Claremont-UC Undergraduate Research Conference on the European Union

Volume 2014 *2014* Article 8

2014

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Recommended Citation
Fairbanks, C. Cole (2015) "The Political Hindrances in Solving the European Sovereign Debt Crisis," *Claremont-UC Undergraduate Research Conference on the European Union*: Vol. 2014, Article 8. DOI: 10.5642/urceu.201401.08
Available at: http://scholarship.claremont.edu/urceu/vol2014/iss1/8

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The Political Hindrances in Solving the European Sovereign Debt Crisis

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Abstract

Once revered as a progressive supranational success story, the European Union now faces excessive public debt, unemployment, and stagnation partly due to its flawed institutional design. This has become apparent in southern Eurozone countries like Portugal and Greece, which continue to suffer from strict austerity measures imposed by the International Monetary Fund, European Commission, and European Central Bank (Troika). This report examines the politics behind the European Sovereign Debt Crisis, including the rise of Eurosceptic populist parties. Furthermore, it analyzes austerity in southern Europe, the 'moral hazard' argument, and the German government's reluctance to lead Europe out the crisis. This report cautions against such a reluctance, which will allow populist parties to gain a stronger foothold in Europe's political institutions and disrupt the European project. Due to the shift of the Eurozone's financial crisis to a political one, it is in the best interest of the European Union and its leaders to continue to integrate its financial, banking, and political institutions in order to face the unique and dynamic political restraints in solving the Euro crisis.

Keywords

European Sovereign Debt Crisis, Political Hindrances, Austerity, German Hegemony, Populist Parties

The European sovereign debt crisis has hit Europe like a financial tsunami. Originating in the United States (US) through financial deregulation, risky bank investments and a colossal housing bubble, it did not take long for the US Subprime Mortgage Crisis in 2007 to make its way across the Atlantic (Zestos & Rizova, 2012). Unlike the US however, the incomplete European Economic Monetary Union (EMU), which was unable to handle major financial shock, ultimately proved to be a 'monetary cage' for Eurozone countries (Razin & Rosefielde, 2012). Thus, the Eurozone has experienced a prolonged recession that recently has been partially curtailed by modest economic growth. Nonetheless, southern debtor countries like Spain, Greece, and Portugal continue to suffer from rising unemployment, austerity, and economic stagnation, which have ignited a political firestorm across Europe (Mackenzie, 2014; McMillian, 2014; Ivanovitch, 2013).

To save the EMU and the single Euro currency, political leaders like Angela Merkel and François Hollande have called for 'more Europe,' hoping to lead the Eurozone towards full economic integration and prevent similar future crisis. However, both tasks could prove to be very difficult, as the Eurozone's financial problems begin to present large scale political ones, both domestically and at the EU-level. This of course, has been exacerbated through the rise of Eurosceptic populist parties like France's National Front. Along with other anti-EU parties, the National Front now partially controls 25 % of the European Parliament (Adamson, 2014). Although division among these parties has yet to be resolved, this political shift towards the far-right could ultimately unravel any plan for a true political and economic union in Europe. Preventing such a failure is imperative not only for the Eurozone, but the rest of the world. The EU is a symbol of universal democratic principles, economic cooperation, and peace. Moreover, the supranational entity is a model for states suffering from secularism, nationalism, and ethnic conflict.

Desperately searching for leadership, the EU has discovered that Germany is reluctant to assume a hegemonic role. However, time is running out for Germany and the EU, as Euroscepticism continues to grow stronger in the midst of fiscal austerity, unemployment, and stagnation. The Euro crisis has dragged on now for six years and has caused division, distrust, and resentment as a consequence. Repealing strict austerity measures and mutualizing public debt must be reconsidered to contain the spread of populist parties from disrupting the European Project. Furthermore, it is in the best interest of the EU to further integrate in the midst of financial adversity in order to overcome the political hindrances in solving the Euro crisis.

