

A critical analysis of the European Union's structure and approach to economic recovery during times of crisis

Hamish Stayt
University of Canterbury
hamishstayt@gmail.com

Abstract

This essay critically analyses the European Union's (EU) approach to economic recovery during times of crisis, focusing on the 2008 financial crisis and the subsequent eurozone debt crisis. The EU's response included various measures such as bailouts, fiscal stimulus packages, and structural reforms. However, shortcomings in these responses are evident, including a lack of long-term planning and the exacerbation of negative effects by bailout announcements. Moreover, the essay examines structural issues within the EU, particularly regarding the European Central Bank's monetary policies and the lack of cohesive fiscal policies among member states. These structural deficiencies contributed to the severity of the crises. Despite lessons learned, including the need for stricter financial regulations and improved coordination among member states, challenges remain. The analysis suggests that while the EU has undergone reforms, its resilience to future crises remains uncertain.

Keywords: Economic recovery, European Union, Eurozone, fiscal policy, sovereign debt crisis

Introduction

In recent years, the European Union (EU) has been faced with several economic crises, ranging from the 2008 financial crisis, eurozone crisis, and the ongoing COVID-19 pandemic. All EU member states' economic stability and prosperity have suffered at differing levels as a result of these crises. The crises have drawn attention to issues around the EU's ability to effectively respond to economic shocks while acting in the best interest of all member states and citizens. It has also raised questions about whether the organization is structured correctly to effectively address these challenges, or to prevent them in the first place.

The EU responded to these crises by implementing various economic stimulus and recovery measures, including structural reforms, monetary policy measures, and fiscal stimulus packages — with bailouts to member states being the most debated and criticised measure.

This essay examines the EU's approach to two economic crises: the financial crisis and eurozone debt crisis. It will be split into three main sections. Section one provides a brief explanation of how the crises started. Section two outlines the measures taken by the EU and evaluates criticisms and shortcomings — focus will be on the bailout measures and the consequential flow-on effects that followed. Section three will discuss failures in the structure of the EU's institutions. It will detail the flawed operations of the European Central Bank along with the lack of structural reforms, each of which helped the crises to build.

Background

The EU is a supranational union comprised of 27 member states across the continent of Europe, with the aim to promote peace, freedom, and sustainable economic prosperity (European Union, n.d.). The union allows member states to operate as a single market, that is, there are no internal economic barriers, so free movement of goods and services can occur. On top of this, initiatives such as the Schengen Zone and eurozone allow for a more harmonized economic zone, providing free mobility of people and capital, and a shared currency promoting price stability and better-integrated markets.

The European Monetary Union (EMU) is a critical aspect of the EU economy. Three key elements make up the union: European Central Bank (ECB), the eurozone, and its fiscal and economic policies. Together, the EU and EMU work to promote economic stability and growth on the continent, while also being the key players responsible to act during economic crises.

Analysis

Section one - crises

Leading up to 2008, the continued economic integration of the EU had been considered by many to be a success, as the EU economy was the strongest it had ever been. 2006 was the year of the region's most accelerated growth in over a decade: 2 million jobs were created at a growth rate of 1.5%, and the overall economy grew by 2.7% (European Commission, 2007a). The union itself reported that the EMU had delivered a "high degree of macroeconomic stability" resulting in deeper market integration between euro countries (European Commission, 2007a).

Following this upswing in economic conditions, the Commission published several recommendations to member states for the medium term. These included encouraging governments to improve their budget positions by making better use of favourable economic conditions, and the improvements of instruments for coordinating economic policy at national and EU level (European Commission, 2007b). The Commission was optimistic about the future of the euro but recognized some potential shortcomings; however, these recommendations were too little too late and failed to prevent what would follow.

In 2007 as the global financial crisis grew worse, the economic boom of the EU was no longer. The EU's economy worsened dramatically in the following 2 years; GDP fell 4% in 2009 alone as global market turmoil resulted in previously strong EU exports slowing, and high-profile bank collapses added to unemployment and disinvestment woes across the continent (Koopman & Székely, 2009). House prices were falling, credit bubbles were bursting, and a great recession was beginning. Thus, the biggest economic crisis the EU had seen had begun.

