Imperfect Yet Indispensable Financial Integration
The Political, Economic, and Social Lessons Learned from the EU Financial Crisis

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Abstract

Financial integration defines European political economy. Though financial integration was crucial in establishing a common currency for the EU and a relatively shared EU political economy, it was partly responsible for the current EU financial crisis. The major question addressed in this paper is: What lessons can we learn about financial integration from the EU financial crisis? Although the EU crisis has exposed some of the glaring weaknesses of financial integration, it is essential for the EU not to financially and politically disintegrate because of the heavy political-economic interconnectedness and interdependency that constrains member states’ political institutions and economies. Though the EU puts constraints on member states’ political institutions and economies, this is acceptable because it serves the interests of the EU, which in turn provides benefits to its member states.
Introduction

Financial integration defines European political economy. Member states in the European Union (EU) are economically linked by shared monetary policy. Yet the effects of financial integration also affect EU state and systemic politics. Though financial integration was crucial in establishing a common currency for the EU and a relatively shared EU political economy, it was partly responsible for the current EU financial crisis, the worst it has endured in its short history.

Understanding the EU formation and the implementation of the EU’s common currency, the euro (the EU common currency), are crucial to analyze how and why the EU current economic crisis has occurred. In 1992, the Maastricht Treaty was implemented, establishing the EU as a network of states in Europe that would be bound together politically and economically. The economic provisions of the Maastricht Treaty were as follows: price stability and/or inflation shall not exceed 1.5% above the level of three performing EU member states; the state budget and/or government deficit shall not exceed 3% of state GDP; and the ratio of total government debt to the GDP shall not exceed 60% (Soltes 2011, 5). The Maastricht Treaty was imperative for the EU to move towards a single currency union. EU member states adopted the euro as the common currency in 1999.

Although the Maastricht Treaty laid out the groundwork for a paradigm shift from self-sufficiency to systemic integration in European political economies, EU member states struggled to meet its criteria. From the genesis of EU financial integration, member states had difficulties satisfying these rules. Of the original 11 EU member states, France, Finland, and Luxembourg were the only countries that met the Maastricht criteria (Soltes 2011). Nevertheless, Maastricht did promote self-discipline among the EU. However, it failed to require that wealthier EU countries assist struggling ones. The difficulties the EU faced at its origin foreshadowed the economic crisis that would come within the next decade.

The cases for European political, economic, societal, and cultural integration at the time the European Monetary Union (EMU) was formed were more strongly presented by countries that had greater corruption and less developed welfare-states, and was more strongly rebuked by countries that thrived more on their individuality rather than being the beneficiary of a financially integrated system. In order that fiscal discipline remain in the EU among all member states, the Stability and Growth Pact (S&G Pact) was ratified so that states would not exceed a maximum public debt of 60% of GDP and not exceed a maximum budget deficit of 3% (Mamadouh and Van Der Wusten 2010, 112). By adhering to the S&G, member states could not regulate their own monetary policy. Therefore, the political-economy of the EU became less about self-sufficiency and more about economic unification. Because EU member states shared a single currency, each state had a separate fiscal policy and a shared monetary policy. Financial integration was not a wholly embraced or wholly effective solution to growing the EU economically.

By analyzing the benefits and consequences of EU financial integration, a clearer picture emerges in regard to what political, economic, and social difficulties the EU and its member states are facing today. The major question I address in this paper is the following: What lessons
can we learn about financial integration from the EU financial crisis? The EU financial crisis is partially explained by the difficulties of financial integration. It has also demonstrated that political-economic sovereignty and political-economic integration have difficulty coexisting. The analysis of EU financial integration can be broken down into several categories: historical, theoretical, social, economic, and political. Much of this analysis takes into consideration the political-economic division and systemic weaknesses of the EU.

Although the EU financial crisis has exposed some of the glaring weaknesses of financial integration, it is essential for the EU not to financially and politically disintegrate because of the heavy political-economic interconnectedness and interdependency that constrains member states’ political institutions and economies. Though the EU puts constraints on member states’ political institutions and economies, this is acceptable because it serves the interests of the EU, which in turn provides benefits to its member states. Financial disintegration is a dangerous solution to the EU crisis. Nevertheless, the social, economic, and political lessons that the EU can learn from this crisis not only offer insight into particular topics within international political economy but also provide a means for more effective EU crisis management and solutions.

**Immediate Causes of the EU Financial Crisis**

Understanding the challenges faced by the EU as a political system and the EMU as an economic system since the Maastricht Treaty, S&G Pact, and creation of the euro help explain the immediate causes of the present day EU financial crisis. The major catalysts of the public finance crisis have come from an abandonment of financial reforms and a lack of consistency of the EU enforcing the S&G Pact. One scholar notes that in practice, the S&G Pact, “had no bite” (Fidler 2010, 1). These factors led to Europe’s economic recession and financial crisis; member states endured banking crises, defaulted, over-borrowed, over-spent, and over-lent.

The Euro area is also vulnerable to economic crises because of strict non-monetary financing, bank-sovereign independence, and a lack of co-responsibility for public debt. The system is skewed towards members cheating and taking advantage of the system with knowledge that it will always be in place to save them if required. EU financial integration was seen as contradictory because the Maastricht Treaty failed to establish a European fiscal union alongside the EMU. This helps explain the correlation of private spending and fiscal deficits. Once private spending imploded, fiscal deficit exploded. But since the EMU cannot be a regulatory body regarding member states’ fiscal policies and relative private expenditures, it left the door open for unchecked, unregulated spending. The lack of member state fiscal responsibility enforcement explains how the EU got into the financial mess it is in currently (Pisani-Ferry and Posen 2009). Overall, imbalances within the EU are the roots of the European financial crisis.

Pre-crisis risk factors included public debt, which was imbalanced and unevenly distributed amongst member states; discrepancies in private debt and private credit dynamics; financial imbalances and external imbalances; and failures to tighten fiscal policies after the 2003-2007 economic booms (Lane 2012). These factors explain why EMU coordination mechanisms of mixing shared monetary policies and separate monetary fiscal policies failed to synchronize the EU system and member state economies. Since EU monetary policy is fairly inflexible, states must look within for remedies.
The EU is currently facing a varied version of the Mundell Trilemma. One study notes that the “New EU Trilemma” is that members can have two out of three of these capacities: one being a fiscal union, two being a financial union, and three being a lender of last resort for sovereign states (Pisani-Ferry 2012). Therefore, states that desire strict no-monetary financing can have one and two, states wanting no co-responsibility for public debt can have two and three, and states opting for bank-sovereign independence can have one and three (Pisani-Ferry 2012, 8). Each EU member state considers itself a specific case with a specific set of economic policies, and, therefore, trilemma interests do not always align. Because the economic interests of member states vary widely, the EU recently entered its most serious financial crisis in its short history caused, arguably, by a lack of effective oversight of banking, financial systems, and political economy considerations (Eichengreen 2012). This begs the question of how it is plausible that some financial analysts did not foresee this crisis. If the risk potential was more seriously understood, it may have been averted or more expediently mitigated.

