JOURNAL OF EUROPEAN PUBLIC POLICY
2021, VOL. 28, NO. 10, 1573–1591
https://doi.org/10.1080/13501763.2021.1954062

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Failing outward: power politics, regime complexity, and failing forward under deadlock

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ABSTRACT
Failing forward describes an endogenous cycle of EU institution-building through lowest-common denominator breakthroughs in Council. This article adds a dynamic called *failing outward*, in which a powerful country steers EU law and policy from outside the EU. Where strong Council deadlocks persist during crises, and a powerful state possesses a critical, excludable resource, it will make access conditional on EU rules and institutions that reflect its own interests rather than Council compromises. A non-EU institution helps it do this, entrenching conditionality. Repeated institutional fixes follow as the system fails (some) other Member States. This model is applied to Germany's effective authority through the European Stability Mechanism over Council and Commission in determining EMU reforms, including Banking Union.

KEYWORDS Failing forward; fiscal union; EMU; European Stability Mechanism; regime complexity; Germany

Introduction

Recurring financial instability has pushed the European Union (EU) to establish the European Stability Mechanism (ESM) as a common backstop for insolvent states and banks, to repeatedly reform Economic and Monetary Union (EMU) institutions, rules and programs, and to develop Banking Union (BU). These reforms attributed instability to excessive government borrowing and bank lending that had to be reduced, ignoring counterclaims that Europe required a fiscal union to offset destabilizing financial flows (Jones, 2020). Nevertheless, periodic financial instability remains, and steps taken remain politically contested (Hodson, 2020), with strong distributional divides between North and South (Matthijs & Merler, 2020; Pérez, 2019). Until July 2020, Germany led efforts to stabilize EMU with national structural adjustment, budget retrenchment and financial sector risk reduction, aided

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by EU and ESM oversight, while resisting French-led proposals to introduce common debt and fiscal transfers between EMU Member States (Quaglia, 2019). In short, institutional development is skewed, reflecting German preferences, while instability persists. The 2020 Recovery Plan (European Commission, 2020) adds limited grants for the first time as a concession to France and Southern Europe, but the ESM remains the lender of last resort.

The puzzles posed here are: why is there simultaneously so much institutionalization and so much continued instability? Why were institutions established that a majority of EMU Member States disagree with, and that continue to perform poorly on financial stability? Finally, how do we account for recent changes?

As a way of merging neofunctional demand (Epstein & Rhodes, 2016; Niemann & Ioannou, 2015) and intergovernmental supply of European integration (Moravcsik, 2018), Jones et al.'s (2016) *failing forward* framework posits an endogenous cycle of crisis-driven institution building in which institutions fail to keep the EU functioning during crises, lowest common denominator (LCD) intergovernmental bargains lead to undersupplied or underresourced institutions, and later crises lead (successor) governments to make new, minimal compromises to survive immediate challenges. The original sin of minimal compromise is repeated, which perpetuates instability and the cycle.

In this paper, I argue that Germany organized and used the ESM to control financial resources critical for stabilizing EMU from *outside* the EU, and leveraged that control to drive one-sided EMU and Banking Union reforms that disregarded the demands of other EU Member States. The poor fit between German demands and several EU national economies led to renewed instability and more one-sided reform demands. I call this variation of failing forward *failing outward* based on the impact of an outside institution on EU bargaining. It does not refute failing forward, but demonstrates a variation under Council deadlock and strong power differentials. I agree accordingly with Gocaj and Meunier's (2013) assertion that the ESM locks in an intergovernmental bias over collective crisis management, but highlight here German agency in using, reinforcing, creating, changing and blocking EU institutions, legislation and programs. This prevalence of German preferences over institutional rules and norms proves useful in explaining the relaxation of ESM leverage over EU policy in mid-2020 in response to the COVID pandemic.

