (Reinhart/Rogoff 2009). The authors drive home their basic message that the next severe crisis will come sooner or later and that any kind of “this time is different” thinking is based on illusions, not on solid empirical ground.

Resilience can be seen as a property of a social system or unit (to avoid system theoretical language and concepts and make room for an actor-centered analysis). It should not be conceived of in a static manner but rather as a process. Resilience is not just about the stabilization of a social entity after a disruptive event, allowing it to return to a former state or equilibrium; rather actors are able to learn from disruptive experiences and shocks and can reduce the level of vulnerability of their resilient unit by a deliberate process of change, by adapting or partially transforming their social unit. Disruptive shocks, then, can be interpreted as windows of opportunity, creating room for social innovations, opening policy windows after “focusing events” in the sense of John Kingdon’s analysis of political agenda-setting processes (Kingdon 1984).

“Vulnerability” is a concept very closely related to resilience. It points to the unpredictable and unforeseeable nature of concrete dangers and shocks. It is to be distinguished from the concept of risk which presupposes that both the likelihood of a danger and the amount of potential damage can be calculated in advance. As Donald Rumsfeld once famously put it: “There are known knowns ... But there are also unknown unknowns”. Resilience thinking and resilience strategies deal very much with the latter, using the concept of vulnerability instead of risks.[2] Many studies in the field of social science resilience research share the basic assumption that systems or collective/corporate actors have to deal with a high degree of uncertainty with regard to the timing and depths of a potential future crisis or shock and have to find ways to limit the damages, to cope with the crisis and to recover quickly.

[2] On the use of vulnerability and resilience and their mutual relationship, see Bürkner (2010).

EMU's response to the euro area crisis: Coping, adapting, transforming

There is little doubt that the euro area's twin sovereign debt and banking crisis falls in the class of events resilience literature usually deals with, namely "high-impact low-probability systems failures and traumatic events" (Brasset/Croft/Vaughan-William 2013: 222). And there is probably also little debate on the existential nature of the threat this disruption represented or still represents for the common currency and monetary union (for breakup scenarios, see Belke/Verheyen 2013). How can resilience research be used to analyze responses and strategies of key actors and assess the change in the level of vulnerability and resilience of the EMU?

In their highly influential contribution to resilience research, Folke et al. (2010) use a trinity of concepts – 'persistence', 'adaptability' and 'transformability' – in order to distinguish different types of reactions to disruptive events. In a similar vein and building on this analytical distinction, Keck and Sakdapolrak (2013) refer to 'coping capacities', 'adaptive capacities' and 'transformative capacities' when analyzing actors' responses to risks and shocks. Along these lines, we refer to coping capacities or persistence as the capacity of a social unit or system to withstand a shock without any purposeful change in structure, function, or identity by reacting in the short term and making use of existing resources and instruments immediately at hand. Adaptive capacity refers to more far reaching, yet incremental changes which not only react to current disturbances but can also be preventive in nature, implying processes of learning along the lines of current or foreseeable trajectories of the social unit under consideration. This kind of adaptation or adaptive capacity points to actors purposefully influencing the resilience of a social unit or system (Walker et al. 2004: 5). Transformability, finally, is defined as "the capacity to create a fundamentally new system when ecological, economic, or social structures make the existing system untenable" (ibid.). The concept of "transformative capacity" as used by Keck and Sakdapolrak (2013: 10-11) also implies this idea of a sweeping and radical shift towards a new trajectory through changes with a long-term time horizon, preparing a social unit ex ante to possible future shocks.

When analyzing the way the Euro area dealt with its twin crisis, it should be immediately clear that we observe mainly examples of adaptation and transformation, not only of coping and persistence.