The relevance of the crisis to international political economy is further emphasized by how wide-ranging the crisis is and how it is not solely an economic misdiagnosis, but also reflects a lack of political will and dysfunctional politics, which have contributed to the EU’s prolonged financial troubles (Boone and Johnson 2012). As a political body, the EU reacted by implementing short term “Band-Aid” solutions. For example, it bailed out banks following the credit crisis and advocated for and oversaw stimulus programs necessitated by the danger of going into a deep economic recession. The bailout packages sidestepped original EMU guidelines that prohibited bailouts. So, in effect, it weakened market incentives for government to foster economic responsibility (Fidler 2010).

The structural formation of the EMU is still a grave failure of the EU political setup: it allows for an over-accumulation of debt in its peripheral member states and wrongly speculates EU financial market actions (Overbeek 2012). Again, this traces back to the EMU’s formation. Although the EMU could provide price stability to previously inflation-prone countries, offer protection against currency crises, and help impose budget discipline, these factors were unable to fully shelter the EU against its great recession (Pisani-Ferry and Posen 2009). Even though the euro and EU financial integration had a relatively impressive first decade, the failure of EU institutional effectiveness illustrate that the EU financial crisis is both a political and economic problem.

**Historical Analysis of EU Financial Integration**

Opponents of EU financial integration argue that doing so would weaken the system because the EU did not meet the criteria of an optimum currency area (OCA). An OCA is defined as a region that maximizes economic efficiency by sharing a single currency. Certain scholars argue that the EU is not an OCA. One scholar notes, “A single currency is appropriate in areas where labor and product markets are flexible, where labor is mobile among regions within the area, and where a central fiscal authority automatically provides counterbalancing fiscal transfers” (Feldstein 2000, 5). The experiences of a shared monetary policy/single currency throughout its first year (1999) made it clear that the EU is not an appropriate territory for a currency union because of differentiating demand conditions among member states.

In the euro’s first years, demand conditions in Germany and Italy were relatively weak
while demand conditions in Spain, Portugal, and Ireland were strong. This resulted in substantially accelerated inflation rates in the latter states. The shared monetary policy affected member states in different ways, and arguably worsened economic unevenness and discrepancies among states. Therefore, disparities of demand continued because of uneven industry growth among EU member states as well as economic policies that caused different cyclical conditions. While pessimistic, this argument is necessary for one to understand the original downsides presented by EU financial integration. A counterargument is that the EMU should be praised for reducing fiscal deficits amongst its members during its first few years.

By becoming economically interconnected and overlapping, the EMU, the political EU governing body, member states, and the EU as a whole changed the way they were thought of as a political-economic zone. Although the economic performances of the EU member states varied greatly, to ensure a smooth transition to a single currency, these differences had to be reduced. Henceforth, there were three main criteria that were established for a state to join the monetary union. A country’s long-term nominal interest rate had to be within 2% of the average rate of the three EU members with the lowest rates; inflation rates had to be within 1.5% of the average of the three EU member with the lowest inflation rates; and lastly, a country had to join the exchange rate mechanism, which required the maintenance of the currency exchange rate for two consecutive years without significant devaluation (Martin and Waller 2012, 325-328). Therefore, there were significant economic requirements to enter the EMU.

Financial integration made the EU a serious player in the global economy, though not without risks. The EU interconnectedness created interdependency amongst certain member states. It only took one failed state to destabilize the entirety. One scholar notes that the, “EMU as a project, unprecedented in its modern ambition, that comprised (one or more) failing state(s) and an incomplete, imbalanced set of rules for its governance ran a high risk of severe systemic instability” (Featherstone 2011, 210). Whether the EMU was prepared for the risks down the road was highly uncertain at the time. By establishing the euro as a common currency, the EU member states became forever linked, for better or worse, by this shared monetary union.

**Theoretical Analysis of the EU Financial Crisis**

There are many theoretical explanations that allocate blame and responsibility for the EU financial crisis. The parties involved—the individual states, the EU political system, and the EMU—are critiqued in a different manner according to several perspectives, including: mercantilism, Marxism, modern-liberalism, and neo-liberalism.

Under mercantilism, it is more important for states to maintain their political-economic sovereignty than risk it by joining a political-economic group that adheres by strict political-economic regulations and guidelines. EU member states gave up a great portion of their political-economic sovereignty when they joined the EU. Even though they were able to retain their own fiscal policy, their monetary policy sovereignty was bound to the EMU. Mercantilism suggests that the economic policy framework in the EU area is flawed theoretically because individual states lose their currency sovereignty. Furthermore, states’ national fiscal policies are subject to one-size-fits-all criteria for public deficits and debt, according to the S&G Pact (Hein et al. 2011). Mercantilists, such as a majority of pre-Adam Smith scholars in political economy, would argue that the EU’s formation was a poor decision in the first place and that states did not
acknowledge that a loss of their sovereignty might not be to their advantage.

In the mercantilist explanation of the EU financial crisis, the blame is shared between the EU, EMU, and member states; they are all responsible for individual states being weakened by buying into a system. Since member states are already incredibly financially integrated with one another, it would not make economic sense to leave the EMU. Instead, a mercantilist solution would be to build stronger states from within. Further EU integration will sacrifice any remaining political-economy sovereignty that EU members have as well as the power individual states have on an international level (McNamara 2003). An example of this would be the IMF acting as a fiscal discipliner for the EU; this exemplifies a lack of EU political-economic sovereignty since an outside actor is regulating the EU fiscally (Fidler 2010). Therefore, it is imperative that member states maintain their political hard power if they wish to emerge less scathed from the financial crisis since they have already lost a great deal of economic power.

Under Marxist theory, the EU financial crisis is not caused by states weakening because of a shared monetary system. Rather, it is state behavior within the system and systemic favoritism that has dragged the EU into this mess. Specifically, Marxist theory focuses on the political-economic exploitation of the weaker EU member states (the periphery) by the stronger EU member states (the core). Marxist views of European integration, such as those of Karl Marx, Vladimir Lenin, and Mao Zedong, look at the failures of the international and state institutions. The discrepancies of the EMU and member states fiscal policies are sometimes vast. Since state fiscal policies have different agendas, they sometimes conflict with the EMU and other EU institutions; the institutions are controlled by states with more fiscal sway, creating a power dynamic (Georgiou 2010).

A Marxist explanation may not tell the whole story, as peripheral countries piggy-back and free-ride off the EU system. This is a major reason why the EU financial crisis has developed as it has. Peripheral states expect their troubles to be alleviated by systemic help. However, with the core countries financially struggling too, the system as a whole is weakened and the periphery is not able to reap the benefits of the system as much as previously (Sanchez-Cuenca 2000). Dependency variables—including corruption and expenditure of social protection (as a percentage of GDP)—also help illustrate that states in the periphery are dragging down the core states and the EU system. Marxism, like mercantilism, suggests that financial integration is dangerous for member states and is also hazardous in terms of systemic exploitation. Therefore, the EU will have to stray from focusing on borrowing countries as culprits if it wants to solve the crisis (Meyer Eppler 2011). The peripheral problems are connected to structural shortcomings in core states and the system; if the EU fails to recognize this, it faces an arduous future.