Taking power politics seriously: regime complexity and authority in Europe

Drawing on realist and historical institutionalist insights, *failing outward* expects powerful states that control critical, excludable resources to react to Council deadlock during crises by establishing and using non-EU institutions (not subject to EU law, decision-making, administration or oversight: De Witte, 2015; Fabbrini, 2019) to selectively promote and block EU institutions, laws and programs in exchange for resource access. This gives the powerful state more weight in Council than without outside institutions, allowing it to push or deny legislative projects that others cannot resist. Authority is established (McNamara, 2018) from outside the EU. The skewed outcomes generate continued instability for others and new institutional fixes to deal with them.

The failing outward variant of failing forward can be visualized as follows:

FF: Crisis >> LCD Compromise >> New EU institutions >>

FO: Crisis >> Deadlock >> Outside Institutions >> New, Nested EU Institutions

I see failing outward as an expected outcome under two conditions. The first is *Council deadlock over core policy beliefs* (Quaglia, 2010; Sabatier, 1988) that shape the EU's programs, regulations and legislative proposals. Following Hix (2018), strong, consistent differences between national electorates and constituents coupled with high political saliency generate Council deadlock over core principles. Within EMU, these are North–South divides over stabilizing public finances and banks through common debt and transfers, or national risk reduction efforts (Braun & Deeg, 2020; Hall, 2018; Matthijs & Merler, 2020; Pérez, 2019; Regan, 2017). The second condition is one country's posses*sion of a critical, excludable resource which other states need to* keep interdependence intact. Germany's surplus of financial capital relative to Southern Europe, plus investment inflows during downturns that expand its available financial resources fulfill this condition for EMU.

Two key mechanisms drive failing outward. The first is *the establishment (or reinforcement) of non-EU institutions to* circumvent Council deadlocks. Following Jupille, Mattli and Snidal's historical institutionalist account (2013), powerful states can be expected to *use, select, change or create* (USCC) institutions and governance architectures as required to suit their own needs. The USCC model expects institutional *use* where bargains can be made within existing institutions. *Selection* is akin to forum shopping (or differentiated integration) when veto players prove difficult and an alternative already exists. *Change* repurposes or redirects existing institutions. *Creation* of new, alternative institutions is chosen when LCD compromises on change would impose unacceptable costs to powerful states (Zürn, 2018).

Following Gruber (2000), powerful states that present new (non-EU) institutional creations to their opponents as a *faits accomplis* rob their opponents of the negotiation status quo (Council vetoes requiring compromise) and coerce them to accept terms they oppose to keep interdependence intact. Similarly, Kölliker (2001) maintains that other governments will continue to accept unfavorable terms into the future where the institution provides a critical, excludable resource.

These outside institutions are not stand-alone, but connected to the EU, creating regime complexity. Regime complexity is understood as a set of overlapping, parallel regimes that interact with one another significantly (Orsini & Morin, 2013; Alter & Meunier, 2009). While frequently used for flexible, voluntary cooperation to meet functional needs of interdependence (Alter & Meunier, 2009; Keohane & Victor, 2011), and escape hatches from deadlock, including forum shopping and differentiated integration (Schimmelfennig & Winzen, 2019) or loose intergovernmental coordination typical of New Intergovernmentalism (Hodson & Puetter, 2019), moments typified by crisis, deadlock and power differentials encourage powerful states to establish institutions they can better control and leverage to steer regime complexity.

The second mechanism is *leveraging resources through outside institutions to guide EU activity*. Powerful states can weaponize conditional access to the critical resources of the outside institution (Farrell & Newman, 2016), to establish practical authority over other institutions, core EU policy principles, programs, institutions and regulations and place conditions on other countries (Donnelly, 2018; Drezner, 2009). Following Pratt (2018) 'By accepting rules crafted in another IO [international organization], Member States can mitigate rule conflict and facilitate a division of labor within the regime complex', but on the powerful country's terms. Other countries accept this institutional nesting (Alter and Meunier 2006), conditionality and authority (McNamara, 2018) from outside the EU to avoid even worse outcomes. Conditional access sets the terms for EU bodies and Member States to negotiate institutions, programs and policies that implement the powerful state's core policy priorities. This is a critical feature of negotiations that goes beyond hard intergovernmental or LCD bargaining. Past institutions do not restrain powerful state options (Schimmelfennig, 2015 Verdun, 2015;). Outside institutions expand them. EU responses then can be strong or weak based on the powerful country's needs.