First of all, there is a broad consensus that the Euro area found itself in a state of high vulnerability prior to the unfolding of the debt crisis for two main reasons:

1. Policy makers were not prepared to deal with a sovereign debt crisis and had no ready instruments at hand for crisis management.[3] When negotiating the Maastricht Treaty, negotiators (especially the Germans) put the main emphasis on rules (no bail out clause; no monetization of public debt; debt and deficit criteria and excessive deficit procedure)

[3] As an example of a widespread type of crisis interpretation, see the contribution of the two Commission collaborators from the Directorate-General for Economic and Financial Affairs, Buti and Carnot (2012).

and institutional designs (independence of the ECB) to prevent such a sovereign debt crisis from happening in the first place (Dyson/Featherstone 1999). With the benefit of hindsight, this trust in the disciplining force of rules and of bond markets to prevent unsustainable fiscal policies clearly proved wrong.

2. A sovereign debt crisis following irresponsible national fiscal policies was the main scenario that the contracting parties had in mind when putting the EMU on track and unsustainable national fiscal policies were also seen as main underlying cause of the Euro area's crisis by many policy makers. Paul de Grauwe, however, identified the "unsustainable debt accumulation of the *private* sectors in many eurozone countries" as the "root cause of the debt problems in the eurozone" (De Grauwe 2010: 1; emphasis in the original; for a similar line of argument, see Pisani-Ferry 2010). The vulnerabilities caused by unsustainable levels of private debt and related banking crises, housing bubbles and external shocks with tremendous spillover potential in highly integrated financial markets were not addressed ex ante by policy makers.

As a consequence of this state of unpreparedness and in view of the imminent danger of a break-up of the Eurozone, coping strategies did not suffice. The EU, lacking instruments for short term crisis management, had to invent them in the midst of the ongoing crisis. Hence, adaptation and transformation were on the political agenda right from the start. Indeed, most instruments deployed at the EU level to deal with the crisis fall in the two categories of adaptation and transformation. Of course, we also find instances of coping, EU actors using existing instruments. The lowering of interest rates by the ECB is an example in kind. However, table 1 displays a number of new instruments and governance reforms that can be interpreted either as examples of the EMU's adaptive capacity through political learning and the creation of new instruments and reformed governance institutions or as examples of outright transformations, with far reaching long-term consequences and leading to major changes in the EMU's trajectory.

Table 1: Changes in policy instruments, governance reforms and reform proposals (in italics)

	Coping	Adaptation	Transformation
Crisis Resolution Mechanisms			
EFSF / EFSM		X	
ESM			X
Eurobonds			X
ECB policy			
lowering interest rates	X		
Fixed rate, full allotment liquidity provision		X	
LTRO (Long Term Refinancing Operation)		X	
Outright Monetary Transactions			X
Banking Union			
Single Supervisory Mechanism (SSM)			X
Single Resolution Mechanism (SRM)			X
Single Resolution Fund (SRF)			X
Economic Governance Reforms (rules)			
SGP Reform		X	
Macroeconomic Imbalance Procedure & MIP Score Board		X	
Fiscal Compact (TSCG)		X	
Economic Governance Reforms (decision-making bodies)			
Institutionalization of Euro summits		X	
Fiscal Capacity for Eurozone			
reform contracts		X	
unemployment insurance scheme			*X*
Insolvency Procedure for Sovereigns		*X*	

Source: Author's own compilation.

The category of adaptive capacity contains instruments such as temporary rescue funds (EFSF/EFSM) and temporary provision of enhanced liquidity to banks by the ECB which can be seen as measures of incremental change with a mid-term time horizon and remaining within critical thresholds because they do not alter the EMU's basic trajectory. *Permanent new instruments of solidarity* such as the ESM or major innovations such as the *shift towards supranational banking supervision and resolution* for the 130 most important institutes arguably represent instances of transformation, changing basic structures underpinning the functioning of the EMU. The same holds true for proposals being discussed during this workshop such as Eurobonds, a system of fiscal transfers at the Eurozone level or a Eurozone unemployment insurance scheme. They would alter the Eurozone's basic trajectory from a German inspired "stability union", built on national responsibility for adapting to the constraints of being a Eurozone member, towards an "intégration solidaire" (as François Hollande has it), strengthening elements of mutual guarantees and liabilities, transfers and common funds. And proposals of a further tightening of European surveillance and top-down supranational control of the fiscal policies of Member States would also alter the EMU's trajectory, this time towards a "fiscal union" or "political union", thus representing cases of transformation, not merely adaptation.

