WHAT SHOULD THE EUROZONE DO? A THEORETICAL ANALYSIS OF THE CREATION, CRISIS, AND FUTURE OF EUROPE'S ECONOMIC & MONETARY UNION

By

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MONETARY UNION

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ABSTRACT

This paper is a theoretical analysis of the creation, crisis, and future of the Eurozone. The beginning outlines specifics of the Eurozone as well as outlines in detail its history. Different viewpoints of economic integration theory are outlined in order to explain the rationale behind the creation of the Eurozone and identify key metrics to measure its success and its failures. I examine the key accomplishments of the Eurozone and the positive impact it has had on Europe. Afterward, I outline the recent crisis faced by the Eurozone and many of the reasons for its great turmoil. This explanation is supplemented by sharing the perspectives of a strong Eurozone economy, Germany, a weak Eurozone economy, Greece, and a European Union member not in the Eurozone, Great Britain. Finally, I propose a solution for the future of the Eurozone. I identify the three stakeholder groups being current Eurozone members, European Union members who elect to use their own currency, and potential Eurozone members and describe how each will act to rebuild the Eurozone. Ultimately, with the new proposition, the Eurozone can not only recover, but can return stronger than before.

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INTRODUCTION

Shortly after the Second World War, leaders within Europe congregated with the purpose to discuss why the nations were quarreling and how they could more efficiently coexist with their neighbors of shared borders. The result was a revolutionary idea that would eventually unite a diverse continent and change the world forever.

The European Union (EU) is a partnership between 28 countries, in which each has voted to integrate its economy and internal operations with the others to facilitate the movement of goods, services, money and people to move freely throughout the region (European Union). This entity, which has roots all the way back to the 1950s, continues to remain the largest group of economically integrated countries in the world. The European Union, a region referred to both as the Economic & Monetary Union (EMU) and the Eurozone, elects to share a common currency, the euro. There are currently eighteen member-states in this group, leaving 10 to be members of the European Union that still employ the use of their own currency. The EMU members share a more integrated set of political policies tied to the euro and the related financial institutions, the most prominent being the European Central Bank (ECB).

In this paper, I will examine the Eurozone throughout its fifteen-year life, exploring both its achievements and its complications. In order to accomplish this, I will explore whether the Eurozone has fulfilled the goals of its original creators. I will portray many of the positive outcomes of the Eurozone and its success over the years. After, I will discuss various issues that troubled the Eurozone in recent times.

To aid in demonstrating these issues, I will portray the perspectives of both a weak economy, Greece, and a strong economy, Germany, and how the current issues are affecting each of them. I will also include the perspective from a EU member, Great Britain, who has elected to employ the use of its own currency.

Finally, the purpose of this paper will be to propose a plan for the future success of the Eurozone. It is no secret that there are many flaws in the current organization of the European Union, and the Eurozone in particular, that date back to its inception. Although some academics propose that the EMU should disband, I will argue that the EMU should in fact, stay together, and with certain systematic changes of structure and processes, the Eurozone can come back stronger than before. I will also propose a plan for the continual stability between other EU countries that do not accept the euro as their currency. With these changes in place, the EMU and its surrounding European Union partners, will experience long-term growth and success.

THE HISTORY OF THE EUROZONE

At the close of the Second World War, the countries in Europe found it very difficult to get along with each other. They consistently quarreled and fought over many issues, specifically concerns in the agriculture market. Because the countries reside so closely together, leaders began to conjure up ways to unite the nations. An attractive solution to their rampant disagreements was to integrate their economies in a way that forced them to work together. As a result, French Foreign Minister, Robert Schuman, proposed a way of integrating the coal and steel industries in 1950, known as the Schuman Plan (NPR 2010). The countries favored this concept

and the founding six countries, Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands, became the European Coal and Steel Community (ECSC) in 1951 (NPR 2010). In 1957, they made the choice to coordinate integration into other sectors of their economies and the leaders of these six countries signed an agreement, now referred to as the "Treaty of Rome," to create the European Economic Community (EEC) that focused on facilitating trade smoothly between nations (European Union). One of the first common decisions made in the 1960s was for a common agricultural policy, ensuring that all farmers are paid the same for their produce. This continued for many years until 1968, when the member countries decided to expand their agreement a step further and remove duties on imports. This created the world's biggest trading group of the time and propelled Europe's growth. Meanwhile, membership continued to grow as Denmark, Ireland, and Great Britain joined the European Union in 1973, Greece in 1981 and, Spain and Portugal in 1986. After the monetary union was firmly created, other unifying programs were established in the 1980s such as the "Erasmus" program, which funds university students to study abroad in another European Union country for one year. Additionally, at the end of the decade, the fall of communism led East Germany to reunite with West Germany so that the united country would be an EMU member (European Union).

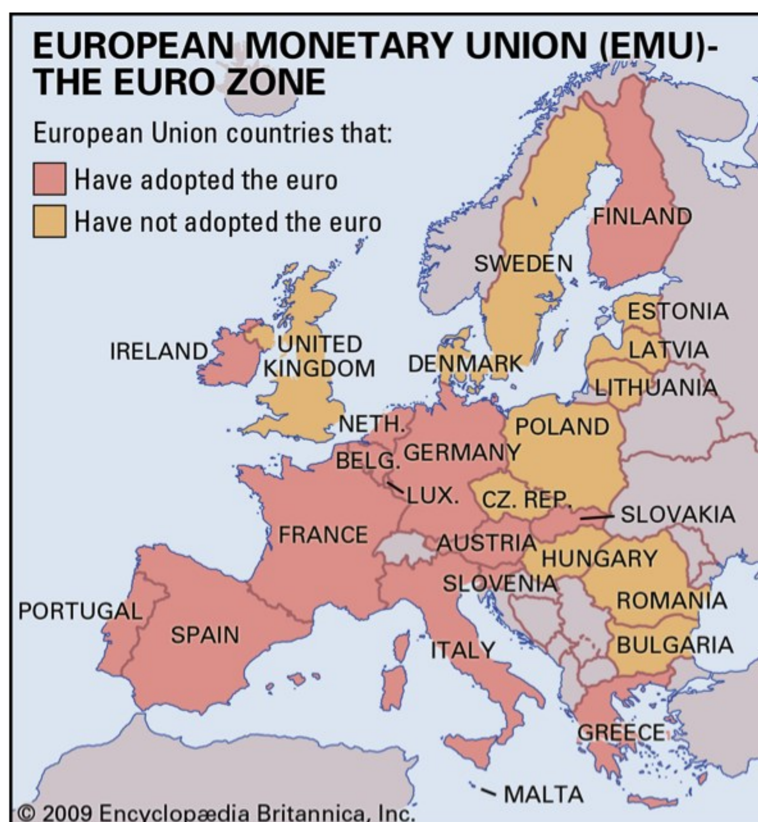
In 1992, a conference was held in Maastricht that produced the famous "Maastricht Treaty." This was a comprehensive treaty outlining the political, economic, and social integration of its members, ultimately legitimizing the European Union, its institutional players, and its economic policies. The plan was

divided into three stages: the first aiming to open borders between EU countries to facilitate business transactions, the second introducing a centralized bank to oversee financial activity and economic convergence, and the third outlining the plans for the common currency for those that wanted to take their integration one step further. Today, European Union nations that do not use the euro either voluntarily chose not to participate or have not been accepted into the monetary union. For countries that voluntarily chose not to accept the euro, there was an opt-out clause in the Maastricht Treaty that allowed the countries to participate in the first two stages of European integration, but opt-out of the third and final stage. Denmark, Sweden and Great Britain were the first three countries to voluntary reject the euro as their currency in 1999. In order to participate in the third stage of the EMU, countries had to meet five criteria outlined in Article 121 (1) of the treaty (European Union).

1. Countries could not have an inflation that exceeded the three best performing EMU nations by more than 1.5%.
2. The ratio of annual government deficit to gross domestic product (GDP) could not exceed 3%.
3. The ratio of government debt to GDP must not exceed 60%.
4. The country must have successfully maintained its monetary exchange rate within a +/- 15% range from an unchanged central rate, or kept within “normal” fluctuation margins
5. Long-term interest rates on bonds should be no more than 2% higher than the average of the three EU member states with the lowest interest rates.

A strong central bank needed to be established to accompany this common currency. All monetary policy regarding the euro would be conducted through the European Central Bank (ECB). In January of 1999 eleven countries accepted the euro as their sole currency and began trading on world currency markets. Ten more member states joined the European Union in 2004 and two more in 2007, bringing the total membership number to 28, where 18 of those are members of the EMU and use the euro. The most recent country to join was Croatia in July of 2013.