This pattern should persist as long as Member States' core preferences remain far apart. When they converge, Hix's framework suggests that Council deadlock subsides, and we expect LCD-based agreements in Council typical of failing forward to resume. This happens in July 2020, as shown below and by Howarth and Quaglia (2021).

I apply this framework to Germany's role in establishing and using the ESM in Europe, and then to ESM conditionality driving EMU reforms and Banking Union from 2010 to 2020. I select four moments of EMU and Banking Union reform to test repeated patterns of deadlock, ESM creation and reinforcement, and leverage over EU reforms.

Failing outward in EMU and banking union reform

EMU's sources of ongoing instability are well-documented: the lack of fiscal union alongside a monetary union exacerbates negative shocks over time (during economic downturns) as well as across countries (asymmetric shocks), and lacks the capacity to promote targeted economic recoveries (structural adjustment through strategic investment). France's promotion of fiscal transfers as an institutional fix, contrasted with Germany's promotion of stronger fiscal discipline and structural reforms is also well-known, though the distance between the two varies with French governments.

The sections below review the model above, specifying four steps that allow us to see the impact of power politics and hierarchical relations on regime complexity at each stage. In the first, we see a moment of crisis in which institutions fail to hold interdependence together and deadlock ensues over the fundamental institutional strategy. In the second, we see Germany create (or reinforce) the ESM in the face of deadlock (failing outward). In the third, we examine the impact of ESM conditionality on EU institutions and the Member States. In the final stage, we assess continuing incompleteness. I apply this approach in five bursts of activity: the first EMU reform (2010-11); the second EMU reform (2012-15); Banking Union (2012-2019); the first attempt at EMU reform during the Great Lockdown (2020); and the Franco-German initiative to introduce a common debt instrument with transfers rather than loans (May 2020-). I test the hypothesis that EU reforms are dependent variables driven by ESM conditionality, and incorporate norms of national risk reduction in fiscal policy (EMU) and banking (Banking Union) while ignoring other interests.

EMU reform 1 (2010-11)

Crisis, incompleteness and deadlock

The financial crisis of 2008 led to capital flight and acute financial fragility in the Eurozone's periphery without fiscal transfers to absorb the shock (Jones, 2020). French preferences for fiscal union transfers and German preferences for EU control of national budgets were both discarded by 2010 to ensure agreement typical of an LCD outcome (Tsebelis & Hahm, 2014). Commission proposals for Eurobonds in 2010 were therefore rejected. France and Germany compromised to support intergovernmental loans tied to national structural and budget reforms to ensure repayment and recovery. However, deadlock still came from UK fears of an eventual fiscal and political union with regulation hurting the City (Hodson, 2020).

Institutional creation and regime complexity

The European Financial Stability Facility (EFSF) side-stepped the UK veto and German concerns about fiscal transfers as it was loan-based, temporary and unconnected to EU legal obligations. This in itself was voluntary failing forward on the basis of differentiated integration. However, as the largest contributor, Germany also demanded an additional Treaty on Stability, Cooperation and Governance (TSCG, or Fiscal Compact) to entrench national commitments to budget balancing as a quid pro quo for EFSF access (Gocaj & Meunier, 2013). Other EU countries signed this intergovernmental agreement to avoid signals to financial markets of unwillingness to balance budgets, which they feared would induce capital flight (Moschella, 2017). German insistence on the TSCG outside the EU then made EU reforms necessary to oversee national compliance. The balanced budget demand surpassed the budget reform expectations of the Stability and Growth Pact.