On the way towards a strengthened resilience of the EMU?

How resilient the EMU proved to be? And in how far the coping, adaptive and transformative capacity the EU displayed contributed to improving the EMU's overall resilience now and in the future? These broad questions can be broken down in several subquestions.

1. How do we evaluate the EU's/EMU's capacity to react and adapt in situations of existential threat?
2. Did the decision output strengthen the resources of the EU to cope with this crisis and improve its level of preparedness for the crises to come?
3. What are the side effects and unintended consequences of key decisions, new instruments and institutional changes?

Adopting a comprehensive resilience perspective, we might look at four different dimensions: a) short term crisis management capacity, b) rehabilitation or recovery from the shock, c) monitoring of current and future vulnerabilities and d) prevention of future crises (see figure 1).

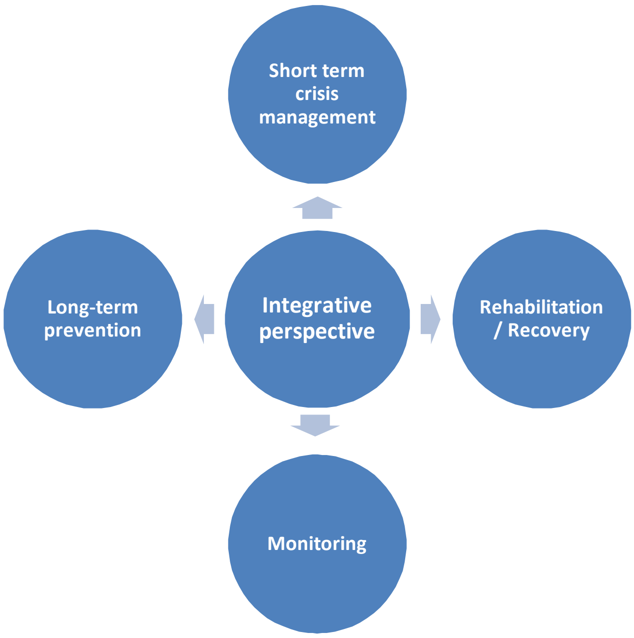

Figure 1: Four Dimensions of Improving the Euro area's Resilience

a) Short term crisis management

In terms of short term crisis management, the EU displayed its adaptive capacity by inventing new instruments at the intergovernmental level (temporary rescue funds) as well at the level of a key supranational actor, the ECB's unconventional monetary policy. The permanent ESM surely improves the Eurozone's future capacity to deal with disruptive economic shocks. In how far will its limited resources prove sufficient to handle future situations of crisis? This, of course, is open to debate.

Another innovation in terms of short term crisis management came with the Euro Summits and their institutionalization. The involvement of the highest political authorities of the Eurozone Member States in crisis management should make speedy decision-making easier in situations of "supreme emergency" (Dyson 2013).

The capacity to provide leadership in the EU's highly complex, fragmented and consensus-oriented system of governance can be seen as a crucial precondition for its resilience to unforeseen shocks. The Eurozone Member States and institution's reactions to the twin banking and sovereign debt crisis indeed displayed instances of successful leadership. With regard to a number of highly controversial issues, Germany and France could act as agenda setters and were able to strike bilateral compromises acceptable to other Member States too. Thereby they proved able to provide intergovernmental leadership on key issues such as the reform of the Stability and Growth Pact, the "fiscal compact", the ESM and the related Treaty reform (Schild 2013).

This provision of leadership by Member States, however, was not sufficient to calm down speculative pressure of financial markets betting against the survival of the Eurozone in its current composition. In this situation, the capacity of the ECB to act unilaterally, based on its delegated powers in monetary policy making, proved crucial for overcoming a potentially destructive dynamic of the financial markets (Chang/Leblond 2014).

