Parahyangan Catholic University

Faculty of Social and Political Sciences

Department of International Relations

Accredited A

SK BAN –PT NO: 451/SK/BAN-PT/Akred/S/XI/2014

Failure of European Monetary Union in Preventing and Solving Spain Economic Crisis

Thesis

By:

Michael Putra

2014330039

Bandung

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Hereby assert that this thesis is a product of my own work, and it has not been previously proposed by any other party in order to attain academic degree. Any idea and information gained from other parties are officially cited in accordance to the valid scientific writing method.

I declare this statement with full responsibility and I am willing to take any consequences given by the prevailing rules if this statement was found to be untrue.

Bandung, 10 July , 2018

Michael Putra

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ABSTRACT

Name : Michael Putra

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Title : Failure of European Monetary Union in Preventing and Solving Spain Economic Crisis

European economic crisis is the biggest crisis impacted Spain since World War II. Creation of European Monetary Union (EMU) supposed to be the solution to prevent past crisis of happening again. It inspires biggest question left unanswered up until today, why is the implementation of EMU combined with domestic policies of Spain failed to solve ongoing crisis and instead worsen the situation? This research will answer and analyse that question with theoretical analysis of economic integration by Bela Balassa, Keynesian economic theory, and Hyman P. Minsky theory of financial instability.

Answering biggest question in this research, market instability was partially caused by incomplete design of EMU. Incomplete economic integration caused discord of macroeconomic policy made by two different actors. Monetary policy made by European Central Bank often contradict Spain government fiscal plan. Situation changed Spain financial model and strategy to get out of crisis. This create Spain financial system become too liberal and out of government control. This situation is primary factor that cause crisis that prolonged due to insufficient policy made and discord in policy.

Keywords: Spain, Economic Crisis, Liberal Market, Monetary Policy, Fiscal Policy, Financial System.

ABSTRAKSI

Nama	: Michael Putra
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Krisis ekonomi Eropa sejak tahun 2008 menandai krisis ekonommi terbesar di daratan Eropa sejak Perang Dunia II. Implementasi "monetary union" di Eropa seharusnya menjadi strategi ekonomi untuk menghindari krisis dan menciptakan kemakmuran bersama. Muncul sebuah pertanyaan menarik, mengapa implementasi "European Monetary Union" (EMU) diiringi kebijakan domestik Spanyol gagal untuk menyelesaikan krisis ekonomi dan malah memperparah keadaan? Penelitian ini akan mencari jawaban atas pertanyaan tersebut dengan menggunakan bantuan teori "economic integration" karya Bela Balassa, teori ekonomi Keynesian, dan teori "financial instability" Hyman P. Minsky.

Menurut asusmsi temuan dalam penelitian ini, instabilitas pasar dan lembaga finansial turut dipengaruhi kekurangan mekanisme untuk mencegah dan menangani krisis di dalam EMU. Integrasi ekonomi yang tidak sempurna sampai tahap ke-7 dari teori Bela Balassa menciptakan kebijakan fiskal Spanyol dan kebijakan moneter European Centre Bank (ECB) seringkali bertentangan dan tidak mencapai hasil yang diinginkan. Situasi yang berubah sejak Spanyol bergabung dengan EMU mengharuskan Spanyol merubah strategi dan model ekonomi domestik untuk menyesuaikan dengan aturan Eropa. Hal ini menciptakan model perekonomian Spanyol yang seakan terlalu bebas dan tidak bisa dikontrol oleh pemerintah Spanyol. Hal inilah yang menjadi faktor penyebab krisis ekonomi di Spanyol tidak dapat diatasi dan terus bertambah parah.

Keywords: Spanyol, Krisis Ekonomi, *Liberal Market*, Kebijakan Moneter, Kebijakan Fiskal, Sistem Finansial.

FOREWORD

This thesis I made is titled **“Failure of European Monetary Union in Preventing and Solving Spain Economic Crisis”.** I choose this topic because of personal interest in economy and Europe. Since Europe plunged into crisis, I became even more interested to see how could a well-established economic integration system in a very developed region could not avoid global financial crisis and got worst damage of it. That interest then made me want to write a research on Europe economic crisis and its correlation to economic integration system called monetary union with focus on Spain as one of the most affected country.

With all of knowledge and experience I gained during 4 years of studying in International Relations Department of Parahyangan Catholic University, the goal of this research was to hone skills in understanding International Political Economy of Europe. Further, this research was done to hone skills in writing platform.

Hopefully this research could contribute to the development of International Political Economy discipline, especially in development of European Crisis management and integration model.

First and foremost, I would like to give thanks and gratitude to God for making everything possible. Many gratitude to both of my parent and my sister who always give very support possible. Many thanks to my parents for letting me finish my thesis in time and always supportive during writing process. I would also give my gratitude to Parahyangan English Debate Society members for giving me precious lesson and knowledge that become the foundation of my critical thinking process. Many gratitude also to mas Yulius Purwadi Hermawan, Ph.D. for guiding me throughout whole process of writing this research. Thanks to Yulius Purwadi Hermawan, Ph.D. patience and input, I can be confident in declaring that my thesis is finished and ready for the thesis defence. Lastly, I would like to give my thanks to team of lecturer for giving opportunity for me to present and defend my thesis.