External conditionality & EU adjustment

The Commission introduced EU programs to implement the Fiscal Compact within days. The European Semester and Six-Pack were tabled in May 2010 as open, soft law forms of fiscal policy surveillance and correction, extended to a wide range of macroeconomic trends supporting structural adjustment recommendations (Macroeconomic Imbalances Procedure: MIP) in 2011. The Council approved both without colliding over macroeconomic effects or a quid pro quo of financial transfers. In addition, three *de novo* European Supervisory Agencies were set up to reduce financial market risks. These included the European Banking Authority, which pressured banks (poorly) to reduce loans and raise capital in the Eurozone's most fragile economies, leading to further economic contraction. This nesting of EU activity within EFSF/TSCG conditions starts the process Pratt sets out.

Overall, these outcomes established the precedents of regime complexity between EU and EFSF as well as external conditionality on the EU and the Member States. This new hierarchy was introduced smoothly compared to 2012, when ESM conditions became more plentiful and politicized and Compact ratification neared completion. Ireland, Portugal and Greece were unhappy with conditions attached to their loans, but accepted them for lack of alternatives (see Gruber). The European Semester and MIP likewise would not have developed in the absence of the EFSF and Compact, but their soft-law, coordination approach to budgetary policy retrenchment initially minimized confrontation (Savage & Howarth, 2018). Within the supervisory agencies as well, mutual national accommodation prevailed over stringent risk reduction.

Undersupply and instability

Financial fragility continued after the EFSF's introduction. Internal devaluation, structural adjustment and budget retrenchment restored financial market access at great social cost for Ireland and Portugal (with EFSF loans) and Italy (without, in 2011). In Spain (2012) and Greece (2010-19), the EFSF's temporary nature led financial markets to raise interest rates for government bonds dramatically. The European Banking Authority also demonstrated insufficient independence and supervisory capacity as a *de novo* body to get banks to increase their capital for safety. Meanwhile, Germany rejected Commission calls for collective deposit insurance to alleviate financial shortages.

EMU reform 2 (2012-15)

Crisis, incompleteness and deadlock

As Italy struggled with access to financial markets in 2011, followed by Spain in 2012, the Commission again floated plans for common debt and met German and Dutch resistance. Rejecting EFSF loans with conditions, Italy's technocratic Monti government introduced its own cutbacks in 2011. Then France elected François Holland in May 2012 as a strong proponent of fiscal union, launching a long and deep confrontation with Germany (Matthijs & McNamara, 2015). With financial markets demanding increasingly prohibitive interest rates across Southern Europe, governments faced default, but Franco-German and North–South deadlock continued in ways that LCD bargaining could not solve.

Consolidating regime complexity

In this context, Germany promoted the ESM as a *permanent* solution – as the successor to the EFSF outside EU laws and institutions. Germany insisted that all Eurozone Member States contribute, that the ESM would provide loans with conditions as an *ersatz* lender of last resort, while the TSCG entrenched balanced budgets within national constitutions. While Germany viewed Fiscal Compact ratification before ESM access as indispensable, government ministers and parliamentarians in France, Ireland and other Southern European countries referred explicitly to German *blackmail* that they had to accept to ensure ESM access (Donnelly, 2018), confirming Gruber's and Kölliker's expectations. Although France won a concession to discuss bringing the ESM under the rule of EU law later by 2018 (making it justiciable in the Court, involving the Commission and Parliament and bringing in new procedures and principles), Germany's conflicts with Cyprus and Greece through 2015 left it convinced that external control was key to its success, and the talks were fruitless

(Donnelly, 2018). The ESM, coupled with the Franco-German conflict, is rightly seen as Germany's success in establishing a new institution (Jupille et al., 2013) that sets terms for the EU (Pratt, 2018).

Conditionality and EU adjustment

Conditional ESM access afterward drove major EU reforms in budgetary and regulatory policy in response to German critique, and to better recognize the ESM's role as an authority in EU law. A significant EMU reform was the introduction of the reverse qualified majority vote to better enforce the Excessive Deficit Procedure (EDP). Regulation 473/2013 permitted the Commission to propose fines for budget violations more easily (though the subsequent Juncker Commission avoided them). It created formal legal links between the ESM, the EU and the Troika (ECB, Commission and IMF) to allow imposition of terms on debtor countries. The ESM's enhanced status allowed enforcement of the EDP and European Semester in ways the Commission and Council were reluctant to do (Papadopoulos & Piattoni, 2019).