A modern liberal explanation of the tumultuous EU political-economy argues that the system does not need an overhaul but that greater EU systemic governance is necessary to support the weaker states. A stronger EU presence is a necessity in retaining a strong political image. Because of the division and political power disparities in EU member states, the EU does not have a solid enough external voice (McNamara 2003). The European Central Bank (ECB), EMU, and member states are all competing for influence and political-economic power in the EU. This is perilous because it arguably dwarfs EU political power as a whole. There is a
division of ideas regarding what the EU is as a political body, with one solution being a greater federal vision of Europe and another being a looser collection of sovereign states. Modern liberals, such as John Maynard Keynes and many left-wing politicians and economists of today, promote the former as their methodology on combating this financial crisis. A greater federal vision will give the EU a single voice which can be viewed as an instrument of power in regards to trade, international representation, EMU policy coordination, and macroeconomic policy (McNamara 2003).

By proposing a clear and stronger system of political-economic representation for monetary and financial governance, modern liberals argue that the EU will more likely avoid financial calamity because member states will be more aligned. This will give the EU international power and domestic accountability, two attributes it drastically needs because fiscal irresponsibility has been high and member state accountability has been low. Because of this, the EU as a system has undergone a diminishment of its international power as well as a decline in its political will—more of a member state flaw than something that comes with financial integration.

Modern liberals also note that states must weaken their individuality and trust that EU integration will still present potential for achieving something greater than the sum of its parts (McNamara 2003). If support of a supranational institutional framework is high and approval of national institutions is low, a member state will favor continual and expanded EU politic-economic integration, with the opposite being true for member states favoring their national institutions over EU systemic institutions (Sanchez-Cuenca 2000). Modern liberals would aspire for states supporting EU and national institutions instead of no support for either. In the former case, member states will still support integration; in the latter, they will not. The modern liberal response to the EU financial crisis of greater economic, political, and fiscal integration parallels some of the aforementioned measures the EMU and ECB are undertaking currently. Even though greater economic integration has promoted greater political integration within the EU, the jury is still out on the modern liberal crisis solution.

A neoliberal explanation of EU financial integration and crisis management has the same core foundation as the modern liberal explanation in that the EU system must stay in place for member states to succeed economically. Unlike modern liberalism, which promotes greater EU political-economic integration, neoliberalism argues that member states need to exercise greater economic self-governance and not be as reliant on the EU system. A lot of neoliberal thought has developed in political-economies within the last half-century, such as Margaret Thatcher’s U.K. and Ronald Reagan’s U.S. Nowadays, neoliberalism is associated with many prominent right-wing politicians and economists. Although it shares a somewhat similar philosophy to the mercantilist approach, it is not as extreme and could be seen as a middle ground between the mercantilist and modern liberal methodology. By promoting a greater individual state presence and a weaker EU presence, each member state is able to take more responsibility for its contribution to the EU financial crisis.

Since the beginning of European integration, the EU was actually founded on neoliberal policies. Regrettably, these neoliberal policies foster disintegrative economic tendencies and intensify EU structural difficulties. Therefore, neoliberal solutions have the potential to lead to
EU de-unification, which could be difficult for peripheral states and their economies. Neoliberal thinking was very much a part of introducing a common currency (the euro) in that it was a hard currency that would discipline inflationary spending and labor (Becker and Jager 2011). Furthermore, neoliberal principles have been used to justify financial crisis emergency measures in terms of individual state-wide crisis mitigation and avoidance policies (Jessop 2012). Individual states, mainly core countries, that believe their national institutions and policies are stronger than corresponding EU ones have undertaken these neoliberal measures. For these states, co-dependence was one of the major reasons for the EU financial crisis. Now, the co-dependence of the system has exposed the EU’s fiscal fragility and structural weakness. Financial integration can still be effective in neoliberal thought but must be monitored more by individual states than regulated by the EU governing body.

Peripheral Southern Europe and Hegemonic Northern Europe

To further comprehend the longevity and severity of the EU financial crisis—notably the Northern-Southern European political-economic divide—the political-economic struggles of the weaker and stronger EU member states must be reexamined. The less powerful states, collectively known as the GIIPS (Greece, Ireland, Italy, Portugal, and Spain), face the brunt of the crisis. All have faced sovereign risk pressures that, combined with a shared monetary union, create a shared monetary debt amongst all EU members. Some academics question the potential for real and nominal convergence of fiscal and monetary policies in the Eurozone. Since different fiscal and monetary policies have conflicted thus far in the EU and are still a major factor in the ongoing crisis, the GIIPS may not have been ready to share a currency and may regret the decision to this day. However, there is potential for solutions to this economic policy conflict. EU member states are looking into their fiscal inadequacies and trying to fix them instead of playing the blame game on the EMU shared monetary policy (Pisani Ferry 2012). What has transpired since 2008, though, is regrettable and unforgettable in the GIIPS.

Greece has had the most difficult time enduring the shared EU financial crisis. The Maastricht Treaty and systemic dysfunction in the Greek economy were the catalysts in its downfall and collapse. Greece’s deficit to GDP ratio was, incredibly, just under 16%, quadruple the amount set by the EU economic criteria. Because of this massive deficit/GDP ratio, Greece defaulted and its debt was forgiven by the ECB. However, the fact that EU member states were originally reluctant to help Greece left its government spending unchecked. It was also contrary to the EU unifying philosophy because wealthier member states were more interested in the health of their own economies than the EU’s systemic monetary health (Mamadouh and Van Der Wusten 2010). Since Greece defaulted, there was a deficiency in the financial health of banks across the EU. Therefore, Greece and other smaller European economies were elevated to the too-big-to-fail category (Fidler 2010). Greece borrowed 110 billion euros from the International Monetary Fund (IMF) and its EU partners under strict mandates that included a sizeable reduction in Greek government spending (Kentikelenis et al. 2011). This explains why Greece has had very little money and few opportunities to spend on government social programs, leading to social unrest because of a decline of health and health care. Furthermore, the EU policing has led to backlash among the Greek population and de-legitimized its government.

Although Greece’s economy has been monitored by the EU because of the bailout, the fact that Greece had to rely on a greater body to monitor it raises the sensitive issue of where the
legitimacy and governability of Greece stands right now. Bailing out Greece can help alleviate its short-term debt issue. However, it fails to provide long-term solutions to enable Greece to avoid monetary crises in the future. Although austerity measures have shown a limited amount of acceptance amongst the Greek population, Greece cannot yet see a clear end to this recession. To win back acceptance with its people, Greece’s government must accept the EU decision making, carry out reforms and adjustments, and reshape its political classes and their agendas to restore its legitimacy. Greece’s economy, although representing just 2.7% of the EU’s GDP, almost single-handedly wrecked the system. This case demonstrates that financial integration is incredibly challenging since a relatively small economy almost led to the collapse of the entire EU. Even though Greece dragged down other members of the EU, it is imperative that it remains in the system for Greece and the EU to survive through and beyond periods of crisis.