Figure 1



The Euro and You. *The Economicon.* Apr 2014. Web.
http://econproject1.wordpress.com/2010/04/06/the-euro-and-you/

Aside from the simple historical facts of how and when they were created, many seek to understand "why" the European Union, the EMU, and the euro came about.

ECONOMIC & FINANCIAL INTEGRATION THEORY

The idea of financial and economic integration began centuries ago, between Italian city-states in the 13th century with goal of making the act of trading between geographical neighbors more efficient (Lothian 2001). Since these early negotiations, the concept of economic integration has grown and developed to become one of the leading considerations in the global community today. Numerous examples exist of local communities, regions, countries, and continents coming together to enact a more efficient mechanism of exchanging goods and services. Some of the largest agreements include the Association of Southeast Asian Nations (ASEAN) between eight nations signed in 1967 and the North American Free Trade Agreement (NAFTA) between Mexico, the United States, and Canada signed in 1994. There are several fundamental reasons for the intertwining of economic policies and strategies.

The ultimate outcome of economic integration is to facilitate business transactions between parties in a manner that both increases efficiency and spurs growth. One primary component of increasing market efficiency is to lower transaction costs. When countries come together to integrate their systems, they lower the costs of doing business in each other's domestic economies in order to make it easier for all parties to conduct business. Especially with a common currency, parties save the time they would have spent monitoring exchange rates or

arranging money to be printed in a different currency. The United States' common market is an example of this. Parties also save time and money when preparing their financial statements because all fifty states share the same currency, individuals can make transactions across borders without having to worry if their money is worth the same in different states. Similarly, all public corporations submit their annual financial statements to the Security and Exchange Commission at the end of the fiscal year. A corporation operating in multiple states can still compile their financial statements with ease because business throughout the common market is conducted under the same currency and the transaction costs are extremely low. Additionally, markets become more efficient due to the increase in economies of scale. By entering into an economic agreement, each country agrees to share some of its resources, whether it is labor, information, or equipment with the others, allowing each member to capitalize on the greater amount of available resources. Perhaps the most crucial of these resources is capital. Institutions benefit greatly from this increased access to capital (Kamal 2011). By opening their borders to do business with other countries, the capital supply is essentially pooled together. This greater amount of investable capital allows all parties to engage in more transactions. This is extremely important for underdeveloped nations that do not have access to large amounts of capital within their borders. For example, South America's economic and political agreement, MERCOSUR, is aiming to provide more capital to its surrounding partners. In September 2009, Argentina, Brazil, Paraguay, Uruguay, Ecuador, Bolivia, and Venezuela established a communal bank. This bank had initial capital of $20 billion and its purpose was to fund projects and

investments in this region, projects and investments that otherwise would have been financed by the World Bank or IMF (Klonsky 2012).

Another positive outcome from economic integration is standardization (Rickenbacker 1961). In order to successfully complete business transactions at high volumes, countries have to have similar systems in place. Standardization is important in three main categories: prices, regulations, and technological processes. The standardization of prices is a direct result of opening one's borders. If there is a disparity in price of the same product across countries, the fundamentals of supply and demand will soon force it to reach an equilibrium point. Economic integration allows countries to combine their supply and demand systems to allow products to be competitively priced across all markets. This eliminates one step that is usually incurred in international transactions, increasing the efficiency of the broader market. One of the most essential aspects of standardization is its effect on regulation (Kamal 2011). If countries are trying to integrate their systems, then they must have a standardized system of rules by which all parties must abide. For example, public corporations operating in the United States must abide by all regulations proposed by the SEC. This standardizes the way in which business is conducted because corporations have the same legal requirements, filing processes, and accounting standards. This eliminates a lot of time and hassle and greatly reduces the number of disputes or lawsuits between parties. Thirdly, standardization must also be present in technological processes. Countries must be able to communicate and share information effectively and customers benefit from being able to access information the same way in each country. This forces countries

to have many of the same systems in place in order to operate efficiently. The result of all three parts of standardization is all parties improving their operations to the level of the most developed party in order to keep up and stay competitive. This facilitates the continual improvement of each member so as to adopt the most advanced technologies and techniques of the greatest innovator in the group. For example, because of the United States' advances in technology, specifically in regards to manufacturing, there has been some diffusion of this technology to both Canada and Mexico due to NAFTA. NAFTA, therefore, has led to an overall increase in total factory productivity of between 5.5% and 7.5% in Mexico (Schiff & Wang 2002). Mexico, in order to conduct large amounts of trade with the United States, has to maintain an updated technology that is compatible, and in turn, this advanced technology has improved their production productivity. In addition to the numerical impact each of these strategies has on business, collectively, they all serve to reduce moral hazard and adverse selection (Kamal 2011). Moral hazard is a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost (The Economic Times). Additionally, adverse selection is a phenomenon wherein the insurer is confronted with the probability of loss due to risk not factored in at the time of sale (The Economic Times). Moral hazard and adverse selection are two of the primary obstacles when conducting business internationally because of the lack of available information regarding foreign parties and institutions. Through economic integration, all members adopt a greater sense of transparency so that more

information is available and institutions can make sound investment decisions in a timely fashion.

When countries come together to discuss these issues and agree upon standards, they eliminate many of the difficulties accompanying with international transactions. This increases the overall efficiency of doing business with other countries. In fact, it encourages business across borders. The increased efficiency and ease of transactions allows markets to expand and grow substantially. The increased access to capital leads to more investment opportunities within different sectors in many geographical locations. These investment opportunities, in turn, provide a country with the ability to grow and increase in value, all the while diversifying its portfolio among many investments. This diversification and larger portfolio, along with those of other member countries, give a strong sense of stability to each individual country (Kamal 2011). With this sense of stability, countries can engage not only in more investments, but larger, higher-yielding investments as well. The ability to engage in investing activities especially helps lesser-developed nations to grow. Providing less financially developed nations with access to international capital at low transaction costs encourages them to participate in international business on a larger scale and grow their economy (Kamal 2011). Likewise, an underdeveloped country that integrates with more developed countries will also benefit from the policy integration by accepting international standards and potentially even restructure their political system if it is not efficient in doing business with neighboring countries (Schiff & Winters 2003).

The lower costs of capital and improved access also encourage more entrepreneurial activities (Badinger 2005). A financial environment that encourages entrepreneurialism tends to continually improve, both financially and technologically. Finally, the result of integrating economies together is a larger well-connected economy. Larger economies, because there is more investment activity, tend to grow at faster rates (Badinger 2005). For example, in the 1980s, Singapore, South Korea, Hong Kong, and Taiwan, also referred to as the NIEs, (newly industrializing economies), experienced up to 12% growth in GDP. They also spurred the rapid growth of the ASEAN Four growing their GDP around 7%, which at the time included Indonesia, Malaysia, the Philippines, and Thailand. The large amounts of direct investment from the Asian NIEs and Japan, allowed the growth of the ASEAN Four to grow exponentially. Intra-Asian trade grew by 21% between 1987 and 1990. Because these two groups of countries were working together, they were able to use trade and investment to expand their economies, thus growing at a much faster rate than one single developing economy (Wu 1991). Therefore, by organizing a way in which nations can cooperate, higher economic efficiency creates an opportunity for exponential growth as one union.

Each of these strategies served to support the decision of the multiple committees who met and contributed to the ultimate implementation of the European Union, the most complex, economically integrated group of countries in the world (Kamal 2011). Ultimately, the vision for this union was to join many individual efforts that are located near each other to create something much larger that can serve as a world power. In James Burnham's article entitled "The Promise

and Threat of United Europe" he states, "The Soviet Union produces more steel than any European country, but less than all" (364). The leaders of Europe saw a potential to combine their resources and strengths to create a union that collectively had more influence and power than that of anyone around them. Although there are several economic powerhouses in present-day global society, the Eurozone serves as one of the major players, fulfilling the vision of its creators.

THE SUCCESS OF THE EUROZONE

This revolutionary partnership has generated tremendous amounts of economic activity. It obtained the ability to integrate itself with the United States' economy and propelled Europe to a position of economic leadership. The Eurozone currently has 509 million members and, in 2012, had an annual GDP of $16 trillion (World Bank). The Eurozone, as a unit, is the largest economy in the world and accounts for nearly 20% of global economic activity. It is also the largest export market for both the United States and China (Miller & Sciacchitano 2012), the world's two largest single-country economies. In 1999, the EMU initiated the euro as a currency. Since 1999, the euro has grown in strength against the dollar tremendously, and remains higher in value than the dollar today, as shown in Figure 2. Additionally, not only has the exchange rate itself been relatively low (roughly around 2%), but also the change in the inflation rate has remained extremely low over the entire life of the euro, shown in Figure 3. From its original inception, maintaining a low level of inflation has been the primary goal of the ECB, and it has successfully accomplished this. The ECB carefully monitored the growth rate of the

money supply so that it would move according to their desired inflation levels (de Grauwe 2008).