The ESM also demonstrated concrete infrastructural power in Cyprus and Greece, with detailed mandates to impose internal devaluation on those countries. Although the ESM is not part of the Troika, it approves the conditions of assistance, and was effectively part of the negotiations with Cyprus and Greece when resistance came (Moschella, 2016).

This shows that Gruber's framework applies after institutional precedents for regime complexity and hierarchy have been set – with Germany's resources allowing it to keep the ESM central, the Compact intact, and fiscal union off the table. The lack of alternatives allowed Germany to reject periodic calls from France, Italy, Portugal, Greece, the ECB and the Commission for Eurobonds to alleviate bouts of financial hardship. The same is true for Kölliker's expectation that critical, excludable resources push the vulnerable to accept membership terms. Spain's willingness to accept ESM principles and terms in mid-2012 to recapitalize its banking system greatly helped consolidate ESM authority among potential clients (Howarth & Quaglia, 2016). The Baltic states also supported these terms, having implemented similar IMF conditions to secure loans through 2011 (Dandashly & Verdun, 2020). All these governments sought competitive borrowing rates in financial markets, which had become prohibitively expensive for them by 2011. The ESM subsequently remained firm on national responsibility for adjustment and consolidated its authority in the face of great criticism from Cyprus, Greece and even the IMF over debt sustainability and economic policy conditions through 2015 (Hodson, 2016). Meanwhile, Italy's more vocal anti-ESM stance left the ESM unimpressed.

Undersupply and instability

Budget policy reform suffered from several weaknesses. Most Eurozone Member States, as well as the Commission and ECB, remained concerned about Germany's intention that the ESM was made 'not to be used' (Schäuble, 2011), that the single currency still lacked a central lender of last resort, and that the policies were counterproductive. Even the ECB maintained that favoring structural adjustment and budget retrenchment before measures to rejuvenate development, growth and jobs generated deflation and new deficits rather than recovery (Donnelly, 2018a). Germany, meanwhile, remained concerned that centralized budgetary surveillance remained insufficient, given Council and Commission reluctance to enforce. This required legalization of special rights for the Troika to enforce Memoranda of Understanding between the ESM and Program Countries (Two-Pack), *pour encourager les autres*. Despite all of this, instability persisted and Mario Draghi felt compelled to announce after the June ESM agreement that the ECB would do 'anything it takes' to keep the Eurozone together by acting as lender of last resort (26 July 2012).

Banking union (2013-2019)

Crisis, incompleteness and deadlock

A declining economy through 2011 and 2012 created critical solvency problems for banks, and then Southern European governments which deployed state aid for them under difficult borrowing conditions. Germany's conflict with France and Southern Europe in the public sector over financial transfers and guarantees versus national adjustment and risk reduction repeated itself in the private sector. France and Southern Europe supported Commission proposals from 2010 onward for a European Deposit Insurance System (EDIS) with shared contributions and benefits, while Germany and Netherlands called for measures to reduce the risk of taxpayer burdens within and across countries (Howarth & Quaglia, 2016).

As with EMU, Germany supported continued reliance on the ESM to stabilize European banks (Schäfer, 2016) from outside. Conditional access to ESM funds was used to demand stronger EU institutions designed to keep national problems under control: European bank supervision; rules for bank resolution and creditor bail-ins; strengthened capital requirements; and minimization of state aid to banks (Howarth & Quaglia, 2016).

Even more so than in EMU, Germany was able to demand strong EU laws and institutions reflecting their own preferences and block others thanks to conditional use of the ESM.