Two years later the EU suffered another crisis, this time caused internally. Monetary policy by the ECB, who had to balance interest rates to suit unequal growth amongst member states, meant capital flowed from slower-growth Northern nations to faster-growth Southern Europe, such as Spain and Greece. Low interest rates were taken advantage of by these nations to service growing public deficits. After the Greek

government disclosed it had been lying about its public deficit for years, Greek bond yields surged, the government was unable to service its debt, and the start of the eurozone debt crisis had begun. The crisis spread across the EU, where levels of both private and sovereign debt resulted in turmoil for governments and citizens alike.

Section two - response and criticisms

In response to the financial crisis, the EU introduced several policies and wide-sweeping reforms to try to mitigate the effect of the recession. The European Commission headlined the creation of these legislations, with the most crucial one being the European Economic Recovery Plan. In principle, the plan gave priority to structural policies supporting short-term aggregate demand and employment. Commission President Barroso stated that the plan had two major pillars: injecting purchasing power into the economy in the short term to boost demand, and promoting 'smart' investments by member states to encourage long-run competitiveness (European Commission, 2008)

The biggest issue arising from the plan was the lack of long-term goals. Many of the proposals focused on short-term demand stimulation through government spending and tax relief, along with relaxations of administration laws to allow for speedier credit and real estate transactions. These short-term policies would increase the risk of dependency for an economy, as well as increase the risk of over-approval of bad credit decisions in the long run (Welch, 2011). While it is recognized that a short-term response was needed, one that had as many potential long-term consequences should have been reconsidered. The EU was criticised by the finance minister of Spain for not committing to a strategy of reversing the spending expansion once the crisis was over, ensuring the long-term sustainability of public finances (Solbes, 2009).

Among other reforms, including the establishment of two institutions to restructure financial regulations, bailouts were one of the biggest aspects of the EU's response. In return for fiscal austerity and structural reforms, Greece was provided financial assistance from eurozone members and the IMF (Copelovitch et al., 2016). Ireland, Portugal, Spain, and Cyprus all received financial assistance following the first Greece bailout.

The bailouts were criticised for many different reasons, one of which is the escalation of damaging flow-on effects. Boros and Sztanó found that announcements of bailout framework by the EMU caused a further deterioration of bond yields in the troubled nations, leading to a spiralling of the negative effects of the crisis (2021). The announcements of the EMU's responses "significantly decreased government bond yields in the eurozone periphery" (Boros & Sztanó, 2021). In a self-fulfilling way, investors pushing up bond yields led to even weaker economic conditions; ultimately requiring stricter austerity and bailout measures and further worsening their returns.

In tandem with the announcements of bailouts causing turmoil, the insufficient size of the bailouts also portrayed a bleak outlook to investors. Due to the reluctance of leading member states such as Germany to agree to adequately financing the bailouts, the size of the bailouts was considered too small to rebuild confidence in the markets. The other leading EU member, France, was fighting for a fiscal union approach to EU policies — emphasizing "solidarity values, risk sharing instruments, the joint issuance of debt, a huge eurozone budget and taxation powers for the EU" (Howarth & Schild, 2021). Germany was after the exact opposite — they believed risk should be borne by

the individual states, and consequences of a lack of appropriate government and private debt handling in one country should not be shared amongst the entire EU. The nation was strongly against the later suggested ‘Eurobonds’, a method of common European debt issuance. Angela Merkel, Germany’s leader at the time, stated there would be no EU debt sharing “as long as I live” (Hassenkamp, 2020).

The lack of cohesion among member states led to a bailout that fell short of providing the full support Greece needed. It showed markets that member states were reluctant to assist other states in crisis, which boosted fears around the euro area breaking up (Chang & Leblond, 2015). The predicted consequences if Greece was forced to leave the eurozone were cause for concern for the entire EU economy. Greece’s debt burden would skyrocket, private wealth be wiped out, and future growth significantly slowed – the country would have to be forced to consider even harsher austerity reforms to conform to international globalised markets (Art, 2015). Only when the ECB introduced further measures such as the targeted longer-term refinancing operations (TLTROs) did investors consider the solidarity of the eurozone likely to be stable into the future, and the effects of increasing bond yields and worsening financial markets were curbed (Chang & Leblond, 2015).