This report will be divided into several sections: The first section will establish the theoretical basis of this report. It will give insight into the dysfunctional architecture of the EU, how the Eurocrisis came about, and why it has lasted so long. The second section will examine conflicting attitudes that the German people have towards the Eurocrisis to explain Germany's reluctance to lead Europe out of the crisis. The third section will highlight the rise of Eurosceptic populist parties in response to the ongoing crisis and the shift from a financial crisis to a political one. The fourth section will offer some optimism to take away from the Eurocrisis as European leaders make reforms to combat unemployment and recession. Finally, the fifth section will reiterate sections one through four and offer suggestions to the EU for moving forward.

The Situation in Europe

The financial disaster following the collapse of the US housing bubble in 2007 marked the beginning of a domino effect that briefly toppled the European continent in 2009. Decades of radical liberalization of the US financial and banking system led to risky mortgage investments to unqualified clients, which ultimately added to the immensity of the US's financial bubble. According to previous research from Zestos and Rizova (2012), "This was a major reversal of the financial and banking regulatory regime that had prevailed in the US after the Great Depression" (p. 70). When the housing bubble finally did burst, the US began to spiral out of control into deeper recession. It was not until 2009, that the US exited its recession largely in part to its central bank (Federal Reserve and Treasury), which became the fundamental tool in combating declining gross domestic product (GDP). The Eurozone on the other hand, has not been so fortunate. On the basis of a series of treaties: Rome (1957-58), Schengen (1985), Maastricht (1992-93), Amsterdam (1997-99), Nice (2001-03), and Lisbon (2007-09), the EU has subjected itself to supranational macroeconomic dysfunction.

Why the Crisis has Lasted So Long

An Incomplete Economic Union

Many experts acknowledge that the EMU represents an incomplete European economic union, which has severely crippled both Eurozone countries, especially the periphery member states (O'Rourke & Taylor, 2013; Zestos & Rizova, 2012; Razin & Rosefielde, 2012). Countries that joined the EMU and adopted the single euro currency relinquished their monetary and exchange rate policies to the EU, maintaining partial control over their national fiscal policies. This turned out to be a major flaw, as Eurozone countries quickly discovered they could no longer devalue their currencies to ease out of recession, leaving national governments fiscally paralyzed (Razin & Rosefielde, 2012; Zestos & Rizova, 2012). On the other hand, the EU was also placed at a disadvantage. Without a political, fiscal, or banking union such as is the case in the US, the EU was unable to fully assist Eurozone countries avoid recession through buying public debt via Eurobonds. The only exception came in the form of an announcement from Mario Draghi, the President of the European Central Bank (ECB), to do "whatever it takes" to save the euro. The ECB later announced it would buy all Eurozone members' bonds, which is known as outright monetary transactions (OMT). Although OMTs were never carried out due to legal disputes, they proved to be extremely beneficial in restoring market confidence and avoiding full blown depression within the Eurozone. However, OMTs also turned out not to be the 'silver bullet' that would bring the Eurocrisis to a swift end.

The situation went from bad to considerably worse when the Greek Prime Minister George Papandreou announced to the EU Commission in 2009 that the previous administration misrepresented to the EU Commission the Greek deficit. Instead of a deficit of 5.7 % as reported, Papandreou stated is was closer to 12.7 %. As a consequence, Greece's credit ratings plummeted, subsequently downgrading Greek government bonds. In addition to Greece's government bonds downgrading to be worth virtually nothing, huge amounts of investment and capital left the country. Many southern European countries like Spain and Portugal would suffer similar fates at a lesser extent (Zestos & Rizova, 2012). For that reason, the International Monetary Fund (IMF) was asked to intervene by Chancellor Angela Merkel. The IMF, together with the EU Commission and the European Central Bank, known collectively as the 'troika,' rescued member states like Greece through relief packages consisting of bailout money. In exchange, periphery countries like Greece, Cyprus, and Ireland were forced to adopt strict austerity measures to reduce public debt and deficits. Whether these measures have worked or will work in the future has been extensively debated.