Consolidating and furthering regime complexity

Rather than a breakthrough in Council on these issues, Banking Union started in 2012 alongside Germany's insistence on using the ESM as a risk reduction program to aid the recapitalization and resolution of Spanish banks (through the Spanish state). Germany rejected talks on EDIS within the EU for distributional and moral hazard reasons, despite strong lobbying from the Commission, France and Southern Europe (Howarth & Quaglia, 2018). Allowing ESM loans for bank resolution was a partial win for Spain, which accepted national responsibility for bank restructuring costs and European bank supervision, while forgoing European deposit insurance. Spain also accepted German/Dutch concerns that EU transfers would encourage moral hazard – evading structural adjustments to get banks back into solvency. In the BU measures that followed, Germany successfully leveraged ESM lending capacity to demand a series of EU laws and institutions for risk reduction in banks, while blocking those for risk sharing. This irrevocably linked the ESM and its conditions to Banking Union evolution.

Conditionality and EU adjustment

ESM access was made possible on the condition of the EU adopting institutions and laws for risk reduction. The Single Supervisory Mechanism (SSM), on German insistence, provided for the ECB to act as direct supervisor for systemically-important banks, exposing and minimizing weaknesses. The Single Resolution Mechanism (SRM) was also a German demand, which established the Single Resolution Board (SRB) and regulations (Bank Recovery and Resolution Directive, Single Resolution Regulation) requiring creditor bail-ins to reduce taxpayer and national deposit insurance support, while limiting state aid. A limited compromise on common funds was found in the Single Resolution Fund (SRF), in which 55 billion euros in bank contributions could be used for failing banks, under strict conditions and under the control an intergovernmental agreement (Howarth & Quaglia, 2016).

While Spain, France, Italy and the Commission continued to insist on EDIS as an indispensable complement to these measures, Germany maintained that the SSM, SRM and further risk-reducing regulations on banks be agreed and implemented *prior to* EDIS talks. Germany's capacity to steer the EU through conditionality is seen in this regard through the Banking Package, introduced in 2017 and legislated in 2019 (European Commission, 2018). The six regulations provided EU implementation of global standards (Basel III) to require banks to increase capital, including funds that could be bailed in during a resolution (Capital Requirements Regulation II, Capital Requirements Directive V).

After meeting these conditions, Germany again refused to discuss EDIS, much to the consternation of France, Italy and the Commission. Instead, Germany demanded even more risk reduction, claiming that the Banking Package had simply implemented global Basel Committee standards (Basel III) from 2017 (Deutsche Bundesbank, 2019), and not gone far enough. Germany wanted Italian banks to either divest holdings of Italian state treasuries or raise capital to compensate for the risk of possible state default before EDIS talks could ensue. Italy and Germany agreed to let the Basel Committee rule on whether Italian banks could legally treat Italian treasuries as having no risk of default, and negotiate EDIS afterward.

When the Basel Committee effectively decided in Italy's favor by refusing to change the global standard, Germany refused to open EDIS talks as promised (BaFin, 2018). Instead, the German government proposed using the ESM as an ersatz deposit insurance guarantee through backstopping national systems through the SRF, which it brought other governments to accept in a 2020 amendment to the ESM Treaty (Khan, 2020). Commission calls to resume talks on EDIS remain unsuccessful in moving Germany to the present day, while Italy remains unwilling to compromise on concentrated bank holdings of Italian treasury bills (Mazza, 2018). But Germany's intent to make the ESM central to financial stability, to demand institutional changes through outside leverage and block EU-based regimes was confirmed.

Undersupply and instability

Banking Union generated significant institutions and regulations on the basis of failing outward: selective institutions linked to ESM conditionality for risk reduction without financial stability provisions for financial fragile Member States. National governments remain lenders of last resort (LLR) to banks, and the ESM serves as a conditional backstop to the Member States, allowing Germany to make ongoing demands for further risk reduction. Governments remain responsible for containing contagion across banks, while the ESM contains contagion across countries, leading to further concern about bank solvency in Southern Europe. Proposals to stabilize these banks with financial engineering rather than common funds (Van Riet, 2017) have not mitigated Germany's insistence on radical change to Italian banks.