Figure 2

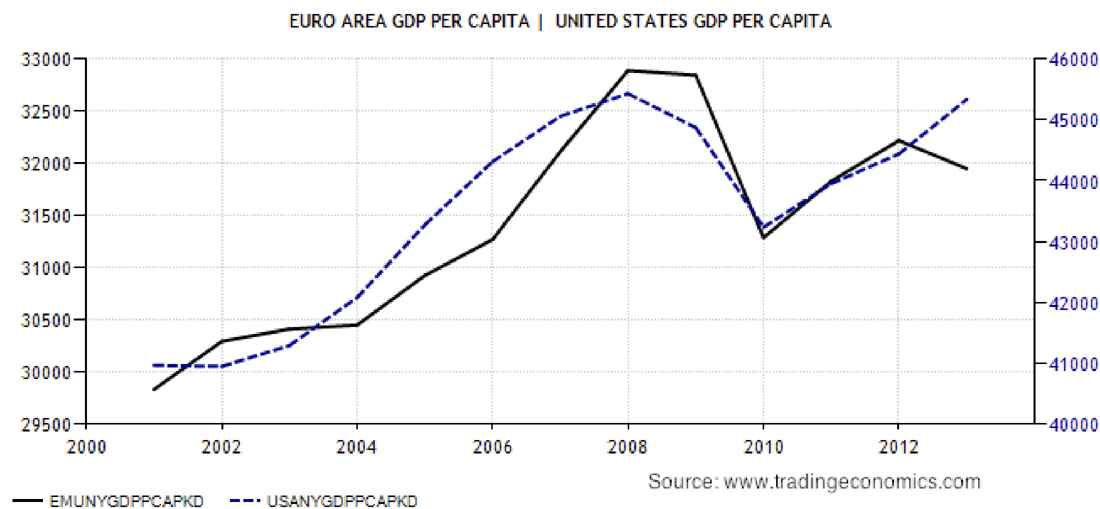
European Union. Euro foreign exchange rates. *Europa.eu.* Feb 2014. http://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html

Figure 3

European Commission. Harmonised Indices of Consumer Prices (HICP). 15 Apr 2014. *Eurostat.* Web. Apr 2014. http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/data/main_tables

These metrics point to signs of great stability within the Eurozone because the relative price level of goods has remained equivalent over the years and the euro has experienced very little changes in purchasing power. Over the years, price stability has come to become one of the Eurozone's greatest accolades. Another key measure of success, however, is GDP per capita. From this, we can see how much output (after inflation) that the Eurozone is producing per person. To provide a benchmark, we can compare the Euro-area's GDP per capita to that of the United States. Although the scales are different, it is clear that the euro area's GDP per capita, with the exception of a times of crisis, has kept an increasing trend since 2000.

Figure 4



Euro Area GDP Per Capita. *Trading Economics.* Web. Apr 2014. http://www.tradingeconomics.com/euro-area/gdp-per-capita

In addition to these statistics, there are less tangible measures of success. These nclude but are not limited to the stability given to individual countries and the synergies involving the convenience of distribution, travel between countries, and the lack of issues involving currency exchange. All of these statistics and synergies point to its ability to achieve its economic goals throughout the past fifteen years.

Along with all of these successes, however, the Eurozone has encountered various troubles regarding their integrated state. These troubles, coupled with the world recession in 2008, have exposed the Eurozone to the greatest crisis it has ever seen. In the next section of this paper, I will outline many of the issues it has faced during this time.

THE EUROZONE IN CRISIS

Although the EMU has indeed fulfilled many of its original goals and experienced many successes, it is currently encountering a severe crisis. When all of the member-states' economies were booming, everyone maintained a positive outlook; however, when the global economic crisis hit in 2008, it affected Europe greatly and uncovered many issues within the Economic and Monetary Union. In some ways, the EMU is able to look at the United States as an example, but it is not completely comparable in the fact that the integration is between states rather than independent countries with different governments. As a result, the EMU is experiencing unexpected hardships and obstacles that it will need to overcome for its continued success. In this section of paper, I will describe some of these obstacles that this recent crisis has inevitably unveiled.

When authorities signed the Maastricht Treaty in 1992, they were more than eager to put their new plan into action. They believed the euro was revolutionary and wanted to persuade each country to participate in the treaty. Because of their eagerness and the lack of expertise in this area, the authorities overlooked various fundamental aspects in the initial structure of the treaty. In addition to the original structural shortcomings, the authorities were far too lenient on requiring potential member-states to uphold the established criteria set in section 104c of the treaty (Van der Sluis & Parlinska 2013). These criteria modeled after the criteria previously established by economists to be the “minimum requirement for the efficient operation of a monetary union” (Baimbridge, Burkett, & Whyman 2012). As mentioned earlier, there were five criteria that each member-state must meet before becoming eligible to join the EMU. Again, because the authorities were eager to grow the Eurozone’s power and influence, they allowed nations to join that did not necessarily uphold the criteria either through political compromises or insufficient justification (Van der Sluis & Parlinska 2013). Although this did not seem to cause any major issues at the time, the failure to strictly uphold these criteria would eventually cause certain nations to be vastly unprepared to contribute to the group at large. Twenty years later, the EMU displays the effects of this lack of strict adherence to the criteria. The evaluation criteria should have been more strictly enforced to determine if nations were a good fit for this union, both economically and culturally. Some nations were financially ready and able to enter into an integration treaty while at the same time, others were not. Although it may not have been detrimental in the short-run, it has undoubtedly led to many of its

long-term issues. As a result, the Eurozone was comprised of members with a varying degrees of financial responsibility and capability. The disparity between nations, not only financially, but also culturally, stands out as a major issue in the successful execution of the Economic and Monetary Union and its policies. In fact, it is the cultural differences that lead to many of these financial differences.

The European Union is a very diverse group of economically integrated entities, encompassing twenty-eight different countries and more than five hundred million inhabitants that speak twenty-four working languages. An area that has so many distinct cultures located together geographically gives Europe its uniqueness and its ability to attract millions of tourists every year. However, this culture-rich atmosphere becomes more troublesome when the economies of these distinct cultures are integrated and their customs and processes seek to become uniform. Janja Hojnik wrote an article entitled "The EU Internal Market and National Tradition and Culture: Any Room for Market Decentralization?" in which he discusses the difficulty of binding all of these culturally different countries together by their economies:

> *In such a diverse system, the appropriateness of uniform rules for all is contentious. The appropriateness of legal rules is measured by the standard of living in a specific area, considering that inhabitants of wealthier regions are prepared to pay more for health, environmental protection and public security than inhabitants of poorer areas. In addition, individuals' tastes differ from one region to another, thereby influencing the appropriateness of legal provisions. The majority's attitude towards gambling or pornographic material depends*

> *upon the religious and cultural background of the inhabitants of a certain area. Direct geographical features can also sometimes influence the context of law. This means that the advantages and disadvantages of legal rules for inhabitants of certain regions vary and so does optimum content of legal provisions (118).*