Austerity in the Southern Periphery

The purpose of austerity measures is to produce long term economic growth and restore market confidence through cutting government spending according to the 'troika' and its supporters. These measures include: wage and pension cuts, downsizing of public sector employment, and privatization of public enterprises (Zestos & Rizova, 2012). Most southern Europeans would argue that long term fiscal discipline is necessary, but also that austerity measures have done more harm than good. The reasoning behind this logic is that cutting spending and borrowing reduces GDP growth and therefore, raises unemployment. Spain in particular has suffered from high levels of unemployment. According to Eurostat, unemployment levels reached 25.3 % in March, 2014 (Table 1). This number is even higher for Spanish youths between the ages of 16 and 24 who make up Spain's *generación cero* or 'lost generation' with an unemployment rate of 53.9 % during the same time (Table 2). This issue of austerity has become central to the Eurocrisis, especially in countries like Spain, where riots are escalating in places like Madrid.

The Moral Hazard: A Northern Perspective

Many Germans, including Angela Merkel, argue that encouraging southern countries to expect and rely on bailouts constitutes a dangerous 'moral hazard' that harms the German taxpayer as well as long term growth for the southern periphery. However, the level of human suffering that austerity has caused threatens to dissolve the EMU. If this happens, Germany will have the most to lose, considering it benefits tremendously from interstate trade and the easy flow of capital through the Eurozone. Furthermore, it was the cheapness of the Euro currency that allowed Germany's exporting sector to boom. With that being said, it is only logical that Germany will eventually have to confront its obsession with monetary stability and lead the Eurozone towards 'more Europe' to prosper economically in the long run. Nonetheless, the country which is 'too small for the world, but too big for Europe' has legitimate reasons for being reluctant to do so.

The Reluctant Hegemon

Germany dominates the European economy as well as its politics. Not only has it weathered the Eurocrisis, it has grown in strength. Unemployment is at 5.4 % (Table 1), the budget is balanced, and government debt is falling. It is also important to note that the decay of other powerful European neighbors has shifted more influence towards Berlin. At the beginning of the crisis, France and Germany were the dominant economic forces in the Eurozone. The close political relationship between Chancellor Angela Merkel and President Nicolas Sarkozy embodied the two economic powerhouses, which ultimately led to the creation of the word "Merkozy." However, the Franco-German 'Merkozy days' of European economic domination are over. France faces stagnation and rising levels of unemployment, which require major reform. Britain too, although outside the Eurozone, has become distracted over a domestic debate relating to its future role in the EU. Germany is almost all that remains of EU countries able to wield a strong influence in policy making at the EU level. However, Germany needs Europe's support, which is why it is hesitant to lead the Eurozone out of the crisis alone.

Many perceive Germany as demanding, especially southern Europe, which strongly associates Germany and Chancellor Angela Merkel with austerity. Others argue the contrary, such as Poland's foreign minister, Radek Sikorski, who claims Germany is not leading enough. In a speech in Berlin, Sikorski said, "*I fear German power less than I am beginning to fear German inactivity," calling Germany Europe's "indispensable nation" (The Economist, 2011).* One thing is for certain, as Europe's most influential member, Germany must take the lead in pushing towards full economic integration. After all, it is Germany that has the most to lose from a dissolution of the EMU, taking into account its aging workforce and large exporting sector. However, to ensure the Eurozone's collective prosperity, the Eurozone debt will eventually have to be mutually shared, which may jeopardize German monetary stability.

Risking such instability is widely unacceptable for Germans, who desperately desire fiscal responsibility. Historically, Germany has suffered from hyperinflation and economic catastrophe, resulting in two world wars and the destruction of the European continent. This still resonates with many Germans, who remember Hitler's Third Reich and the Soviet occupation of East Germany. However, the current threat is not the sort of hyperinflation that led to the iconic 'wheelbarrow of Deutschmarks for loaf of bread' image of the 1930's, rather, it is deflation. Nonetheless, the obsession with monetary stability directly conflicts with another German value, the belief in European integration, which is entrenched within the German psyche. After the war, Europe offered Germany a path towards redemption, reconciliation, and prosperity. This is embodied in the Germany's constitution, which describes Germany as an "equal partner in a united Europe" (Beddoes, 2013). Thus, despite their concern over monetary stability, Germans are also eager to redeem themselves through European unity, which is politically apparent.