EMU reform 3a (2019-April 2020)

Crisis and deadlock

The Great Lockdown of 2020 was preceded by continued consternation between Germany and the EU regarding how well the EU and its Member

States implemented the late EMU and BU reforms – which was not very strongly at all. This was illustrated by the Commission's unwillingness to apply the Stability and Growth Pact's (SGP)'s Excessive Deficit Procedure against France, its attempts to manage rather than enforce agreements on deficits and debt, and its leniency in implementing freshly-agreed rules on state aid during bank resolutions (Donnelly & Asimakopoulos, 2020; Matthijs, 2020). French hopes for EDIS were reflected in the 2018 Franco-German Meseberg Declaration with calls for a common backstop instrument of *national* systems.

This divide extended to renewed French calls for fiscal union with a eurozone budget both before and after the crisis, versus continued national efforts at budget retrenchment & structural adjustment. Macron's Eurozone budget proposals were agreed by Germany's Finance Minister in November 2018, but cut down by June 2019 after domestic critique in Germany into a Budgetary Instrument for Convergence and Competitiveness (BICC) within the EU's normal budget. German fiscal conservatives, buttressed by the Dutch-led New Hanseatic League, insisted on national responsibility, competitiveness and ESM loans as *ersatz* LLR. Meanwhile, the ESM was to be more strongly involved in designing and monitoring loan conditionality where the Troika had previously led. This reflected LCD bargaining within Council, not deadlock. Once COVID19 demanded greater fiscal responses, this turned into deadlock not only in Council over fiscal union versus loans, but in the ESM as well.

Consolidating regime complexity

Until May 2020, Germany proposed a response to COVID19's spread by *using* ESM loans with conditionality. It showed willingness to *select* other non-EU bodies as well rather than the EU budget. Additional funds were organized in Council through the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (ERBD).

Conditionality and EU adjustment

Germany rejected calls for fiscal union from February to early May. The EU would not be granted further own funds, nor a budgetary increase, and the BICC would be the primary COVID19 response, stressing competitiveness and convergence through structural adjustment, and within the confines of the existing Multiannual Financial Framework, as advocated by the upper house of parliament (Bundesrat, 2018). Given the severity of the crisis, breathing room for national governments could be allowed by *changing*, relaxing the SGP.

The next changing of terms involved waiving conditionality on ESM loans as long as spending was for COVID19-related expenditures. Meanwhile, the Netherlands held firm on rejecting grants and imposing conditionality, threatening both ESM and EU responses.

Undersupply and instability

Further deadlock and instability ensued during these months. The prospect of an LCD-driven veto by the Netherlands on increased EU funds *and* increased use of the ESM stood across Italian refusal to apply for ESM and other loans, given the conditions that would be imposed.

But by late May 2020, the Bavarian government, normally hawkish on grants, supported them. Former finance minister Wolfgang Schäuble, also normally hawkish, admitted that loans would be insufficient, like 'giving stones instead of bread' to those in need through no fault of their own given the enormous economic and social dislocation, and the great and uneven strain on public finances (OÖNachrichten, 2020).

Overall, this short period proposed some important intergovernmental loan instruments built on the pattern established from 2010 onward. Regime complexity and ESM hierarchy from outside the EU persisted and intensified. But as the German government considered a compromise with France, it found the Netherlands threatening to veto both ESM loan agreements that lacked conditionality and increases to the EU budget (with the so-called Frugal Four).

EMU reform 3b (May 2020-)

Crisis, Franco-German rapprochement and deadlock

For the first time by June 2020, Germany's government saw the possibility of a 'Great Fragmentation' in Europe between North and South unless it pursued both domestic and European stimulus along French proposals, adding financial transfers to intergovernmental loans. A collapse of Germany's export markets and intensified need to focus on domestic demand rendered its economy more like its neighbors (Romel, 2020), making it rational to approximate the French position on fiscal union for demand management, even if domestic concerns remained about long-term viability. Furthermore, the lack of Franco-German conflict made it more attractive to work within the EU rather than outside it.