The other members of the GIIPS have experienced similar, albeit not as severe, economic crises throughout the EU recession. The debt crises in Ireland and Spain have been caused by banking weaknesses, the banks in these countries were over-connected with the government. Therefore, when the banks failed, the balance sheets of the Irish and Spanish governments became liable. In 2007, Ireland’s debt-to-GDP ratio was 25% and its deficit-to-GDP ratio was zero. By 2010, the debt/GDP rose to 93% and its deficit/GDP was over 30% (Martin and Waller 2012). The steep progression of Ireland’s sovereign debt has been monumental. Since the EU has focused its resources on bailing out Greece, Ireland has not received the same degree of support. It is essential that Ireland’s sovereign debt be paid in full because it is dependent on international trade and investment to sustain its economy. Fortunately, Ireland’s government has already carried out fiscal adjustments with moderate degrees of success (Cline 2012). In Spain, the current economic crisis is largely due to external imbalances resulting from fast growth but little increase in relative wages (Cline 2012). Spain has also experienced a bursting of its housing/property bubble, paving the way for a sharp recession.

Portugal is a similar case to Ireland in that its debt/GDP ratio increased from 48% in 2000, to 68% in 2007, and to 93% in 2010 (Martin and Waller 2012). Throughout the 2000’s, Portugal also maintained a relatively low deficit/GDP ratio at 3%. By 2010, it climbed to 10% (Martin and Waller 2012). Besides Greece, Portugal may be in the most trouble of the GIIPS due to its rising debt and deficit rates combined with a 12.5% unemployment rate as of the end of the fiscal year 2011 (Martin and Waller 2012). But as in Ireland, austerity measures have been taken to cut public expenditures and concentrate on wage relations (Becker and Jager 2011). In Italy, the EU economic crisis has only hit recently. Italy was fiscally balanced for a decade before the crisis, had large private savings, and a strong manufacturing sector. The adverse economic effects of Greece’s crisis (mainly contagion) forced the Italian government to implement economic reforms that include cutting transfers to local authorities, raising capital gains and value-added taxes, and renegotiating the social security system (Cline 2012).

Some lessons learned from the struggles of the non-Greece GIIPS are that default preventative measures may not be enough to reverse the lackluster growth that has plagued these vulnerable countries for years. Fortunately, the swift action taken by the EU on Greece has prevented the other GIIPS from defaulting (Lazear 2011). Therefore, financial integration can help mitigate widespread defaults that would wreck the system. The IMF can also provide funds from the EU and the rest of the world to put together a sizable new support program for the
GIIPS (Bergsten and Kirkegaard 2012). This again affects EU political-economic sovereignty. Overall, the GIIPS are resorting to finding immediate solutions to their economic issues rather than devising a plan to provide lasting economic success and avoid future financial crises.

The leading economic powers in the EU that have not been as devastated by the financial crisis are France and Germany, and in general, the Northern European member states. France, and especially Germany, can be termed the hegemons or leaders of the EU. Their economies, political systems, and influence in EU decision-making are stronger than their Southern European neighbors. By providing financial assistance and debt relief to the GIIPS, France and Germany are feeling the economic effects of the EU financial crisis. Instead of jointly proposing economic solutions to the EU financial crisis, Germany and France are proposing different solutions, a sign of divisiveness at the top. Germany believes that the crisis stems from members violating the S&G pact, whereas France argues that it was an originally negligent response by powerful EU members that caused and, thereafter, exacerbated the crisis (Mamadouh and Van Der Wusten 2010). They are both strong economic powers being weighed down by the financial system. France favors greater systemic financial oversight while Germany favors greater self-sufficiency and accountability. Exhibiting Marxist and modern-liberal ideas and behavior, scholars note that, “given the strong role of the state in French finance, successive governments have favoured domestic consolidation of banking and financial services in order to make domestic actors fit for EU-wide and international competition” (Grossman and LeBlond 2011, 21-22). French ideology and policy are concerned with the systemic well-being first and state power second.

On the other end, Germany favors a more mercantilist and neo-liberal solution to this shared economic crisis. It is arguably more concerned with self-gains than overall EU gains (Becker 2011). This is contradictory because Germany is accepting greater trade liberalization but insisting on greater obstacles to EU financial integration. One scholar notes, “this is mainly due to largely segmented markets in Germany…the implementation of reforms, such as the respect of EU state aid rules, has proved difficult and politically explosive, as regional governments have supported regional and local players at the expense of EU rules” (Grossman and LeBlond 2011, 22). Germany was also hesitant to support measures such as substantial EU rescue packages that were developed to avoid sovereign debt crises. Against French opposition, it even went as far as using the IMF for financial support for these rescue packages instead of its own funds. Therefore, Germany is setting a poor example as hegemon by letting federal actors override EU and EMU criteria. If the core states play by a different set of rules, than periphery states (GIIPS) believe they have the right to do so as well. This view may be too harsh on Germany. Its perseverance throughout the EU financial crisis can be heralded as a success because of its surplus in a time of deficits for other EU member states.

Even though financial integration has not hampered Germany’s economic success, it still faces domestic problems of a frail banking sector, lackluster investment performance, and rising inequality (Meyer Eppler 2011). This gives credence to the fact that Germany will still face trouble similar to the GIIPS. Instead of lecturing borrowing states about their irresponsibility, Germany should acknowledge its role in the EU financial crisis in that its careless and neo-mercantilist lending policies are just as much to blame for the continuation of the crisis as is excessive borrowing by the GIIPS. Germany needs to realize that by helping the system, it is
helping itself. One academic points out that Germany may be softening its lending stance by supporting the Eurozone periphery through the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) (Meyer Eppler 2011). By propelling and spearheading EU support measures, Germany will gain more from the financially integrated system and will establish greater legitimacy as the EU hegemon.

By comparing, contrasting, and analyzing the weaker Southern European member states and the stronger Northern European member states, there is a clear core-periphery divide in EU political economy. In 2005, most EU states were benefitting from a financially integrated system because the political-economic power dynamics were much more marginalized. However, post-2005, expected growth fell off in Southern European states because of current account imbalances (Campa and Gavilan 2011). These current account imbalances among weaker member states explain how individual current account imbalances are combined into a collective one in a financially integrated system, which can result in an interconnected financial crisis. Italy, Portugal, and Spain are among the member states estimated to have greatest current account volatility (Campa and Gavilan 2011). The many current account imbalances in the EU have created an inefficient allocation of capital, “fueling real estate bubbles (Spain and Ireland), high public deficits (Greece), and excessive private consumption (Portugal)” (Meyer Eppler 2011, 3). It is essential for EU and EMU longevity that the ECB and wealthier, more influential states, take their fair share of responsibility to help alleviate the overall GIIPS debt.