Germany is the most pro-European country in the Eurozone. Eurosceptic political parties have failed to reach the double digits such as the alternative für Deutschland (AfD). Over 60 % of Germans still support the euro, and therefore, Germany will be expected to act boldly to secure the single currency's future. This has become clear through Angela Merkel's push for more European fiscal integration. However, Germans' conflicting attitude towards price stability and the moral hazard manifests itself through Merkel's tough stance on fiscal prudence. Germany must let go of its fears of instability and act boldly to secure the future of the EMU in a united Europe. For reasons such as its reluctance to lead, fear of instability and desire for European integration, Germany continues to stall in resolving the crisis. As a consequence, Europe is starting to witness a shift from a financial crisis to a political one, domestically and at the EU level.

From a Financial Crisis to a Political One

Although the EU has experienced slight economic recovery, it still faces fierce criticism from all sides of the geopolitical spectrum. In terms of ideology, the Right views the EU as a massive bureaucratic impediment to competitiveness and growth. The Left, on the other hand, sees the EU as a disguised fine-tuned neoliberal machine. In terms of geography, there is a clear division between northern creditor countries and southern debtor countries. The South's position on 'mutualizing' or sharing the Eurozone debt directly conflicts with the North's 'moral hazard' argument. Germany and Finland among others fear they will be forced to subsidize the irresponsible (Kundnani, 2014). Nonetheless, these member-states may have to abandon strict austerity, or risk EMU being dismantled by populist political backlash.

Domestic Backlash

At the national level, populist parties are gaining popularity almost everywhere in Europe, especially in countries suffering from high unemployment and stagnation. Far –right parties in particular, such Greece's Golden Dawn and France's National Front, have gradually gained a foothold in Europe. Furthermore, they openly support dismantling the EMU, which deeply concerns many Europeans (Ivanovitch, 2013).

After significant gains in local elections, France's National Front (NF) led by marine Le Pen, has sent a clear message to the French government, "distrust, distress, and disunion" (Alduy, 2014). The NF has capitalized on the French public's frustration with poverty and corruption. Additionally, the far-right party has toned down its ideological extremism to appeal to more voters. Greece's fascist Golden Dawn on the other hand, has done anything but tone down its radical ferment. Since ascending into the Greek parliament two years ago with 7 % of the vote, the neo-Nazi party has been labeled a criminal organization after a series of murders that are currently under investigation (Smith, 2014). The Golden Dawn is by far the most extreme Eurosceptic group in the EU. However, its rise along with other European populist parties highlights the dangers of a prolonged crisis, which thus far has directly linked with unemployment, economic stagnation, and austerity. These dangers have led to a major gain in seats for Eurosceptic parties following the European Parliamentary elections in May, which have the potential to block any proposal geared to further integrate Europe and resolve the crisis.

More Danger at the EU-Level

Facilitating public debate on EU-level decisions and European integration did not produce a mass of pro-European citizens like EU elites had hoped. Rather, the financial crisis is causing a popular backlash in both debtor and creditor countries (Scicluna, 2012). The frustration over austerity has been taken advantage of by Eurosceptic populist parties such as the NF in the European elections. However, European leaders such as center-left Martin Schulz will also capitalize on Europeans' frustrations, attacking austerity directly in order to combat the rise of populist parties. French Prime Minister Jean-Marc Ayrault reinforced these sentiments, "You can see populist parties on the rise everywhere and if they succeed in the European elections, they will be able to block a reorientation of Europe" (Mackenzie, 2014). Overall, most EU incumbents did not fare well in the EU elections. Therefore, all political parties will be hesitant to discuss hot topic issues such as fiscal measures and immigration. Furthermore, most politicians will try to distance themselves from Brussels to win over popular appeal (Mackenzie, 2014). With the European Parliament partially under Eurosceptic political control, mainstream EU politicians will have to work together to further integrate or diffuse, the former being the one most EU officials will support.

The Eurozone's Long Road to Fiscal Unity

Despite political setbacks, there is still reason to be optimistic about the Eurocrisis. Although some argue that attempts to resolve the crisis through an unrelenting faith in 'more Europe' in a political culture of total optimism will fail, there are signs that things are improving. The most tangible examples include the development of a European banking union and the prospects for future treaty change that ill push the Eurozone towards a fiscal union.