When talking about the EU and EMU from an outside perspective, it is easy to refer to it as one unit and overlook all of its culturally rich members. However, when delving further into each country's uniqueness, it becomes apparent just how complex this union actually is. Differences arise in each of the following categories that affect the processes and systems of individual countries, some of which are as follows: Food, traditional labeling and packaging, closing times of shops, national heritage, media law and the film industry, morality and family, and language (Hojnik 2012). When attempting to integrate these cultures, a controversial question arises: Which is the primary goal? to maintain the traditional culture of a country or conform it to establish an optimal common market? There are two differing approaches to this question. A decentralist approach prioritizes culture and tradition, respecting the views of each country's citizens and spending time and money to preserve its heritage. On the other hand, a centralist approach favors economic effectiveness, and focuses primarily on creating the most efficient market with all of its members. (Hojnik 2012). There are citizens, authorities, and outsiders who take each of these approaches. From one perspective, individuals feel that their traditional values are being eroded in an effort to make an economically efficient entity. From another, individuals are convinced that their tradition and history are

hindering Europe's ability to become a united world power. The leaders of this union must find a balance between the two approaches, which is an extremely daunting task. In the United States, there are fifty states that comprise our one, large economic unit. Although these individual states are different in nature and have distinct cultural differences, the values of the people and the manner in which individuals conduct business are relatively the same, allowing uniform regulation to be accepted with generally no issues. However, when putting together the culture, values, and business practices of differing countries that have been set in their ways for thousands of years, convergence is not always accepted. Ultimately, cultural values and practices provide the framework for how a nation conducts business. Therefore, as a result of the immense diversity within the EMU, member-states are extremely different in their economic positions, thus creating a union where member-states are unequal in contributions. For centuries, each country has been developing its economic and financial systems, and no two countries have taken the same path. The one-size-fits-all approach simply does not create an optimal environment for these vastly differing economies. In fact, trying to converge economies with such different structures and balances actually weakens the union because although some nations are thriving in this environment, other nations are suffering and experiencing significant deficits. This widens the disparity between the strong and weak nations (Baimbridge, Burkett, & Whyman 2012). One example of a conflict with this disparity involves interest rates. Because all of the member-states are operating on a single currency, they must operate on set interest rates as well (National Review 2011). This proves to be extremely difficult when following

the fundamentals of economics that state that different countries must issue and borrow debt at rates that reflect their current financial position. Vastly different nations having the ability to engage in the same economic behavior does not provide for an optimally integrated union. (National Review 2011). As a result of these differing rates and behaviors, one nation's debt and instability ends up spilling over into another inter-connected nation. To limit this, rescue packages are sent to the suffering nations so that their poor financial position does not spread too far (Van der Sluis & Parlinska 2013). Although this may seem to temporarily fix the problem, it does not create a solution to equalize the nations and there still exists an immense financial disparity between the nations.

Because the disparity between nations is so large, both culturally and financially, different member-states serve different roles in the EMU. For example, Germany serves as an economic power and sets many of the standards for other member-states to uphold. Conversely, less economically successful nations take on the role of supporting the larger nations and relying on their business for survival. Although the differing of roles can be productive to a certain extent, it can also have negative effects, the most drastic being the free-rider problem. A free-rider problem, by definition, is a situation where some individuals in a population either consume more than their fair share or pay less than their fair share of a common resource. This phenomena always occurs in a group setting because one or multiple parties think that other members in the group will make up for their lack of effort. The free-rider problem has always been a threat when multiple parties join together to pursue a common goal; the Economic & Monetary Union is no different. Authorities

in the EMU will go to extreme measures to prevent a withdrawal or expulsion of any nation because of the turmoil it would cause and the message it would send to the rest of the world. Each member-state is aware of this. As mentioned previously, the poor financial position of one economy in the EMU can have negative effects on economies that are largely connected. The ECB, in efforts to prevent this from occurring, has "bailed out" many countries that have not been responsible by sending them financial stimulus packages. Because the ECB has portrayed their willingness to take such action, nations now make decisions with the rationale that the EMU will rescue them if they fail (Baimbridge, Burkett, & Whyman 2012, Burkett, & Whyman 2012). This creates a lack of responsibility among nations continually act ethically and in the best interest of the EMU. It also creates a lack of trust between nations to always act in a just manner (Baimbridge, Burkett, & Whyman 2012). Ultimately, it becomes an issue of moral hazard (Bergsten 2012). Countries may act in their individual interests rather than the interest of the union because they know that the likelihood of their membership being taken away is miniscule. Although there are few instances where one nation acts completely as a free rider to the extent in which they assume no responsibility, it is a psychological issue that most definitely affects the way in which decisions are made among members in a group scenario, particularly among member-states of the EMU in times of crisis.

One potential solution to the free-rider effect, and many problems facing the EMU at this point in time, is a strong, efficient fiscal authority to regulate and guide the economy. Unfortunately, the Economic & Monetary Union does not possess this.

This could potentially be the biggest failure of the establishment of the EMU. The European Central Bank and the European Commission are deemed as the principal authorities of the European Union, however, the creation of these two entities was more a result of moving to the next stage in the integration process rather than a carefully planned and executed vision. They did not adequately establish the roles and functions of a central governing body (Bergsten 2012). Although the ECB was established in this treaty, its specific roles and jurisdiction were not clear. This has since caused a lot of debate and introduced the question "Who really is in charge?" As a result, the governing institution lacks democratic control; the ECB can tell the leaders of nations to abide by something, but has little control over its implementation or execution because all of the countries have to vote (Baimbridge, Burkett, & Whyman 2012). A prime example of the governing institutions' lack of authority is the simple fact that the EMU cannot print its own money, normally a fundamental right of the central governing body. The governing institutions of the EMU issue demands to national leaders but often times have no cooperation or collaboration with the individual governments (Bergsten 2012). A single entity with the power and influence to establish and monitor financial institutions is something for which the EMU is desperate. It lays the grounds to be able to efficiently regulate and reform such a gigantic economic entity and make adjustments in times of crisis. The response from the Federal Reserve to the recent crisis in 2007 demonstrates how important having an efficient authority is to a large economy. When the domestic economy collapsed in 2007, the Federal Reserve, the U.S. Treasury, and the U.S. Congress responded aggressively. The Federal Reserve began aggressively

driving down interest rates by cutting the federal funds rate until it was almost to zero. Additionally, the federal government nationalized two large mortgage companies so that they would not file for bankruptcy. The U.S. Treasury pledged fifty billion dollars to ensure shares in the money market funds so financial institutions could have access to short term funds. The U.S. Congress authorized seven hundred billion dollars to purchase mortgages and CMBS loans to increase the money supply and stimulate the economy. These are few examples of the measures made by the United States' fiscal and financial authorities in an effort to improve its economical situation. That is not to say that the United States has a perfect system by any means, but it is helpful in demonstrating the need for a strong authority. The Economic & Monetary Union lacks the ability to make decisions to propel the economy in certain directions. In order for any legislation to get passed, the central bank must first receive approval from each member-state's government, which is nearly impossible on any particular issue. Moreover, the central bank rarely has the jurisdiction to make any substantial changes. Although the ECB can provide some relief in times of crisis, the Eurozone consistently chooses austerity over stimulus and they do not have an efficient system in place to be able to effectively stimulate the economy (Baimbridge, Burkett, & Whyman 2012). When the financial positions of member-states began to diverge, the central authority did not possess the capabilities to take action to reverse these trends (Van der Sluis & Parlinska 2013). There is no system in place to make adjustments in a timely manner to keep the economy from suffering when situations change. This is a primary reason that the Eurozone has struggled so much during this recent economic crisis. In the article

"The Next Europe," authors Nicolas Berggruen and Nathan Gardels quote former Prime Minister of Spain, Felipe Gonzalez, discussing this issue:

> *It is ridiculous for member states to maintain different rules in this common and integrated space where financial institutions operate freely. The absence of homogenous regulation will only sow the seeds of the next financial crisis and hobble Europe in the decades ahead as it faces new competitive challenges in the global economy (139).*

The ECB does not have the power to implement immediate policies to correct unavoidable fluctuations in the market. This all stems from the structural problem concerning the failure to identify a central governing figure with the power to influence the Eurozone through policy and regulation. This is arguably the most concerning issue regarding the Economic & Monetary Union that, if corrected, could propel the EMU into unprecedented future success.

The issues of the European Union and the EMU in the most recent economic crisis have been a popular topic of discussion between economists. To further demonstrate their effect on specific countries, I want to offer perspectives from two very diverse nations, Greece and Germany.

THE GERMAN PERSPECTIVE

Germany serves as both the largest and most productive economy in Europe. It has a nominal Gross Domestic Product of over three trillion dollars and is deemed the world's fourth largest economy (The World Bank 2012). Germany's success began after the Second World War and is a large result of their domination in the manufacturing industry. Their expertise in this industry has allowed them to

maintain a high level of exports and compete with other world powers. Today, Germany is one of the largest leaders in innovation and sets many of the Economic and Monetary Union standards to which the other EMU countries must adhere. West Germany was one of the original founders of the European Economic Community in 1957 and once Germany reunited in 1990, it took an even greater role in the European Union. Germany is very centrally located in the EMU and is bordered entirely by EMU members, with the exception of Switzerland. Because Germany accounts for almost one-fifth of the GDP of the Economy and Monetary Union, it has significant influence in its policies and decisions. Germany also has the power to make economic decisions that would influence other member-states, such as buying large amounts of their exports to decrease their deficits. In a sense, smaller economies in the Eurozone rely on Germany for their stability and their country's economic prosperity. Without Germany, the EMU would not be the world power that it is today and many other countries would not be benefitting from their connected economies.