If unaddressed, sovereign debt and current account imbalance discrepancies between peripheral Southern Europe and core Northern Europe will increase, in which case peripheral countries may leave the EU. This would cause a massive disruption and lead to the potential dissolution of the EMU (Aslund 2012). Although the core member states may argue that this has potential, history suggest that there is only one recent success story of a breakup of a currency zone (Czechoslovakia in 1993) and forewarns an EU breakup would be more similar to the much greater recent failure of the Soviet Union-Yugoslavia currency zone breakup (Aslund 2012). One scholar argues that a more viable alternative than Northern Europe funding debt instruments to Southern Europe would be for them to buy Southern European goods and services (Bergsten and Kirkegaard 2012). Regrettably, this would also present issues within these states’ domestic economies.

It is debated whether the North-South divide and overall EU financial crisis is due to systemic flaws (the popcorn theory) or one country’s economic problems spilling over to the others (the domino theory). The EU presents a unique case in that it illustrates both theories. Greece’s defaulting impacted the system greatly, but it was the fact that the EU is so interconnected that there was such an economic shock-wave of a response hitting other member states (Lazear 2011). The philosophical differences between Southern and Northern Europe need to be bridged or else there will be a continuation of lackluster growth within state economies and the system as a whole.

The Social Explanations and Lessons: Power Dynamics, Morality, and Free-Riding

Although the EU financial crisis is a sign of both economic and political weakness within Europe, weakened national and regional institutions—state-governments and the EU governing body—have affected EU societies. Specifically, class dimensions and inequality have been
significantly pronounced since the beginning of the crisis. Class inequalities in countries such as the GIIPS have paved way for violent protests over the last few years. Because some of the GIIPS’ population has denounced their governments as illegitimate, they have resorted to violence.

A recent example of this has been a series of protests involving Greeks storming parliament in Athens to voice their displeasure with economic stagnation, failed austerity measures, and high unemployment (Kentikelenis et al. 2011). These riots have the feel of an elites versus masses struggle. The Greek population wants its voice heard in decision making. Unfortunately, it has been relatively silenced at the expense of Greece’s government looking towards EU-inclusive strategies to combating its financial and sovereign debt crisis. Greece’s social unrest illustrates that its economic crisis can help explain the limitations of representative democracy in the EU. Democracy has been diluted in Greece and the rest of the GIIPS because their governments are a puppet to the EU. This has caused ample concern that state institutions may not have the power that populations believed they had to improve social well-being during an economic crisis. Representative democracy in states has been unsatisfactory in the GIIPS throughout this crisis.

Social lessons that can be taken away from the EU crisis are explained not through a government versus population scenario, but rather through individuals’ behavior during the crisis. If people in the GIIPS know that the EMU will be there to support them and make sure their state does not collapse, individuals in those states may not be as active in seeking employment if they know they can free-ride off the government. This creates a social and moral dilemma for the GIIPS; if more people are free-riding off welfare checks, fewer people will be productive members of society.

In the hegemonic states such as France and Germany, individuals have to sacrifice more of their earnings to their respective governments to enable their governments to provide money to the struggling GIIPS. This creates another moral hazard in core EU states. Faced with higher tax rates, individuals in France and Germany may be more likely to save money than invest (Meyer Eppler 2011). This would be detrimental for economic and social growth in hegemonic states. The free-rider social issue in the EU is one of the largest impediments to effective progress in social reforms.

The Economic Explanations and Lessons: Fiscal and Monetary Policy, and Sovereign Debt

One of the underlying causes of the EU financial crisis has been overviewed as the conflict between members shared monetary policy but separate fiscal policies. The current fiscal disturbances and imbalances in EU member economies are ample. The EU financial crisis is rooted and intertwined with the ECB banking crisis and macroeconomic imbalances that harm the EU member states. Therefore, one must analyze the costs and benefits that the EU has being both a monetary union and an optimum currency area. Economic measurements include the degree of openness, production and diversification, international economic competitiveness, and integration of monetary unions (Bukowski 2011). One of the economic precursors to the EU financial crisis was that member states attempted to derive future incomes and relative prices from current accounts (Campa and Gavilan 2011). Therefore, one should not blame the EMU’s shared monetary policy for the crisis genesis, but instead blame state fiscal (current account)
Economists are now attempting to find innovative solutions to address the dichotomy of EU member states having shared monetary but separate fiscal policies. The EU monetary policy can be reformed via inflation targeting through short-term interest rate policies and financial market deregulation. Likewise, member states’ fiscal policies can be unified through greater efforts to implement a one-size-fits-all recommendation of stability oriented fiscal policies. The EU also needs to emphasize structural reformation that demonstrates a reliance on wage and price flexibility and capital mobility as adjustment mechanisms to macroeconomic imbalances (Hein et al. 2011). To ensure a more level playing field and mitigate the weaknesses of its shared monetary/separate fiscal system, the EU must continue to measure regulatory and legislative activity of its financial institutions and examine the degree in which its markets are converging. The debate regarding whether the EU should economically regulate or deregulate its markets and integrate or disintegrate its members’ economies will continue until EU economies strengthen.

The most significant actors in lightening the EU’s and member states’ financial and debt burdens have been the EMU and the ECB. These institutions have shared but different roles in the European political economy. When the EMU was formed, it was characterized as a full and irreversible convertibility of members’ currencies, a full liberalization of capital transactions and full integration of financial markets, and the elimination of fluctuations of exchange rates and their irrevocable fixation (Isa 2002, 16). This gave the EMU a great deal of control over its member’s economies, especially in terms of trade and exchange. Regarding the ECB, it bought weaker members’ sovereign debt via a 750 billion euro bailout package (Kolb 2009). By taking money out of their reserves and significantly weakening their balance sheets, the EMU and ECB may not even exist in the future. The ECB has the ability to write a check and begin to purchase much larger amounts of relevant sovereign bonds. Even though the bailout reduces individual state debt, the collective monetary union debt is problematic because capital is not being created, it is simply being reallocated. Nevertheless, the EMU is praised for having the ability to affect the bailout by having a single currency system in place. Single currency unions enhance banking integration and eliminate currency risks that promote transparency and deter competition. And by providing necessary financial aid, the EU assumes the risks associated with being a shared monetary union and an OCA.

EU governments and the ECB have fought over ways to save the euro. The ECB argues that a unified fiscal entity could combat financial crises whereas EU member governments have used a shared system of ECB government programs started from scratch to combat their individual state-level crises (Bergsten and Kirkegaard 2012). Together with the ECB, the EMU has been the catalyst in shaping EU monetary policy. Its primary goal is to maintain price stability within the EU. The ECB is currently evaluating the effect of economic shocks on price stability. It uses a system of money stock and financial indicators to formulate further quantitative economic solutions. The failures of the ECB throughout the last few years indicate that its inaccurate prognosis of a financial crisis have deeply rooted the EU’s aforementioned economic issues. One cannot solely blame the ECB shortcomings though, as EU financial integration should also be viewed in the context of global financial behavior and integration. Trends in the EU and global economies can also help explain strengths and weaknesses in
financial linkages (Lane and Walti 2006).