European Banking Union has been the most concrete reform to emerge from 2011 and 2012. It delegates more national power to the ECB, which will take over supervising Europe's biggest banks. In addition, the banking union establishes a Single Resolution Mechanism fund to deal with future crisis (Barker, 2014). However, the banking union also has its flaws. Eurozone members will not share the burden of rescuing banks. Furthermore, the Single Resolution Mechanism fun is to be constructed over the next eight years, which many experts consider too long (Barber, 2014). Nonetheless, the newly created banking union will dispel concerns over hidden problems in the financial sector, give more teeth to the ECB, and most importantly, bolster market confidence (Barker, 2014).

Treaty Change is also on the horizon for the Eurozone. Negotiations are scheduled to commence at the end of June 2014 following the EU elections. Whether the EU moves closer towards a fiscal union and how much closer will be extensively debated. Debt mutualization and fiscal discipline will be hot topics for leaders such as Angela Merkel, who envision a more centralized Eurozone. Her version, supported by Wolfgang Schäuble, Germany's finance minister, will specifically establish a "budget commissioner empowered to use common funds and reject national fiscal plans if they don't correspond to the rules" (Wagstyl & Barker, 2014). This highlights "Berlin's determination for the EU to build on the Eurozone's fragile recovery from the financial crisis by creating institutions strong enough to withstand future turmoil" (Wagstyl & Barker, 2014). Despite this development, some still argue that attempts to resolve the crisis through an unrelenting faith in 'more Europe' in a political culture of total optimism,' will fail for the same reasons the Constitutional Treaty failed -- any push to achieve fiscal integration will upset the balance of power drastically (Scicluna, 2012). However, The EU will have to gravitate eventually towards a banking, fiscal, and monetary union in order to prevent a perpetual financial 'doom loop' (O'Rourke & Taylor, 2013). 'More Europe' may not be the ultimate answer for the Eurozone, but in the case of the Eurocrisis, perhaps 'just enough Europe' will speed up bringing it to an end. Regardless, leading up to its sovereign debt crisis, the EU in the past was plagued with frequent economic confrontations which allowed it to grow stronger and move forward towards further European Integration (De Wilde & Zürn, 2012). This round of treaty changes could ultimately prove to do the same.

Conclusion

The European Sovereign Debt Crisis continues to divide Europe and threatens to seriously damage the economic and political integration that embodies the European Project. The Eurocrisis has dragged on for too long and has caused division, distrust, and resentment. Strict austerity measures and sharing the burden of debt must be reconsidered to prevent populist parties from disrupting the European Project. Through European leadership, the EU must stand together in the face of financial adversity to overcome the political hindrances in solving the Euro crisis. There is a vast amount of competing political forces at work. In regards to the ideological spectrum, the Left and the Right are constantly pushing for their own ideological agendas. Geographically, there is a deepening divide between northern creditor countries such as Germany and Finland and southern debtor countries such as Spain and Greece over austerity and the 'moral hazard.' The former are unwilling to share the collective burden of debt as Europeans, instead clinging to their national countries of origin.

Meanwhile, the latter countries continue to suffer from austerity as unemployment, poverty, and human suffering rise. How exactly the Eurocrisis will continue to unfold is not clear. What is clear is that Germany will have a large role in the future of the Eurozone. Although the country is reluctant to do so, Germany must let go of its fear of instability and strive to bring the EU closer to economic and political integration as a way of thriving economically as well as redeeming itself for past transgressions of the previous century. However, Germany and the EU together must act swiftly to enact reform before populist parties gain enough influence to destroy the fabric of European Project. Preserving this project is not only in the interest of the EU, but also the world. The EU is not just a trade union, it is an idea. This idea represents universal democratic principles, economic cooperation, and peace, which are imperative to overcoming secularism, nationalism, and ethnic conflict. By analyzing the problems, arguments, as well as the failures and successes of the Euro crisis, we can pave the way for future supranational institutions to gain a solid foothold in the world and promote the universal ideas they stand for.