Because of its extreme success, some may claim that Germany is extremely self-sufficient and thus would be better off on its own. However, when taking a closer look, it becomes apparent that Germany needs the Eurozone just as much as it needs Germany. The Eurozone and the euro play a crucial role in German economics. If the euro were to dissipate, each country would have to resort back to its original currency and its value would be determined by its economic situation. In Germany's case, if it were to re-employ the use of the deutsche mark, its economy would respond negatively. Because Germany has experienced such extreme success,

the deutsch mark would significantly rise in value (Berggruen & Gardels 2013). Due to the unfavorable exchange rate, Germany's exports would become must less attractive. For a country whose economy relies so heavily on manufacturing and exporting products to other nations, this appreciation in currency would prove detrimental to its economy's success. If Germany's export economy plunges, its effects would be seen all throughout Europe and Germany would likely be blamed for causing such distress (Bergsten 2012). In addition, Germany is one of the main investors in the peripheral nations. Therefore, if the Eurozone were to fail, Germany's financial sector would suffer tremendously as well because other countries, which are experiencing deficits, would default on their loans (Berggruen & Gardels 2013 2013). Ultimately, although Germany is contributing a disproportionally large amount to the Eurozone, it would not be better off as a stand-alone nation.

Although Germany provides a large financial contribution to the Eurozone, many argue that Germany is prospering at the expense of the lesser-developed Eurozone countries. For example, when Germany runs a trade surplus, their currency cannot appreciate to balance out the system. The burden is pushed down and the underdeveloped countries, usually on the periphery, hurting their economies. Therefore, Germany's continued success ultimately happens at the expense of the periphery nations; they are in effect purposefully draining income away from troubled countries.. This effect is inflated even more when considering wage levels. Germany, with its repressed wage policies, keeps their labor unit costs very low, while they are rising in other countries without these policies. This wage

gap gives Germany a competitive advantage and the peripheral nations are further affected by Germany's actions (Miller & Sciacchitano 2012). Finally, Germany is not acting in the interests of the euro and Eurozone, but rather of their individual country. Maybe this would be acceptable if their actions were not negatively affecting other countries in the EMU. Some economists say that Germany should buy exports from countries with deficits and generate a lower surplus in order to even out the imbalances between the Eurozone countries (Berggruen & Gardels 2013). Because of its size and influence, Germany could positively affect the Eurozone and help during the crisis, but it is not acting accordingly. The original design of the system does not promote cooperation between nations with bigger and smaller economies.

The German perspective, both its positive and negative aspects, points to flaws in the original EMU system. The crisis is causing difficult situations for many nations, not just Germany. However, by taking a closer look into Greece's perspective, it becomes apparent that the issues presented to Greece are vastly different than those presented to Germany, largely due to the disparity between the nations and the differing roles each country plays in the Eurozone.

THE GREEK PERSPECTIVE

Greece joined the European Union in 1981 and has used the euro since 1999. Since its joining, Greece has been referred to as a country on the "periphery." Since the crisis, the "periphery" is a term that has come to represent the nations that are on the outskirts of the euro area that have weaker-performing economies. Greece resides in the southwest corner of Europe and borders the Mediterranean Sea.

Greece has never been an extremely powerful member of the Eurozone, as Germany has. Instead, it was a smaller, lesser-developed nation that took advantage of the opportunity to join a larger union. This provided them with a strong currency and increased access to capital and they experienced high levels of growth for many years. Unfortunately, Greece did not act responsibly with their budget surpluses and borrowed large amounts of capital in the early years. Greece did not use these borrowed funds in productive ways; instead they focused on giving their citizens a better quality of life through high retirement funds and social security. This eventually resulted in Greece accumulating large amounts of debt. Although Greece should have used their funds to achieve long term goals, they are not the first country to spend more than they acquire. Other countries have generated deficits but it has had a different outcome. For example, Germany and France ran budget deficits for three consecutive years from 2002-2004 (Milios & Sotiropoulos 2010). However, because they possess strong economies with the ability to influence the Eurozone, they were able to adjust their actions to alleviate their budget deficit and bring themselves out of debt. On the contrary, once Greece encountered a debt crisis, because of the structure of the euro, it was not able to devalue its currency to help with its deficits so, eventually, these deficits translated into a serious debt problem (Van der Sluis & Parlinska 2013). When Greece encountered this debt crisis, they were unable to successfully issue sovereign debt. The European Central Bank does not have the authority to directly buy government debt, so Greece had to issue its debt at a rate representing the risk to investors, which peaked at 35% in 2011 (Miller & Sciacchitano 2012). As a result, Greece fell deeper and deeper in

debt. Greece also possessed a trade deficit because they had been continually purchasing imports from other countries, but not exporting the same amounts of goods. Other peripheral nations, such as Italy and Spain, are experiencing similar situations, however, Greece's case is the most severe. Thus, Greece has just fallen further into financial oblivion. To add on to their debt crisis, Greece is experiencing a severe immigration problem. In 2004, Greece brought in four million migrants to provide cheap labor for the Olympic games in 2004 because they were struggling financially. Many of these migrants have stayed and taken away the jobs from the Greeks. Also, Greece serves as the gateway to Europe for the Middle Eastern countries and millions come into Greece willing to work for low wages. As a result, Greece's unemployment rate is approximating a staggering sixteen per cent (Margaronis 2011). This has ultimately led to the worst financial crisis of the EMU with Greece as the scapegoat for all of its problems. This crisis, for the first time, introduced the threat of a country abandoning the euro and the Eurozone's collapse. The ECB has sent them rescue packages, however, it has only temporarily stopped Greece from declaring bankruptcy. In fact, the Greeks seem to think that the EMU authorities have put them in a compromising situation: either their government implements these bailout strategies with drastic measures that will prove very straining on its citizens, or it simply defaults (Margaronis 2011). Moreover, the Greeks are not convinced that the Eurozone authorities have their best interest in mind; rather, they are merely concerned with keeping the Eurozone from experiencing the repercussions of Greece's default (Margaronis 2011). It is indeed a priority for Greece to mend their financial crisis, whether that involves drastic

measures or not, however, their primary concern at this moment in time is its people and improving their quality of life. Maria Margaronis 2011 describes the current landscape of Greece in her article "Greece in Debt, Eurozone Crisis" when she quotes:

> *Already parts of Athens look like New York City circa 1980, with shut-up shops, derelict building and graffitied walls. The effects of the game of chicken being played out by bankers and politicians are visible in the way Athenians walk now, head down and defended, through once-safe neighborhoods; in the irritable, shamed anxiety you see on people's faces. Depression is endemic; suicide rates have soared. For Greeks, this is much more than an economic crisis. It is a social and political convulsion unlike anything seen here at least since the fall of colonels' dictatorship in 1974 (12).*

The results of Greece's debt crisis are heartbreaking. This example, though, provides insight into how the current financial crisis has affected countries differently. Although Greece may not have acted as financially responsible as other countries, their severe debt crisis can be greatly attributed to the EMU system design that includes a spiraling downturn for suffering nations. Nevertheless, just like Germany, it is in Greece's best interest to remain a member of the Eurozone. Without the euro, Greece's drachma would experience hyperinflation and its purchasing power would diminish substantially, not to mention Greece would lose a lot of its access to international capital. The issues presented to Greece at this moment in time are very different than those presented to Germany. This further

portrays the disparity among nations within the Eurozone and how this disparity unfolds in times of crisis.