I would like to apologize for any mistakes found in the thesis. Hopefully, shortcomings in this thesis could serve as extra motivation to keep learning and become better in future. I know that word enough is never applicable in academic fields that keep advancing everyday, and hope that any mistakes or shortcomings will make me able to learn and correct any mistakes in the future and contribute to advancement of political science and humanity in the future.

Regards,

Bandung, July 10, 2018

Michael Putra

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GLOSSARY

EEC	: European Economic Community
EMU	: European Monetary Union
EU	: European Union
FROB	: Fund for Orderly Bank Restructuring
GDP	: Gross Domestic Product
IMF	: International Monetary Fund

CHAPTER I

INTRODUCTION

1.1 Background

European economic integration which produced single currency named Euro along with monetary union was a long-planned strategy to create prosperity. European Economic Community which create single market followed by decision of 19 countries to fuse their currency supposedly create resilient and strong economy. However, that prosperity might only theoretically true for Europe right now. A big hope for prosperity was destroyed by economic crisis that run wild across Europe since 2008. Eurozone economic crisis said to be exported crisis which origin came from the United States (US) housing bubble so big that it effects could be felt worldwide. European financial crisis, turned to be bad omen for European Union (EU) member states as instead of seeking way to achieve prosperity as dreamed by EU founder, EU member states was occupied with way to get out of crisis and save their own economy.[1] It was such an irony that strategy to create resilient economy instead become the reason for downfall in the most developed region in the World.

European Monetary Union (EMU) should be the blame for European Economic Crisis. Decision of 19 EU member states to unified their own currency

[1] Mark Landler, "U.S. housing collapse spreads overseas," The New York Times, accessed September 20, 2017, http://www.nytimes.com/2008/04/13/business/worldbusiness/13iht-housing.1.11931770.html?mcubz=0

and implement single currency system complimented by EMU create a closely interconnected economy across Europe that might be good at a glance. However, it also indicated interdependency was which resulted in spread of recession if one country experience it.[2] Before crisis even hit Europe, there were signs of problem as Eurozone member states often seen not in the same wavelength when discussing their fiscal plan. Lack of fiscal coordination within Eurozone only widen the gap between economically strong and develop country such as Germany, and country still developing their economic power such as Greece and Italy.[3] Euro might be controlled by ECB to maintain value exchange stability, however, miscalculation happened when European countries decided to leave fiscal policies unattended and only impose common monetary policy which endanger European economy as potency of recession, crisis, and sovereign debt crisis remain large without any buffer policy.[4]

Eurozone crisis was real life prove of lack of fiscal coordination, coupled with inability of a country to adjust currency value and interest rate would only widen gap between countries, where only the rich and powerful one got benefits.[5] Since implementation of single currency in 1999, the only common macroeconomic policy ever set was monetary union which now within authority of European

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[2] Francesco Paolo Mongelli, and Juan Luis Vega, *What Effects is Emu Having on The Eurozone and its Member Countries? An Overview* (2006 Report), (Germany, European Central Bank, 2006), 32-35

[3] Florence Bouvet, *Dynamics of regional income inequality in Europe and impact of EU regional policy and EMU*, California: Sonoma State University, 18-25

[4] Benoît Cœuré, " The monetary policy of the European Central Bank," Barclays' European Conference, Tokyo, March 26, 2012, https://www.ecb.europa.eu/press/key/date/2012/html/sp120326.en.html

[5] Larry Elliot, "Greece's problems are the result of the eurozone having no fiscal policy," The Guardian, accessed September 21, 2017, https://www.theguardian.com/business/2015/feb/01/greece-problems-eurozone-fiscal-policy-germany

Central Bank (ECB) instead of state government.[6] Since then, Eurozone interest rate was controlled by ECB holding to common goal of keeping price and inflation rate stable.[7] What being neglected from Eurozone single currency mechanism was sound fiscal policy that more often than not have more direct implications toward inflation rate and price fluctuation inside one country.[8] In the context of European countries whom each have their own set of welfare policies funded by government spending, fiscal deficit become unavoidable. Fiscal deficit which only impact one country economy and currency before now have unavoidable implications toward whole Eurozone if not wider. Fiscal deficit then proven to be the cause of long-term crisis that somehow lead to sovereign debt crisis up which left not fully resolved until today.