Author's Notes

I would like to offer my special thanks to Dr. George Zestos for his excellent guidance and encouragement throughout my study. I would also like to thank Dr. Tatiana Rizova for her appreciated advice and critiques. Correspondence concerning this article should be addressed to Chandler Fairbanks, 1000 University Place Box 4589, Christopher Newport University, Newport News, Virginia 23606 Contact: chandler.fairbanks.12@cnu.edu
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Appendix

Table 1

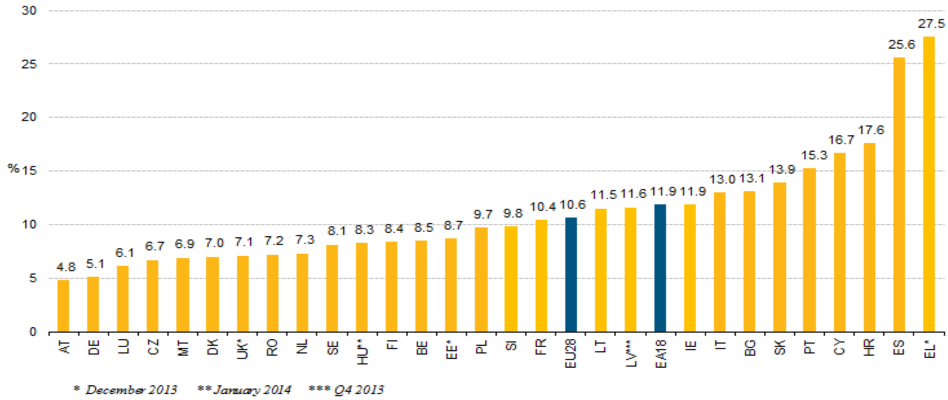

Table 2

	Youth unemployment rate				Youth unemployment ratio		
	2010	2011	2012	2012Q4*	2010	2011	2012
EU-27	21.1	21.4	22.8	23.2	9.0	9.1	9.7
Euro area	20.9	20.8	23.0	23.7	8.7	8.7	9.6
Belgium	22.4	18.7	19.8	22.0	7.3	6.0	6.2
Bulgaria	21.8	25.0	28.1	28.4	6.7	7.4	8.5
Czech Republic	18.3	18.1	19.5	19.3	5.7	5.4	6.1
Denmark	14.0	14.2	14.1	14.2	9.4	9.6	9.1
Germany	9.9	8.6	8.1	7.9	5.1	4.5	4.1
Estonia	32.9	22.3	20.9	19.3	12.6	9.1	8.7
Ireland	27.6	29.1	30.4	29.4	12.0	12.1	12.3
Greece	32.9	44.4	55.3	57.9	10.0	13.0	16.1
Spain	41.6	46.4	53.2	55.2	17.8	19.0	20.6
France	23.6	22.8	24.3	25.4	8.9	8.4	9.0
Italy	27.8	29.1	35.3	36.9	7.9	8.0	10.1
Cyprus	16.6	22.4	27.8	31.8	6.7	8.7	10.8
Latvia	37.2	31.0	28.4	24.7	13.9	11.6	11.4
Lithuania	35.3	32.2	26.4	24.2	10.4	9.0	7.7
Luxembourg	15.8	16.4	18.1	18.5	3.5	4.2	5.0
Hungary	26.6	26.1	28.1	28.8	6.6	6.4	7.3
Malta	13.1	13.8	14.2	14.5	6.7	7.1	7.2
Netherlands	8.7	7.6	9.5	9.8	6.0	5.3	6.6
Austria	8.8	8.3	8.7	8.7	5.2	5.0	5.2
Poland	23.7	25.8	26.5	27.5	8.2	8.7	8.9
Portugal	27.7e	30.1	37.7	38.4	8.2	11.7	14.3
Romania	22.1	23.7	22.7	22.2	6.9	7.4	7.0
Slovenia	14.7	15.7	20.6	23.2	5.9	5.9	7.1
Slovakia	33.9	33.5	34.0	35.1	10.4	10.0	10.4
Finland	21.4	20.1	19.0	19.3	10.6	10.1	9.8
Sweden	24.8	22.8	23.7	24.1	12.8	12.1	12.4
United Kingdom	19.6	21.1	21.0	20.7	11.6	12.4	12.4

* The quarterly youth unemployment rate is seasonally adjusted.
e: estimate