Critics of Germany’s reluctance to bailouts argued that the whole point of the eurozone was to allow all members to share the benefits of using a single currency and the economic prosperity that comes with it. Therefore, it is the responsibility of every nation to respond to the shortcomings of the single currency, including the failures which led to the debt crisis. Yet Germany’s outlook on fiscal policy and economic regulations, when taking into consideration their size and power, are too important to overlook according to other critics. Art argues that while the EU may appear as a “straightjacket” to smaller states such as Greece, conforming to Germany’s stability mindset regarding economic management is the only way for these smaller states to manage globalization while preserving a set of core European values (2015). Germany’s strong influence in deciding the structures of economic institutions in the EU means smaller states have little alternative to try and operate against these wishes. The instability the eurozone crisis brought has shored up many citizens and politicians’ beliefs regarding future economic regulations; given a choice of going it alone or accepting German conditions, the latter is the most sensible option (Art, 2015).

Section three - structural issues

Financial crisis

One major criticism faced by the EU is how the financial crisis was able to impact the economy as much as it did. The inadequate design of the European Central Bank and its monetary policies are seen by some as a key factor in the credit implosion suffered in 2008.

Kotarski writes that the ECB’s design has not been adequate in conducting effective monetary policy. They explain the institution displayed a syndrome of “captive minds”, where experts and decision-makers had a shared background in financial experience which drove them to favour rapid financial deepening as the only appropriate way to boost economic growth (2018). The main goal of stabilising low inflation had led to a favouring view of rising private debt, especially on mortgages.

The prevailing economic structures were embraced by banks to enable productive business investments, all while they turned a blind eye to the unchecked effects of their creation of purchasing power (Kotarski, 2018). Thus, asset and credit bubbles grew in the early 2000s, with house prices in major EU nations including France, Ireland, Italy, and Spain growing nearly exponentially before 2008 (Bank for International Settlements, 2022). Private sector debt in the euro area rose from 110% of GDP in 1999 to 147% of GDP in 2009 (Myers, 2017).

Turner notes that the relationship between the inelastic supply of desirable land and highly elastic credit demand had become highly destabilizing (2014). The rising private credit was overwhelmingly used to purchase already existing assets. The accumulation of mortgage-related debt by proportion of income had grown noticeably since the 1970s in 8 out of 11 studied EU members (Jordà et al., 2014). While high levels of public debt are often blamed by many for worsening the financial crises, high private debt does a significant amount of damage itself. It has been demonstrated that historically warning signs for financial crises were rooted in rising private leverage, not fiscal problems (Jordà et al., 2014). The build-up of unstable private debt was therefore a major factor in the damage the GFC caused in the euro area, and the ECB was partially responsible for this escalation.

Kotarski concludes that the European Central Bank allowed two critical failures in its economy: growing debt levels driving moderate GDP growth, and an unhealthy debt structure leading to future financial instability. They accuse the ECB of turning a blind eye to the fact that achieving constant GDP growth required ever-expanding debt levels, and financial deepening is not immune to the law of diminishing marginal returns which prevents infinite economic growth (2018).

Therefore, while the lack of strong regulation in the financial sector is often the main blame for the crisis, it is argued that damage was amplified through the ECB's failure to control the abnormal rise of private debt in the region. The central bank's policy of maintaining steady inflation had worked — inflation had been kept in check for over a decade since its inception (Hartmann & Smets, 2018). Yet a lack of foresight on the flow-on effects of this policy would have meant the ECB's structure had failed to stop a crisis from building. The ECB had served its purpose in terms of its assigned job yet had caused immense damage by failing to control the private debt and asset bubble catastrophe. Going forward, the eurozone must find an optimal balance between maintaining economic growth with less credit dependence (Kotarski, 2018).

Eurozone crisis

The euro debt crisis was also amplified by internal failings of the structure of the European Monetary Union (EMU). A lack of structural policies to deal with unstable debt levels led to bailouts being the only solution to avoid a complete collapse of the euro.

The interconnectedness of the member states led the EU, as well as investors, to believe the system was “too connected to fail” (Frieden & Walter, 2017). In short, if a country came into distress, the rest of the eurozone would be able to step up to bail them out. This created the moral hazard of reassuring high borrowing states of the existence of a safety net if unable to service their debt, so governments continued to borrow. To counter this, at the formation of the eurozone, EU governments agreed there would be no bailouts to any member nations. Yet investors recognised this as an empty

statement — if things turned sour, bailouts would have to occur, or the euro would collapse.