THE BRITISH PERSPECTIVE

After examining the history and structure of the Eurozone, delving into its recent economic crisis, and sharing perspectives from various member-states, I want to take a step back and look at the Eurozone from an outsider's view. Great Britain became of a member of the European Union in 1973, but voluntarily did not accept the euro as their currency in 1999. For specific reasons, Great Britain decided to participate in only the first and second stages of integration outlined in the Maastricht Treaty. This might seem strange, as the UK was an early member of the EU and houses the largest city in Europe. However, the reasons are clearly outlined in what is now referred to as the "Five Economic Tests." Great Britain's move to the third stage of European economic integration would never occur if these five benchmarks were not met. The five tests include:

Table 1

Convergence of Business Cycles	Business cycles in the Eurozone and the UK must be compatible. Main indicators include inflation, interest rates, and the output gap.
Flexibility	The UK economy must be flexible enough to respond to any shocks in the market.
Investment	The UK participation in the euro must encourage investment in the long term.
Financial Services	The acceptance of the euro must improve the UK's financial services industry.
Growth, Stability, and Jobs	EMU must have positive effects on UK growth and employment

Data from: United Kingdom: EMU opt-out clause. *Europa.eu*. Mar 2014. http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/l25060_en.htm

Great Britain, in 2003, re-evaluated their decision to join the euro, still keeping the five economic tests as the deciding factor for joining. Again, the results

were insufficient for Great Britain to make the change; with only one or two of the tests being met. The fourth test, relating to financial services, works in the Eurozone's favor, as the EMU would improve the financial services industry in the UK. The third test was particularly controversial regarding investment. Although greater access to capital and investment is the main attraction to joining such a large entity as the Eurozone, it is unclear if those effects would transfer into economic success for Great Britain, and therefore can be argued either way. However, the other three tests explicitly failed to meet Britain's needs. Although interest rates and output gaps were much closer than they were in 1997, there was a housing price boom that showed the lack of convergence between business cycles in Great Britain and the Eurozone. If the housing boom turned into a bust, they would be able to lower interest rates to help the economy to recover, something they would not have freedom to do within the Eurozone. With respect to economic flexibility, Britain was still uneasy about the effect joining the euro would have on their wages and prices. The authorities had not changed their viewpoint regarding the fourth test relating to financial services, stating that the Eurozone would not particularly help nor hurt Britain's position. Finally, with respect to growth and jobs, Britain had actually grown faster than the Eurozone from 1999-2003, therefore was not convinced that accepting the euro would help them in this regard (The Economist, 2003).

Although Great Britain should not make the transfer to the euro according to the economic tests outlined in 1997, there are many politicians and scholars who still argue that it would be in Britain's best interest to switch. One of the main arguments is that because Great Britain conducts large amounts of business in

euros, the fluctuation of exchange rate between the euro and the pound is a substantial, on-going risk. This risk is hurting investment significantly, both from the perspective of investments in the UK from others and from the UK engaging in European investments. The figure below portrays the different exchange rates between the dollar and the pound since the euro's inception. Although the exchange rates have steadied out somewhat in the recent years, still these fluctuations can make an extreme difference on returns of large investments. Some believe this is greatly hurting the manufacturing industry, one of Great Britain's largest industries (Howard 2010). Since 60% of Britain's exports go to Europe, the exchange rate makes a significant difference in the profits realized through sales. Long-term investors are hesitant to invest in this industry because, even if production and sales targets are met, if the pound appreciates in value, the profits will result in much fewer pounds. This could work out favorably for Great Britain as well, if exchange rates move in their favor, however, long-term investors are not readily willing to accept this risk. As a result, Britain is losing manufacturing market share to some of its big, Europe-based competitors (Howard 2010).

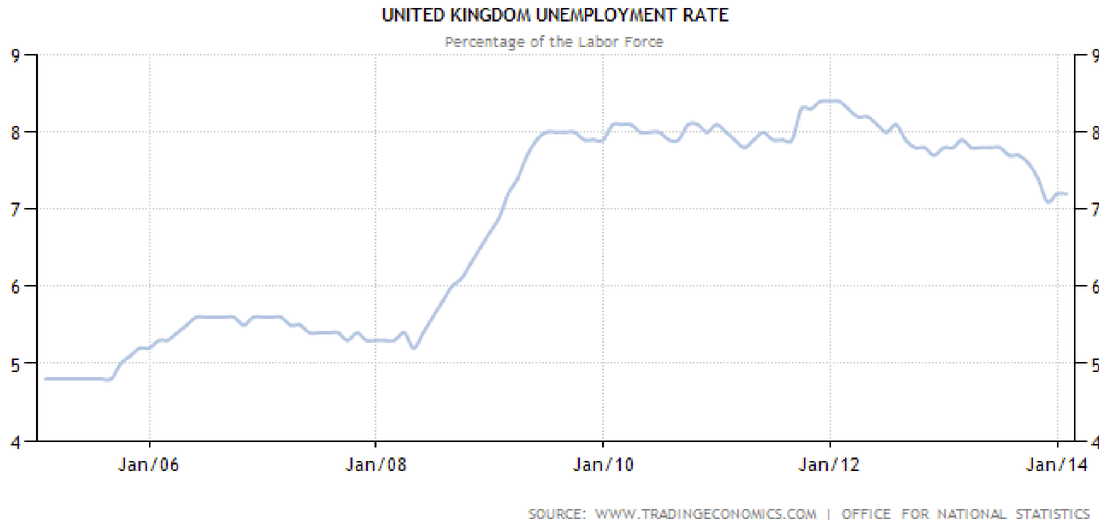
Figure 5

European Union. Euro foreign exchange reference rates. *Europa.eu.* Feb 2014.
http://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-gbp.en.html

Other arguments suggest that Great Britain would greatly benefit from the ECB's control over inflation levels and the price transparency that would occur between Britain and the Eurozone. However, despite these opposing perspectives, the political and financial authorities have chosen to remain on the pound for their currency. Let's examine how Great Britain was affected by the recent Eurozone crisis.

Great Britain elected to stay out of the euro, therefore, they were not directly involved in the Greek crisis or the Eurozone's financial turmoil. Great Britain was never pegged as contributing to the crisis. Also, they were not held responsible for "bailing out" Greece or helping to find a solution to this extreme financial situation. However, just because Great Britain was not politically involved in this union, does not mean it did not feel the financial impacts from the crisis.

Figure 6



United Kingdom Unemployment Rate. *Trading Economics*. Web. Apr 2014. http://www.tradingeconomics.com/united-kingdom/unemployment-rate

From the chart, it is clear that the unemployment rate rose dramatically between 2008 and 2010, during the same time as both the crisis was occurring in Greece and the U.S. recession in 2008. Because so much of their business transactions are done with Eurozone countries using the euro, there is no doubt that this crisis affected them harshly as well. With economies as closely linked as theirs, Great Britain still felt effects of the Greek crisis despite not being on the euro.

The main advantage of Great Britain being autonomous during the EMU crisis was that they could more readily provide recovery measures for their country. For example, the Bank of England began issuing loans at an inexpensive rate to jump-start their economy to help pull it out of the recession (New York Times 2012). Because Great Britain still has their own bank system, they only had one perspective to consider and were able to respond in a more effective and efficient manner to help their country in times of crisis. Any decisions coming from the ECB are much

more controversial and take more time because they have 18 countries to consider in any one decision.

Over the years, there have been many different proposals for how Great Britain should be involved and integrated with the greater part of Europe. Although there seem to be various concrete advantages to becoming a Eurozone member, the financial and political authorities of Great Britain do not think the benefits outweigh the costs. The concept of the five economic tests is unique and could prove useful to other countries or situations in the future. The crisis has ultimately unveiled many of the issues of the Eurozone that did not surface when times were prosperous. It has led to a thorough investigation and reflection upon the Eurozone's principles and processes, and a look into members of the European Union who have elected to use their currency. Looking into the future, there are many areas in which the EMU and the European Union can improve upon so that it continues to remain an economic world power.

THE FUTURE OF THE EUROZONE

The recent turmoil has caused scholars all over the world to analyze and question the Eurozone. It is no secret that the creation of the EMU had many flaws, which have led to this crisis and lack of confidence in the future of the Eurozone. A primary example of this is the leniency of the original criteria to allow countries to become member-states of the EMU. There were obvious doubts whether or not some countries met all of the requirements, however, authorities were so eager to implement the euro, that they overlooked many shortcomings (Bradley & Whittaker 2000). Additionally, from a statistical perspective, the probability of all eleven

countries that adopted the euro in 1999 meeting each of the five criteria is extremely low. Similarly, the Stability and Growth Pact did not prove adequate in outlining the European Central Bank and its duties nor in regulating member-state performance (The Economist 2012). Although these issues did not seem to be drastic at the time, they have unraveled throughout the years resulting in a devastating crisis. Due to the severity of the crisis, some economists argue that the Eurozone should simply dismantle; there exists no strategy crafty enough to mend the damage already done (Baimbridge, Burkett, & Whyman 2012). If not the complete dismantling, at least an exit by some of the weak countries that are bringing the Eurozone its problems. However, this would lead to chaos, as banks and firms all over the world would collapse with a swarm of lawsuits to follow (The Economist 2012). Because the Eurozone accounts for almost 20% of global economic activity and is the largest export market for both the United States and China (Miller & Sciacchitano 2012), its effects would be felt in economies throughout the world. Although an extremely complex solution is necessary, I will argue that the dismantling of the Eurozone would not prove to be the optimal solution. Despite select economists' perspectives, the Eurozone is not yet defeated. As we have seen through the examples of Germany and Greece, it is in each member state's best interest to work to save the Eurozone and to play an active role in its recovery. The recovery will be a lengthy, costly, and complicated process, however, it leaves every EMU member in a better position than does the alternative (Bergsten 2012). Not only would it hurt EMU members to dismantle, but it would also hurt other economies that are closely linked to the Eurozone, including Great Britain and

the other EU members who do not use the euro. For all of the reasons outlined in the economic theory, the Eurozone will function better as one larger unit than to break up and be eighteen separate units; this is proven through the statistics that show the EMU's pre-crisis success. The Eurozone, because it is the first monetary union to face some of these particular issues, will need to closely monitor the recovery's progress and make adjustments along the way. However, with a new structure and new systems set in place, the Eurozone can suppress its short term issues, prevent the same issues from occurring in the long-run, and eventually come back stronger than it's ever been. My proposal will outline three distinct stakeholder groups and provide suggestions for each of the different parties involved: current members of the EMU, EU members that do not use the euro, and potential EMU candidates in the future.