The Frugal Four (Netherlands, Austria, Denmark and Sweden) threatened to block EU grants at the European Council summit starting June 19. The same applied to loans through the ESM. Dutch PM Rutte insisted on conditionality to 'ensure that imbalances do not get more imbalanced' through pension system, labor market reforms, fighting informal markets and tax evasion. He saw no need to rush, rejecting grants, demanding that any Commission loans have conditions attached at least as stringent as those of the ESM, and after a July meeting with Italian PM Conte, that Italy further increase budget surpluses to be saved for future crises (Schaart, 2020).

Recovery plan creation alongside ESM backstop

The rapprochement described above gave German Finance Ministry official Jörg Kukies and his French counterpart Odile Renaud-Basso unprecedented room in mid-May 2020 to propose collective EU borrowing for a temporary Recovery and Resilience Fund, which would provide 500 billion euros in grants over four years. The Commission offered to raise another 250 billion to disperse as loans for countries (Italy) that found the ESM and conditionality unacceptable (Renaud-Basso & Kukies, 2020). Critically, Kukies had made such preparations since Olaf Scholz had become finance minister in 2018, but lacked the domestic political support to propose common debt until May 2020 (Donnelly, 2021).

The ESM would therefore retain its emergency loan function, providing COVID19-related loans to applicants, and augmented by loans by the European Investment Bank and European Bank for Reconstruction and Development. Closer French and German domestic politics made this incremental innovation possible.

Conditionality and EU adjustment

France and Germany preferred as few conditions as possible to access the Fund, but recognized that funds might be wasted unless they promoted structural adjustment. Kukies was primarily interested in ensuring that the finance organized would be sufficient in scope and purpose to calm financial markets, and get the Frugal Four to support the plan. This meant some form of conditionality (Renaud-Basso & Kukies, 2020). In the July summit, the Frugal Four collapsed as Denmark and then Sweden supported a deal rather than continued deadlock. The Commission's Next Generation EU plans then outlined conditions for sustainable recovery to be embedded in the European Semester system of oversight (Commission 2020). ESM conditions were waived for corona-related expenditures, but what that entailed remained vague. Failing outward was weaker than before, but for how long?

Undersupply and instability

The collective package of intergovernmental loans, plus the temporary Recovery Plan fits the pattern of just enough intergovernmental movement to avert immediate disaster that failing forward expects (Howarth & Quaglia, 2021). Like the EFSF, its temporary and limited resources raise the question of sufficiency for Eurozone stability the longer the Great Lockdown lasts, especially after the Fund's four-year agreement ends and the EU reverts to ESM-centric institutions and policies. German Finance Ministry official Kukies acknowledged that debate over transfers would resume as a result (Renaud-Basso & Kukies, 2020). The failed Dutch attempt to force continued ESM dominance and conditionality shows that decision will rest in German hands.

Discussion and conclusions: failing outward

This article argues that a failing outward dynamic is a critical mechanism for failing forward under deadlock during and after crises – a powerful state uses, selects, changes and creates non-EU institutions to hold interdependence together on its own terms through regime complexity. Access to a critical, excludable resource for holding the EU together is weaponized to demand EU institutions, policies and programs that it could not secure in Council. This maneuver to replace LCD bargaining with power politics cuts the Gordian knot, but ignores other states' interests, resulting in highly selective institutional architectures that underperform and remain incomplete, requiring further EU action. The outward institution persists as long as the powerful state's preferences diverge greatly from those of other EU Member States. This article demonstrated Germany's agency in establishing the EFSF and the ESM, and the weaponization of access to ESM funds to drive national risk reduction efforts through EU legislation and institutions. Nevertheless, financially fragile states remained vulnerable.

I also specify the conditions for a powerful state to accept renewed LCD bargaining within the EU, which is an external event that renders the powerful state's preferences more like those of its neighbors. COVID19's impact on the German economy and preferences created the necessary political room to break the taboo of common debt and cross-border transfers that France and Southern Europe wanted and needed from Germany.

The breakthrough, then, fits the pattern of piecemeal reforms that failing forward expects will drive new crises. The Recovery Plan remains temporary, small in comparison to national initiatives, and retains the ESM and its norms of national responsibility as the final guarantor of EMU stability.

Disclosure statement

No potential conflict of interest was reported by the author(s).

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