The better solution would have been to establish institutional structures to deal with potential defaults of countries. Methods such as bank controls and mechanisms to restructure debt should have been created to give the EMU a way to avoid a debt crisis in the first place (Frieden & Walter 2017). However, key member states believed discussions of how to counter financial crises would sow distrust in the system, so defaulted to a non-credible commitment to no bailouts (Frieden & Walter, 2017). This was a key failing in the structural design of the eurozone —the lack of a preventative system to avoid severe debt imbalances amplified the damages of the eurozone crisis.

On top of this, the lack of harmonisation in fiscal policy decisions amongst individual EU members failed to stop the capital flow imbalances from spiralling. High-saving countries such as Germany should have stimulated their own growth rather than invest their current account surplus in southern states. In contrast, these southern high-growth states should have implemented restrictive fiscal policies to restrain their overheated economies (Frieden & Walter, 2017). The European Commission had created the Stability and Growth Pact (SGP), which was one tool it thought would prevent a debt-fuelled crisis. could individually conduct sound fiscal policy while also coordinating their fiscal policies to avoid a critical debt imbalance (European Commission, n.d.). However, member states were able to undermine this mechanism; large and Eurosceptic nations were able to amend recommendations from the Commission regarding their concern over the individual fiscal policies of members. This behaviour “systematically eroded the power of the oversight mechanism”, and the lack of power of the EMU to enact binding laws around individual nations' fiscal policies contributed to the build-up of the eurozone crisis (Baerg & Hallerberg, 2016, p. 997).

An important part of the structure of the EU is the member states' right to sovereignty regarding certain areas of governance, one of which is fiscal policy. While it is crucial member states feel they still have an adequate level of sovereignty, especially to avoid a 'democracy deficit', it is clear the EMU did not have enough power to influence member states into coordinating their fiscal policies. The lack of power meant the union could not stop nations from accumulating unsustainable levels of public debt, which was a catalyst in triggering the debt crisis. Overall, Europe's debt problems occurred due to long run structural deficits, which were not corrected by member nations after the foundation of the EMU, despite the set intentions of the SGP (Collignon, 2012)

Conclusion

An evaluation of the EU's response to the two crises reveals many criticisms of the economic stimulus and bailout measures conducted. From a lack of long-term planning to the negative flow-on effects of bailouts not being considered, the response had many shortfalls.

The crises also exposed failures in the structure of the EU's institutions. Measures could have been taken to avoid these crises — stricter regulations of the financial sector, robust mechanisms for addressing sovereign debt crises, and a more focused

central bank avoiding the build-up of unsustainable private debt — all could have helped prevent the damages both crises had on the continent.

The lack of harmonization between member states regarding fiscal policy was also notable in helping cause the crises. The limited power the EU has over fiscal policies allowed powerful member states to disregard the SGP and conduct non-cooperating fiscal operations, while also allowing smaller developing states to make the most of cheap debt, inflating the debt bubble.

Overall, the EU has suffered through many hard lessons since 2006. While the response and structural deficiencies of the union can be widely criticised, it can be argued the EU has come out the other side of these crises stronger and structurally improved. Time will tell whether the reforms were enough to prevent future crises affecting the European Union and whether the lessons learnt will be enough to curb any damages a future crisis may bring.

Bibliography

- Art, D. (2015). The German rescue of the eurozone: How Germany is getting the Europe it always wanted. *Political Science Quarterly*, 130(2), 181–212. <https://www.jstor.org/stable/43828571>
- Baerg, N. R., & Hallerberg, M. (2016). Explaining instability in the stability and growth pact: The contribution of member state power and Euroskepticism to the euro crisis. *Comparative Political Studies*, 49(7), 968–1009. <https://doi.org/10.1177/0010414016633230>
- Bank for International Settlements. (2022). *Residential property prices: Detailed series (nominal)*. https://www.bis.org/statistics/pp_detailed.htm
- Boros, E., & Sztanó, G. (2021). The evolution of European bailout arrangements and its impact on sovereign bond yields in the aftermath of the euro crisis. *Society and Economy*, 43(1), 1–20. <https://doi.org/10.1556/204.2020.00024>
- Chang, M., & Leblond, P. (2015). All in: Market expectations of eurozone integrity in the sovereign debt crisis. *Review of International Political Economy*, 22(3), 626–655. <https://www.jstor.org/stable/24673309>
- Collignon, S. (2012). Europe's debt crisis, coordination failure, and international effects. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.2103987>
- Copelovitch, M., Frieden, J., & Walter, S. (2016). The political economy of the euro crisis. *Comparative Political Studies*, 49(7), 811–840. <https://doi.org/10.1177/0010414016633227>
- European Commission. (n.d.). *Stability and growth pact*. Retrieved January 15, 2023, from https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact_en
- European Commission. (2007a). *European economy annual report*.
- European Commission. (2007b). *The European economy: 2006 review—strengthening the euro area*. <https://eur-lex.europa.eu/EN/legal-content/summary/the-european-economy-2006-review-strengthening-the-euro-area.html>