The Current Economic and Monetary Union

In order for the EMU to function as one unit, it needs to become more tightly integrated. Currently, there is a lack of a central authority, too much disparity between country's economic systems, and too lenient requirements for gaining and maintaining a place in the EMU. The solution is to re-structure the EMU and to make it more integrated. Below, are the four parts to this re-structuring.

Fiscal Integration

The first issue to be addressed should be the lack of efficient fiscal authority. As outlined previously, one of the Eurozone's greatest flaws is the absence of a strong government entity to design and enforce processes and regulations. If this type of government were to be established, the Eurozone would act more as an

integrated union, rather than individual member-states using the same currency. Nicolas Berggruen and Nathan Gardels accurately describe what the Eurozone needs in their publication "The Next Europe" when they state, ""Europe needs a strong but limited central government that accommodates as much local diversity as possible" (137). The Eurozone needs a strong fiscal entity that is elected on behalf of each country to take an aggressive approach in fulfilling the financial goals of the monetary union. In Paul de Grauwe's article, "The Greek crisis and the future of the Eurozone," he states about the political influence:

> *Put differently the structural problem in the Eurozone is created by the fact that the monetary union is not embedded in a political union. This imbalance leads to the dynamics of creeping divergencies between member states and no mechanism to correct or to alleviate it. These divergent developments have much to do with the fact that important economic decisions are decided at the national level. These divergent movements in competitiveness also lead to budgetary divergences whereby countries that loose competitiveness experience stronger deteriorations or their budgetary situations. Thus the lack of political integration leads to a buildup of economic and budgetary divergencies leading to a crisis (4).*

By integrating the monetary union into the political structure, member-states will have influence over how their union in organized. There should be requirements for equal representation from each country the scope of each country's influence proportional to the contributions. It will also contribute to the authoritative nature of this entity. The ECB and the Eurozone financial system will operate in tandem

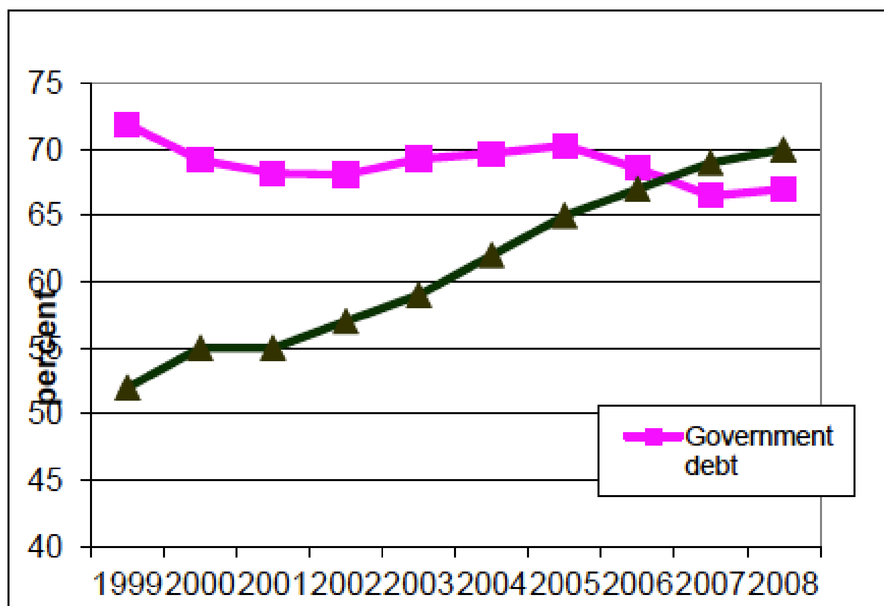
with this fiscal entity and it will have the authority to adjust the behaviors of the banks and other financial institutions. The ECB and European Commission currently serve as the Eurozone's fiscal entity, however, it needs to take a much more active role in setting policy and enforcing its standards throughout all of the financial institutions administering the euro. Currently, the ECB is primarily focused on keeping inflation levels low (Bradley & Whittaker 2000). This is important, however, this needs to be one of the many functions of the ECB. Perhaps a theoretical example could be structure of the United States financial system. There is a strong federal government, however, not so centralized in the fact that states have the freedom to make their own decisions. Each state has its autonomy and its individual infrastructure; however, all financial institutions have to abide by the over-arching rules and regulations set in place by the federal government, especially as it relates to the financial system and taxes. Additionally, the central bank can make monetary policy decisions regarding interest rates and money supply in efforts to stimulate the economy that will effect all financial institutions, despite their individual state laws. The Federal Reserve has the unlimited ability to create money without having to ask the fiscal authorities. The ECB does not have this ability. The Eurozone would be able to better combat crisis if it had a fiscal entity with deep pockets and the power to shape the markets (Miller & Sciacchitano 2012). Another opinion comes from Berggruen & Gardels who suggest that the governing body resemble the Swiss federation, with an "executive body that is directly accountable to Europe's citizens" (135). Either way, the European citizens at large must elect the leader of the governing body so that he or she is democratically

elected and represents one body (Berggruen & Gardels 2013). Ultimately, the Eurozone needs a better functioning governing body to create a balance between centralism and decentralism that will preserve the traditional culture of each member-state as much as possible but also will act to influence the Eurozone economy and ensure its stability. This will be especially crucial in times of crisis. Filling this gap will, in turn, improve the efficiency of the financial system by providing it with more structure and organization. With a stronger leader and a more efficient and adaptable financial system, the Eurozone will position itself to experience growth and handle unexpected situations in the future.

Integration of Systems

A central authority is the first initiative to better integrate economies through systems within the Eurozone. First and foremost, the banking system needs to be integrated. One of the main drivers of the recent crisis was the debt accumulation of many member-states. And with the exception of Greece, surprisingly most of the recent increase in debt accumulation was not by governments, but rather within the private sector (de Grauwe 2010).

Figure 7



Source: European Commission, AMECO database and CEPS

De Grauwe, Paul. 2010. The Financial Crisis and the Future of the Eurozone. *Bruges European Economics Policy Briefings,* 21. 25 Mar 2014.

Eventually this debt gets passed on to the governments, however, the deficits mainly originated from the private sector. This is due to the fact that banks and corporations are under national regulation, rather than an EMU regulation. These individual systems need to be united under one regulatory agency that determines reserve requirements and appropriate debt levels. The crisis of 2008 that occurred in the United States was largely due to debt accumulation. In response to the crisis, the Federal Reserve issued stricter regulations in hopes of preventing future crises. Perhaps, the EMU could develop a system similar of that in the United States. Each country has their own banks that function autonomously, however, they abide by the rules and regulations of the larger authority. Similarly, by integrating the

banking systems, a standardization will arise with credit regulations and requirements and transaction costs will be even lower.

Another example of system integration is taxes. Currently, each country pays taxes to its own national government. Therefore, citizens' money ends up in the hands of the national governments, rather than that of the EMU or ECB. This undermines the authority of the EMU because the governments possess the citizens' money, not them. By restructuring the tax system to give some portion to the EMU authorities, economies will be more tightly integrated and more authority will be given.

The banking and taxation systems are just two examples of the way in which economies can be further integrated within the EMU. Once the systems are on par and compatible with each other, it will make it easier for the union to operate efficiently and effectively, with little risk of one country creating a crisis.