All these elements, innovative capacity in terms of the invention of new instruments, new decision-making bodies, intergovernmental leadership capacity and unilateral options for decisive action by supranational actors can be interpreted as indicators of resilience in terms of short term crisis management capacity.

b) Rehabilitation / Recovery

The Eurozone's capacity to quickly recover from the shock is surely more doubtful. Current debates over the best economic policy strategy to avoid a deflationary scenario and a "lost decade" testify to this. The post-crisis experiences of individual Member States provide us with a highly mixed picture, both in terms of their economic and growth performance as with regard their individual coping, adaptive and transformative capacities when they had to deal with their respective disruptive shocks.

c) Monitoring

The capacity to permanently monitor the state of its own vulnerability by improved self-observation can be regarded as key for improving the resilience of a social unit. In this respect, the EU and the Eurozone are surely better equipped today than in the past. Not only does the European semester provide a framework for a tighter permanent monitoring of the fiscal policies of the Eurozone's Member States; the regulation on the prevention and correction of macroeconomic imbalances from 2011 moreover extends multilateral surveillance beyond the fiscal policies to cover broader fields of Member States' economic policy making. The eleven indicators of the MIP (Macroeconomic Imbalance Procedure) scoreboard[4] serve as an early-warning system indicating serious imbalances that endanger the sustainability of national economic policies and that might undermine the stability of the wider Euro area.

d) Prevention

In terms of prevention, the Six pack legislation not only provided for a strengthening of the Stability and Growth Pact's preventive arm (including possible sanctions), but also empowers the Commission and the Council to issue preventive recommendations to Member States in the framework of the new excessive imbalance procedure.

The new supranational powers of the ECB in the field of banking supervision overcome the uneasy co-existence of integrated financial markets and fragmented national supervision of financial institutions, improving the capacity to detect and address vulnerabilities at the level of individual systemically relevant institutions early on. And the very purpose of the overhaul of the European System of Financial Supervision (ESFS), including the establishment of the European Systemic Risk Board (ESRB) as part of the ESFS, is to improve the macro-prudential oversight of the financial system as a whole.

When analyzing processes of change in terms of measures and strategies of adaptation or transformation, resilience research is sensitive to the unintended consequences these measures might have across geographical scales and across time.

Some core issue debated since the start of the Eurozone crisis relate to these unintended longer-term consequences of short-term measures of crisis management. Many of these debates revolve around the moral hazard implications of instruments of solidarity (rescue funds, Eurobonds, fiscal transfers, bank resolution fund…) and deal with the long-term impact of the unconventional policies implemented by the ECB. These instruments and policies were apparently successful in avoiding a breakup of the Eurozone and a spiraling out of control of economic crises in individual Member States. They are buying time. But what happens if this time is not used by the most vulnerable Member States to reduce public debt, to stabilize their banks and to adopt and implement structural reforms improving their competitiveness? Are those instruments of solidarity not reducing the pressure to adapt and to reform felt at the Member State level because they reduce the effectiveness of market discipline in limiting excessive risk-taking by states and banks? Do short-term measures to stabilize the Eurozone actively contribute to *increase* the long-term vulnerability of the Eurozone instead of contributing to the prevention of future crises? The apparent short and medium term stabilization of the Eurozone might hide growing vulnerabilities at the lower

[4] See http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_scoreboard/index_en.htm

geographical level of individual Member States with possibly highly disruptive spill-over potential for the wider euro area.

Conclusion

Resilience thinking provides some interesting questions and useful concepts to analyze the past, current, and future vulnerability and resilience of the Eurozone. This highly disruptive and deep crisis provides us with a very instructive case of a high impact-low probability event, the favorite type of study object in resilience research. Clearly distinguishing between vulnerability as a state and resilience as a process, namely the capacity to withstand, to innovate and to create new resources and strategies for facing current and future crises, can provide new insights and allows for development of a broad and integrative perspective on this object of study.

Future research on the EMU in a resilience perspective should include the development of a set of empirical indicators to operationalize the concepts of vulnerability and resilience as well as core resilience related concepts such as adaptive or transformative capacity with regard to this specific object of study.[5] This might allow to develop a set of testable hypotheses in order to move from resilience thinking to resilience theory.

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[5] See for a contribution on possible ways of operationalizing of these concepts.

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