- European Commission. (2014, August 8). *Review of the European system of financial supervision (ESFS) – European Systemic Risk Board (ESRB)*. Economic and Financial Affairs. https://ec.europa.eu/economy_finance/articles/governance/2014-08-08-review_european_systemic_risk_board_en.htm
- European Union. (n.d.). *Aims and values*. Aims and Values. Retrieved January 14, 2023, from https://european-union.europa.eu/principles-countries-history/principles-and-values/aims-and-values_en
- Frieden, J., & Walter, S. (2017). Understanding the political economy of the eurozone crisis. *Annual Review of Political Science*, 20(1), 371–390. <https://doi.org/10.1146/annurev-polisci-051215-023101>
- Hartmann, P., & Smets, F. (2018). The first twenty years of the European central bank: Monetary policy. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.3309645>
- Hassenkamp, M. (2020, May 21). SPIEGEL-Umfrage: Mehrheit der Deutschen für EU-Wiederaufbaufonds. *Der Spiegel*. <https://www.spiegel.de/politik/deutschland/corona-krise-mehrheit-der-deutschen-fuer-eu-wiederaufbaufonds-a-a51b787a-3845-49cf-9e55-b9eda3ba98fb>
- Howarth, D., & Schild, J. (2021). Nein to ‘transfer union’: The German brake on the construction of a European Union fiscal capacity. *Journal of European Integration*, 43(2), 209–226. <https://doi.org/10.1080/07036337.2021.1877690>
- Jordà, Ò., Schularick, M., & Taylor, A. M. (2014). *The great mortgaging: Housing finance, crises, and business cycles* (Working Paper No. 20501). National Bureau of Economic Research. <https://doi.org/10.3386/w20501>
- Koopman, G. J., & Székely, I. P. (2009). *The financial crisis and potential growth: Policy challenges for Europe*. 3.
- Kotarski, K. (2018). The eurozone’s crisis conundrum and the role of macroeconomic theory. *World Review of Political Economy*, 9(4), 477–506. <https://doi.org/10.13169/worlrevipoliecon.9.4.0477>
- Marina, D. (2020). *The lack of ECB’s conduct supervisory power: An analysis of the architecture and application of supervision*. https://www.unive.it/pag/fileadmin/user_upload/dipartimenti/economia/doc-eng/eudifin/wp/WP8.pdf
- Myers, S. (2017). *Private sector indebtedness and deleveraging in the euro area countries*. 4. https://www.ecb.europa.eu/pub/pdf/other/ebbox201704_05.en.pdf
- Roy, S., & Kemme, D. M. (2012). Causes of banking crises: Deregulation, credit booms and asset bubbles, then and now. *International Review of Economics & Finance*, 24, 270–294. <https://doi.org/10.1016/j.iref.2012.04.001>
- Solbes, P. (2009, February 10). There is room for rate cuts. *Wall Street Journal*. <https://www.wsj.com/articles/SB123413364587461303>
- Turner, A. (2014). Escaping the debt addiction: Monetary and macro-prudential policy in the post crisis world. *Centre For Financial Studies Frankfurt*. <https://www.ineteconomics.org/uploads/downloads/Paper-Escaping-Debt-Addiction.pdf>
- Welch, J. (2011). The financial crisis in the European Union: An impact assessment and response critique. *European Journal of Risk Regulation*, 2(4), 481–490. <https://www.jstor.org/stable/24323295>