A counterargument to the EMU/ECB vulnerability is that the EMU/ECB has actually limited the impact of the EU financial crisis regionally and globally because they have prevented exchange rate and interest rate tensions among members, reduced the level and volatility of inflation and interest rates in the EU, and have adopted a resilient monetary stance that has adeptly managed liquidity (Pisani-Ferry and Posen 2009). There are other causes of this crisis than a systemic or institutional EU weakness. The EU would be worse off without the EMU and ECB. If these institutions did not have the capacity to alleviate the EU’s and member states’ financial and debt issues, then not only would those states suffer but other countries that peg their currencies to the euro would be in economic trouble as well. Therefore, the EMU and ECB are critical institutions in the financially integrated EU.

The EU economic crisis can be broken down into three levels: sovereign debt, banking, and underinvestment (Varoufakis and Holland 2011). The EU financial shock became a sovereign debt crisis when yields on sovereign bonds collapsed in Greece, Portugal, and other peripheral EU member states. The sovereign debt crisis is arguably the most pressing and urgent to mitigate because it presents many dangers and consequences to EU members and is growing rapidly among certain states. The borrowing and lending is multilayered: The indebted member states borrow money from the EU, and the EU borrows money from the IMF. The economic costs of borrowing and temporarily revitalizing collapsing economies may not be worth the long term setbacks for the borrower (Kolb 2009).

To mitigate sovereign debt, the EU needs more mechanisms to initiate debt resolution procedures, conduct negotiations, and provide credit, something it has struggled to comprehensively solve (Gianviti et al. 2010). One economist notes that members affected by sovereign debt are looking too inward for solutions. Instead, they should be looking outwards towards the global financial crisis and find more macro-solutions (Overbeek 2012). Individual and collective sovereign debt is becoming a frightening situation in the EU. An assemblage of sovereign debt is arguably the worst economic scenario for a financially integrated system of states.

Additional economic lessons include moral hazards associated with member states’ external indebtedness, as well as how state-wide debts can lead to union-wide debts. The ECB-led bailout presents a potentially dangerous solution to EU survival. Even though it may have been fiscally responsible, caution should have been exerted to a greater extent so that states were not presented with morality choices of compensation versus a free-riding the system (Boone and Johnson 2012). For the EU to mitigate its sovereign debt crisis, a mechanism must be in place that will solidly restructure debt. It is essential that debtors and lenders minimize moral hazard problems that would effectively create more controversy, such as Germany blaming the GIIPS. Rules and guidelines need to be established to provide financial assistance to debtors; it should not be provided unless there is a strict agreement put in place by the debtor and lender regarding the restructuring of the debt (Gianviti et al. 2010).

By improving the relationship between the debtor and the lender, there is potential for more collaboration and cooperation between EU member states, thereby expediting resolution of
the sovereign debt crisis. Solving the sovereign debt crisis is imperative to long-term EU economic success, and the EU must learn the lessons of having the combination of a self-governing EU financial market with the ECB and member states acting as lenders of last resort and insurers. (Menendez 2011). There are conflicting economic forces at play here, so the EU must step back from labeling it as an economic crisis and instead characterize it as a political-economic crisis.

The EU can take away many economic lessons from its current financial crisis, the most obvious and critical being that EU states cannot have both individualized monetary and fiscal sovereignty because of the euro and its limitations. Even though state monetary policies are sacrificed for the greater good of the EU, it is essential that state fiscal policies are less realist and mercantilist. In the EMU, state economic power is not nearly as vital as it would be if states were not part of a shared monetary union.

Realist approaches to fiscal policies are inherently limited because they undermine the possibility for integration and cooperation among individual states. If state fiscal policies can be reformed to the benefit of the individual state and the EU system, this would be ideal. Fiscal reformation also presents the possibility of alleviating sovereign debt issues within states. The lessons learned from a shared monetary policy trace back to the EU and EMU founding discussed earlier in the paper. It is inherently more difficult for a state to control and govern than its fiscal policy. Therefore, it is necessary that EU states look inward at their own fiscal policies and make them more conducive to integration than blame the shared monetary policy.

The Political Explanations and Lessons: Sovereignty, Stability, and Legitimacy

The EU financial crisis has been intensified largely because the EU as a political union is institutionally flawed. By agreeing to a shared monetary union, member states are sacrificing some of their individual state political power for the sake of a multilateral, transnational, collectivized power. The interconnectedness of economic and political sovereignty directly affects the legitimacy of a state, state government adequacy, and social growth. And the divergence of EU member states in regards to economic policy, political sovereignty, and representation is vast. One scholar summarizes these differences by noting that “monetary, trade, and competition are within the competence of European institutions; others, like fiscal and structure policies, which are also part of international policy cooperation, remain largely the competence of the Member States” (Smaghi 2006, 261).

European integration is a contradictory process. Although states share capital because of a transnational, integrative monetary policy, they are arguably too self-interested in their own problems (Georgiou 2010). Therefore, the collective union as a whole suffers. Perhaps the EU needs to have the elements of a stronger political zone to limit self-interested behavior of its states. Indeed, one scholar notes that the survival of the EU is dependent on whether it can establish a more legitimate political union. He notes that there must be a transfer of sovereignty in conducting macroeconomic as well as monetary policies, and member states that have misbehaved should be given less authority over their political-economic sovereignty (Baldwin et al. 2010). This would dis-incentivize members to cheat the system and bind them more tightly to the rules and regulations of the EU and EMU.
Having a stronger political union would prevent differences in economic competitiveness and address trade imbalances amongst member states. It could also encourage greater political-economic cooperation within the EU. A political union could redress the imbalance fault line and result in a transfer of sovereignty in economic policies (Baldwin et al. 2010). The EU financial crisis became a debt crisis because of governments’ reckless economic spending. A default in one state increased interest rates on bonds issued by other EU governments, thereby increasing their borrowing costs (Fidler 2010). Even though budget policies in the EU were interconnected, there was no mechanism in place to prevent governments from overspending. Political weaknesses at state and systemic levels were exposed by a flawed financially integrated system.

Another systemic weakness of the EU is that financial integration and the EU financial crisis results in winner states and loser states. As analyzed in the above case study section, the more unscathed states in this crisis continue to be hegemonic ones whereas the affected states are largely comprised of the peripheral ones. Some believe that the EU’s economic weakness will continue for the foreseeable future, thereby presenting more negative consequences for the periphery and harming the democratic legitimacy of the EU (Overbeek 2012). This pessimistic view of the crisis is one that will continue to haunt the EU unless political transformation narrows the gap between winners and losers. Another argument is that the EU must democratize more, as there is a clear differentiation of political-economic power between Northern and Southern European countries (Hix 2008). However, EU political failures are not an institutional design failure. Rather, shifts in policy are severely weakening the EU as a whole. This gives the EU a credibility crisis among its members and members’ societies.