Stricter Evaluation of Member-State Performance

Another one of the primary issues facing the Eurozone is the great disparity among the nations, especially economically. Countries are on such different levels financially and in so many different stages of development that many issues arise. As a result, the authorities of the EMU need to ensure that each member-state is a good fit for the union and that they uphold their individual requirements in order to productively contribute to the EMU's success. Although this will work for potential candidates, which will be discuss in more detail in a later section, how does the EMU make up for the leniency of the original criteria that originally admitted countries? The EMU will outline their requirements. They will have certain levels as it relates

to debt/GDP ratios, growth rates, budget deficits, and trade deficits. The current member-states will be required to uphold all of these levels at all times throughout their membership. In order for the euro and EMU to be successful, each member-state needs to be productively contributing to its prosperity. If certain member-states, such as Greece or Spain, are not at these levels, they will work directly with the EMU to develop a plan to gradually improve to achieve these requirements and uphold them. Certain spending limits, lending restrictions, and time restraints will be included in the plan. With each member-state adhering to the same requirements, proportional to their size and wealth, it will abolish the fear of one country causing a crisis in the larger union because of irresponsible choices or unfair disadvantages.

Reprimands & Incentives

Building on the previous idea, countries will be held accountable for their actions. The EMU will never again be blind-sighted by the incidental actions of one nation. The EMU will closely regulate countries and their performance measure. They will even regulate more heavily the countries that have not been meeting requirements or are in danger of not meeting them. When a country fails to meet the target requirements for EMU membership, there will be a probationary period followed by severe reprimands if the country does not improve its financial position. Examples of these reprimands could include cuts in government spending and the restriction of debt to be issued. If the country consistently fails to maintain these levels, they will be asked to leave the EMU and gradually disintegrated.

The EMU will not only reprimand countries for not meeting requirements,

but they will also reward countries that meet exemplary levels or take specific efforts to help other EMU economies that are suffering. Because positive reinforcement is proven to work just as effectively if not more than negative reinforcement, incentives will be set in place for countries to act in the greater interest of the EMU. Moreover, it will greatly reduce countries from engaging in the free-rider effect. If there are strong incentives to perform well financially, countries will be more motivated to strive for these goals, rather than simply maintain the minimum requirements and reap the benefits of belonging to the EMU. Incentives and positive reinforcement are one of the strongest tools used to accomplish goals. If economists devise a growth strategy to pull the Eurozone out of the crisis and ensure its future success, they can use incentives to influence behavior to accomplish the goals laid out in the strategy. Countries with economies that are experiencing financial success should help those who are not, in an effort to keep the monetary union as strong as possible. For example, in this current crisis, countries in Germany's position should stop focusing on their own deficit reduction and rather buy more goods and services from countries such as Greece and Italy in efforts to lessen their debt burden (Bergsten 2012). If Germany were to engage in these activities, they would be given rewards. Developing a system of reprimands and incentives will help to align the interests of member-states in the EMU, so that they will behave in a manner that does not only benefit their specific country, but the EMU at large, similar to the strategy behind aligning interests in a business with multiple SBUs. The Eurozone itself needs to work as one unit to ensure that no

outliers undermine their success. This will improve the overall productivity of the Eurozone and their ability to collectively respond to crises.

These four integration tactics will decrease the likelihood of another instance of the Greek crisis occurring again and will ensure cohesion and financial stability from the EMU as a whole. However, they do require a strong commitment and a large degree of transparency for each country involved. The current member-states will be given a choice whether they want to begin the process of integrating further with the Eurozone countries or if they want to go on their own. Current member-states will likely opt to integrate further, so as not to jeopardize their stability or financial position. However, whichever decision the country makes, the EMU authorities will aid them in pursuing their goals with the least amount of individuals negatively affected. Although there will be significant benefits to being a part of the Eurozone, in practicality, not every country will want to make this large of a commitment. The EMU will have to prepare for this and aid them in diverging their economies to be less integrated. Afterward, they will develop ways to create optimal relationships with countries that are in the European Union, that have elected to still use their own currency.

European Union Members Who Do Not Adopt The Euro

As we have seen through examples of Great Britain, Sweden, and Denmark, there currently are and likely will be more countries that voluntarily reject the euro as their currency. Great Britain in particular has concrete reasons for not accepting the euro known as the five economic tests. This could be a wise decision for countries that do not feel that their economies will converge with the EMU. The three

principal advantages to Britain and all other outsiders joining the EMU is (Minford 2004):

1) The reduction in transaction costs of changing currency
2) The reduction of exchange risk leading to greater trade and foreign investment with the rest of Europe
3) Increased transparency in price competition

For countries that choose not to accept the euro, it is in their best interest to try and capture these advantages as much as possible to better facilitate trade. For example, Denmark and Sweden have tied their currencies closely to the euro. This eliminates some of the exchange risk regarding trade and investment. The authorities of the non-EMU country should congregate with the EMU authorities to develop a plan to converge economies as much as possible so as to formulate an optimal agreement between semi-integrated nations. Because the EMU will be more intensely integrated, there will likely be other nations who opt to not fully integrate with the EMU because of the strong commitment. The EMU will be prepared for this response, and will work with the other party to create an efficient plan that eliminates as many barriers as possible.

Potential Economic and Monetary Union Members

The final stakeholder group of this proposal is the future prospective EMU members. The Eurozone has several potential members, countries that wish to integrate their economies and use the euro as their national currency. Several countries have applied to become members, and undoubtedly there will be more if the Eurozone recovers. Because many of the issues during the crisis originated from

countries not being able to contribute to the EMU, this process will need to be reformed and made much more stringent. My proposal is that the potential new member be closely evaluated by EMU authorities for a lengthy period of time to determine if their economy and financial system is able to be made compatible with those of the EMU. If granted acceptance, the country will not suddenly become a member of the EMU, but will rather enter into an integration process. This process could potentially last up to several years and will take steps to integrate the systems and economies as well as preparing the new member's financial and political leaders to be a part of the governing bodies of the Eurozone. As a result, when the country does accept the euro, they are well aware of their requirements that they must uphold, their systems are up to par, and they are ready to contribute to the union both financially and politically. It will be similar to Great Britain's five economic tests, with all five having to be met before the country will be able to physically begin using the euro. This integration process will weed out countries that, at first glance might seem like a good addition but that's infrastructure and practices in fact do not align with that of the Eurozone. This process will prevent a situation such as the Greece crisis from happening in the future because of the lack of disparity among nations, the result of a lengthy process and strict requirements the country must meet for a substantial period of time before joining.

With these structural changes for the current EMU members, suggestions for the relationship between EU countries who do not use the euro and the EMU, and the system of integration for potential candidates, the EMU can successfully become a more integrated, better-performing unit. Also, because the governing and

regulatory authorities will be larger, there will be more individuals focused on strategically integrating the economies and systems of the EMU, ensuring the success of each country and the larger unit.

CONCLUSION

The Eurozone, although currently encountering a crisis, has collectively been a world power since its inception. The crisis has uncovered multiple issues due to the original structure of the monetary union; however, no issue is too big to overcome for this group. It is important to identify the specific problems and determine what drives each issue and how to best combat those issues. It is very important that the EMU understand that it must become more inter-connected to enhance performance in the future. The use of the United States as an example of tighter integration will prove very useful to the Eurozone authorities, especially in terms of the Federal Reserve and the fiscal government. The ECB could very well benefit from implementing some of the Federal Reserve's characteristics, such as adopting a dual mandate system that would direct them to target unemployment as well as inflation. It is important to remember also that not every nation will be eager to sacrifice some of its independence and there are alternatives in place to work to optimize those specific relationships. Finally, there will be a new system for evaluating potential EMU members so as to prepare them to contribute to the EMU from the day they employ the use of the euro and prevent vast disparity among member-states in the future. Ultimately, the restructuring of this group will need to be implemented in stages over a long period of time. The parties involved will most definitely resist this change at some point, as it is natural for humans to resist

change, however, the long-term vision of the organizers will allow the Eurozone authorities to overcome this resistance and keep pushing forward towards the end goal. Although this transition will be tough and inevitably complications will arise, the outcome will be far better than the EMU's current state.

The outlined proposal is a high-level solution; there will be many smaller tactical parts to the overall strategy that will have to be worked through. However, it is a unique approach that identifies three different stakeholder groups and devises a strategy for each of them to be successful. If the strategy stays consistent with this proposal, the Eurozone and the rest of the world will profit from the Eurozone's future success as a monetary union. Through this strategic restructuring, the Eurozone cannot only aim to prevent future crises, but can prove itself to be stronger than ever.

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