The EU is also encountering difficulties as to whether it is a regulatory or supervisory body. It appears regulatory as to monetary policy yet supervisory as to fiscal policy. This differentiation gives the EU a lack of accountability on a national level, where member states have historically not applied mandatory EU policies in their governance (Hix 2008). These policies include trade liberalization, industrial regulation, and agricultural policy. EU financial integration policies apply better for the core hegemons than the EU periphery, again creating winners and losers. Evidence that these policies affect peripheral countries more than core ones are shown in terms of peripheral countries’ public debt, lack of balanced fiscal budgets, unemployment rates, and lack of effectiveness in fiscal adjustment programs (Bieling 2012). Until some type of EU political reformation occurs, the hegemonic countries will continually be strong and the peripheral countries will continue to suffer.

When EU financial integration went awry, it created stability and legitimacy issues within member states and reflected in the EU system as a whole. Since the euro’s genesis in 1999, the EU has lacked political institutions that would restore financial stability in times of economic uncertainty and market volatility (Bergsten and Kirkegaard 2012). Therefore, instead of being categorized as a fiscal crisis, a competitiveness crisis, or a banking crisis, the flaws of financial integration can seen as a political crisis because of the structural flaws and functionality of the EMU, the euro, and the ECB. Even though EU banking systems are linked together, it is the policy decisions by political actors that are most important to the survival and prosperity of the EU (Lane and Walti 2006).
Arguably, there are a greater number of potential triggers for an EU collapse than other financially integrated systems. They include a unilateral exit, periphery states continually fighting with Germany (and vice versa), failed austerity measures, and markets losing patience (Boone and Johnson 2012). Therefore, it is imperative that political reform deter stability and legitimacy issues. The counter view: even if “a credible, strong, and democratically legitimated new style EMU with strict regulated financial markets were to emerge, it is very unlikely that this would mean the end of economic and financial problems” (Overbeek 2012, 45). This argument is pessimistic to a greater democratized and regulated EU fixing the crisis. It suggests a negative correlation between greater governance and institutional integration in the EU economy and a solid economy recovery.

The EU needs urgent measures in containing the crisis to restore stability and legitimacy. These include a more resilient EU financial sector and stronger international coordination (Pisani-Ferry and Posen 2009). By deflecting the focus as a regional financial integration problem to a global economic problem, the EU can arguably regain credibility that it has lost among its members by member states economically fighting each other. As an international organization, the EU has suffered from a lack of enforcement against its members. If member states cannot follow protocols and obligations, the legitimacy of the EU as a governing body declines because it has less authority over the actions of its states (Soltes 2011).

Member state failures have trickled down to EU societies. Regimes are marred by economic policy failures and declining levels of public support, factors that directly correlate to a declining level of legitimacy. Citizens across the EU have lost trust in their policymakers and respective governments because of their flawed responses to the EU financial crisis. The policymakers must re-establish systemic and institutional trust in the EU and member state governments to legitimize order once again. One scholar succinctly states, “When trust breaks down, the social system is threatened with unrest, the democratic legitimacy of the political system is endangered, and the legitimacy of the marker-based economy is called into question” (Roth 2009, 203).

Solutions to state political mistrust in the EU are simple yet complicated. One solution is greater, smarter state intervention in markets at a national and regional level, and overall less economic integration and globalization. Government mistrust has reduced people’s confidence in EU institutions as well as their national institutions. A polling of EU citizens found that the majority now distrusts the ECB, the first time this has happened since the ECB implementation (Roth 2009). Therefore, there seems to be a positive correlation between government distrust and supranational, multilateral EU institutional distrust. This all ties back to EU systemic political failures. If states cannot adhere to terms regarding EU systemic arrangements, than why should the EU exist? Its power is only as strong as what its members put into it.

The political lessons that can be taken away from the EU financial crisis are that even though the EU is exemplary in acting as a unifying body for states with different political, economic, and social standings, it creates problems of ensuring member states’ political sovereignty and autonomy. Financial integration has helped fix problems in Europe over the years in the political realm, such as preventing violent interstate conflict. Nevertheless, financial integration not only weakens states’ political power but also creates economic and political
dependency by peripheral states to hegemonic ones. There are important political trade-offs in the EU; these trade-offs explain the EU’s struggles as a political body throughout this economic crisis.

Another major lesson involves the persistence of realism in EU financial integration. Similar to mercantilists, realists argue that there is no point in attempting to integrate individual countries beyond the minimal level because it is, in the end, the interests of each state that will always be prioritized by governments of those states. Germany is a prime example of failed realist behavior. Although it initially resisted, Germany ultimately financially assisted the GIIPS. This signifies that realist state political behavior has no place in the EU. Systemic integration outweighs state self-interested behavior. In the future, it is imperative that EU states not exhibit realist political tendencies at the outset so EU states can limit bickering about their respective political and economic responsibilities. If all states are on the same political page, it will make for a more conducive economic recovery.

Proposed Solutions and Fixes: The Hazardous Necessity of Financial Integration in the EU

One proposed solution to the EU financial crisis would call for the dissolution of the EU and end of EU financial integration as we know it; some member states and populations are calling for it already. Although this would provide certain benefits, it would be catastrophic in the long term. It would be devastating for the EMU to collapse because of its large, un-cleared imbalances. A debt default by weak countries would not strengthen their case for leaving the EU. For example, a Greek exit would devalue Greece’s currency and disrupt EMU payment mechanisms (Aslund 2012). The costs of the damage to the EMU of a breakup would outweigh the need for a breakup. Furthermore, linked financial institutions throughout the EU and the rest of the world would be badly hurt. This potential cost could pave way for many years of a global depression. A well-functioning payments system is vital to the survival of the EU and to prevent the domino effect of an EMU collapse.

One scholar presents a five measure plan that will help the EU survive: instituting an immediate program to deal with excessive sovereign debt, having far more aggressive plans to reduce budget deficits and make peripheral nations “hypercompetitive” in the near future, having a supportive monetary policy from the ECB, introducing mechanisms that credibly achieve long-term fiscal sustainability, and having institutional change that reduces the scope for excessive leverage and consequent instability in the financial sector (Boone and Johnson 2012, 1). Though these measures are simple on paper, their execution would be challenging.

The EU’s one-size-fits-all monetary policy deserves critique because it helped get the EU into its current financial crisis. Yet, it is still more beneficial for the EU to propose small structural changes to its monetary policy and encourage states to reexamine their fiscal policies. To alleviate and eventually solve the EU financial crisis, three reform options are: a broader ECB mandate, the building of a banking federation, or a fiscal union with common bonds (Pisani-Ferry 2012). These policies would entitle the ECB as the lender of last resort for sovereigns, break the vicious dilemma of the banking-sovereign crisis, and establish a fiscal union. Though all three would potentially be feasible, enacting them would be difficult because of a lack of common EU political will.
Fiscal issues in the EU include cyclical tax receipts, monitoring private debt development, excessive external imbalances, and broader use of fiscal stabilization policy (Baldwin et al. 2010). One proposed solution to countering these is to set up fiscal councils in EU member states. Greater cooperation mechanisms would help develop mutual trust among member states and establish greater surveillance of fiscal irregularities. Another solution focuses more on restructuring sovereign debt and bank debt without a fiscal transfer of taxpayers’ money. It involves transferring member state sovereign debt to the ECB to be held as ECB bonds. These scholars propose that member states reduce the debt burdens of the most afflicted while not enlarging it for others (Varoufakis and Holland 2011, 2). By stabilizing debt through transfers and holding them as bonds, the idea is that more capital would flow from state banks which, in turn, would create more sovereign wealth. This would incentivize the European Investment Bank (EIB) to fund the European Economic Recovery Program (EERP) to a greater extent.

A final reason that explains why the EMU is so difficult to maintain traces back to it being originally not well-suited to be an OCA. Fiscal federalism is undeveloped at an EU level due to political reasons and statewide political-economy sovereignty. Furthermore, the small EU budget is disproportionately allocated to agriculture and infrastructure. This has paved the way for resistance from high income core countries (Eichengreen 2012). This poses the question of whether there will be more resilience if there is greater discipline for economic austerity. Instead of disbanding monetary policy, the EU needs an integrative solution of simultaneous economic surveillance and governance, including stronger enforcement of structural policies, fiscal coordination, and macro-economic imbalances (Bieling 2012). To achieve this, the EU needs to alter its vulnerable political image.

EU financial integration alterations and solutions to mitigate the EU financial crisis are worthless unless the EU as a system has the political will to implement them. Shortcomings in EU political legitimacy, such as the lack of enforcement of Maastricht and the S&G, explain why the EU as a political body is struggling to regulate the crisis (Mamadouh and Van Der Wusten 2010). Therefore, it is imperative that the EU and member states transform how they are politically imagined and focus more on more responsible social spending. By doing so, the confidence of the member states’ populations in their governments would be restored. Happy societies results in member states legitimizing their power. This, in turn, would legitimize the EU power because of having a shared monetary union. Therefore, the EU can achieve a more positive political image through bottom-up reformation; surpluses must be used in socially responsible and environmentally friendly investments (Varoufakis and Holland 2011). EU governments and the system arguably need a change in austerity policies to effectively respond to this costly crisis. Bank rescues, economic stimulus programs, and automatic stabilizers have worked only to varying degrees over the past few years. Therefore, EU institutionalization should correspond to EU economic governance reforms and the increases of overall public debt (Bieling 2012).

The EU is currently at a turning point in its history. Having suffered its worst financial crisis, the EU must now decide whether member states will become more separate or more unified (Statham and Trenz 2011). Several options are on the table, some more realistic and beneficial for the EU than others. The worst case scenario is that the EU breaks apart due to the overwhelming amount of shared pressure that financial integration creates and a more
nationalistic, populist EU is created due to an institutional collapse. Under this scenario, countries would gain greater political sovereignty but lose EU member benefits, thereby exacerbating the division of winners and losers. Winner would include countries (such as Germany and France) with strong fiscal policies but monetary policies dragged down by EU financial integration. Countries with weaker fiscal policies (GIIPS) that are benefiting from shared monetary policies would lose.

Another poor scenario is that the EU partially splits—some countries stay and others leave. Under this scenario, there would be disagreement and controversy, and the EU would become a questionable and possibly illegitimate governing body. A tolerable yet not ideal scenario would be for the EU system to stay together. Under this scenario, stronger countries would be dragged down by weaker ones due to financial burden-sharing and redistribution of wealth. This would create an “empire” effect in that the strong would assume greater hegemonic control and the weak would be characterized as more periphery. The best case scenario is that the EU weathers the storm and tightens its interconnectedness among the member states. The EU political system would be democratized to a greater extent because of increased EU decision making in national politics. Under this scenario, there would be a more normalized and legitimate form of shared governance.

It is unlikely that the EU will break apart. Instead, it will continue exhibit characteristics of self-sufficiency and systemic anarchy. Though any member state is allowed to withdraw from the EU (provided it is in agreement with its constitutional requirements), member states threatening to leave the EU should not be taken seriously because they are fully aware of the negative economic consequences that will result from leaving. Further, they are well aware that the EU’s binding, interconnected economic policies are not a choice but, rather, a requirement.

**Conclusion**

Financial integration is a complex and dangerous policy in the EU political-economic system. Yet, the positives of having EU financial integration stay in place outweigh the negatives of an EU breakup or further de-integration measures. EU structural reform is perhaps the best policy, and one that would take into account declining public support as well as state and systemic incompetence. An EU institutional policy framework is problematic because of asymmetric shocks, channels of monetary policy, income and interest rate elasticity of demand for money, and financial capital mobility (Arestis and Sawyer 2001). The EU needs to be restructured because the policies of the EU governments and the ECB in cooperation with the IMF are unlikely to initiate recovery (Hein et al. 2011).

Financial integration has made the EU a political dwarf. Greater external representation is necessary to help the EU shed this label. Retaining multilateral EU economic integration is vital because, on its own, each EU member state can only have a minimal impact (Smaghi 2006). This argument supports increased integration among the EU community because of the interconnectedness of the EU member states with the global economy and would result in the EU attaining a greater voice on the global stage. And it definitely needs one. The EU cannot completely participate in multilateral cooperation unless it adjusts its structural and budgetary policies (Smaghi 2006). Even if the EU has unified monetary and exchange rate policies, its members’ fiscal policies are too small to have a global impact on their own.
The EU needs more budget discipline and fiscal coordination if its common currency (the euro) is to survive, as past efforts to interfere with governments’ taxation and unchecked spending have failed. Solutions exist but have been hard to implement because of member states’ disagreements over how economic burdens should be shared (Begg 2012). Burden sharing blame deflection has been rampant among the EU member states. As a result, the short term prospects for an EU recovery are not great. Over the long run, the EU and state governments need to ensure that imbalances and poor policy choices of the past are not repeated.

Financial integration has impeded the EU’s recovery from one of the worst economic crises it has ever endured. It is critical that the EU continues to support this system of financial integration and not let any member states leave. The consequences of an EU collapse would have devastating wide-ranging effects in Europe as a region, countries whose currencies use or are pegged to the euro, and the global economy as a whole. The EU needs to strengthen its financial integration now more than ever. Cooperation among member states is imperative at a time like this. Self-sufficiency behavior by member states will only further harm the EU economic system. Therefore, a transformation in EU hegemon-periphery interactions and overall political-economic culture is required. The EU needs public finance reforms, structural reforms, market adjustments, and more competitive member economies to ensure it economically strengthens in the long run. Short-term solutions may stop the immediate financial bleeding in the EU but are not adequate long-term fixes. The EU needs a political-economic model overhaul among its member states.

This crisis has two ways of ending, with the collapse of the euro or through greater European fiscal, monetary, and institutional integration. With the EU currently on life support, member states can and must bind together and, on a collaborative basis, find more effective integrated solutions. The EU should take social, economic, and political lessons from this financial crisis to develop collaborative solutions that prevent such crises in the future. Financial disintegration is not the road to recovery. Future studies should analyze the progress the EU makes in applying these lessons to its governance. There is too much at stake within individual EU countries, the EU region, and the rest of the world for the EU to fail to understand the lessons of financial integration. Financial integration in the EU must persevere.
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