Many researches were made and produced varieties of argumentation on what is the root causes of European economic crisis. All those researches have produced different kinds of findings, some found that the cause was indeed global recession, some other found that state are being reckless in their spending. Some findings interestingly tried to put the blame on Eurozone lack of sound policies and mechanism to deal with large scale economic crisis, whatever be the cause of crisis. Eurozone inability to minimize impacts of the crisis and proceed to solve the crisis put Europe in a situation where they have to face what possibly biggest economic crisis after World War II.[9]

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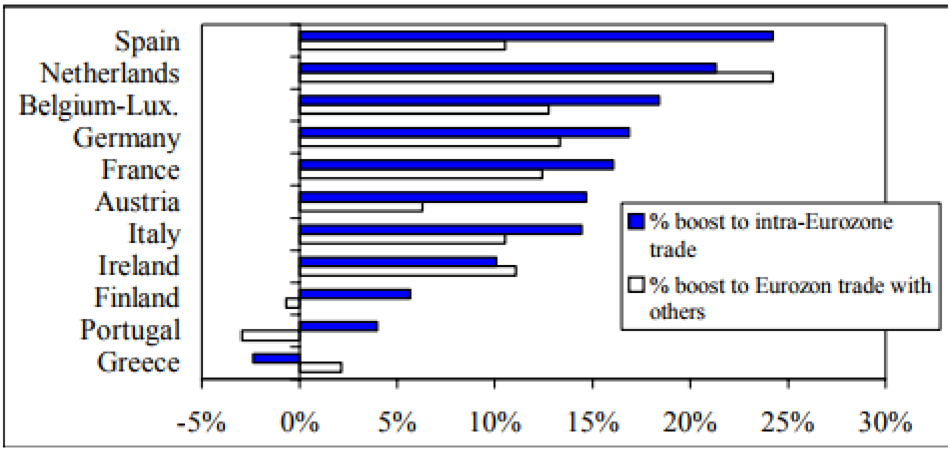
[6] *Treaty on the Functioning of the European Union* article 127
[7] ibid
[8] Dr. Willem F. Duisenberg, "Monetary and fiscal policy in the Eurozone," International Monetary Conference, Berlin, June 3, 2003, https://www.ecb.europa.eu/press/key/date/2003/html/sp030603.en.html
[9] Maartje Wijffelaars dan Herwin Loman, *The eurozone (debt) crisis – causes and crisis response*, Economic Report for Rabo Bank (2015)

Idea to use single currency across Europe was originally come since era of European Communities which aimed to further ease intraregional trade by removing what was thought to be biggest barrier, different value of currencies.[10] The idea was further developed to become single currency named Euro for 19 members of European Union that agreed to give up their rights to make monetary policies to pursue better economic benefits. At first, prospect of economic benefits looked promising. At one point in time, some even tried to sound a dream of further integration into ever closer union which Winston Churchill call as dream to create United States of Europe.[11] Implementation of single currency also marked the end of Eurozone member states right to make monetary policies which now within ECB authority which each member are required to comply with.

Figure 1.1 Eurozone Trade Boost



Sumber: Baldwin and Taglioni (2004) based Micco, Stein, dan Ordenez (2003), table 8

[10] Menzie D. Chinn dan Jeffry A. Frieden, "The Eurozone in Crisis: Origins and Prospects," La Follette Policy Report Volume 21 Number 2 (2012), 2
[11] Winston Churchill: Calling for a United States of Europe, European Commission

In early years, implementation of single currency showed positive improvement, with 10-15% average increase to trade as seen in the figure 1.1. However, the figure could be translated differently. Improvement to trade that happened to Eurozone members was unequal one, as stronger economy such as Spain and Germany enjoyed significantly higher increase than smaller economy such as Ireland and Greece. Even comparing growth of Germany as largest economy in Europe and Italy as 3rd largest in 2006, Germany economic growth was 3.7% almost doubled Italy with only 2%.[12] Growth disparity showed there was something wrong with single EMU which supposedly increase economy equally no matter what economic situation is as long as compliance maintained.

Up until this research finished, all monetary policies within Eurozone still governed fully by ECB without state interference. European Central Bank retain the right to determine interest rate, managing foreign exchange reserves, printing money, and also maintaining price stability by suiting trend and monetary policies.[13] All of those functions, supposedly still within authority of each country central banks as each country have different situations and need different approach to deal with situation such as crisis. No one can generalize the needs and situations of every country as different problem need different approach that would lead into different desired results.

During period of 2008 – 2013, Europe got hit by crisis caused by global recession that left a deep scar in European countries economy. European crisis

[12] "Italy," The World Bank, diakses pada 14 Oktober 2017; "Germany," The World Bank, diakses pada 14 Oktober 2017

[13] "European Central Bank (ECB)," European Union, diakses pada 14 Oktober 2017, https://europa.eu/european-union/about-eu/institutions-bodies/european-central-bank_en

affected whole economy of European countries and still cannot recover until this research was made. After seeing long term crisis without any sound recovery plan made by EU, European countries realized that there is a mistake in design of EMU. One of the mistake was that by giving up right to make monetary policies, countries no longer have luxury to flexibly adjust interest rate to control amount of money flowed in the market or at least to promote domestic consumption. Other than that, what have to be remembered is that ECB represent interest of all members of Eurozone. That would mean ECB have to also accommodate interest of powerful economy such as Germany and France that wanted different approach compared to smaller countries such as Spain.

Problems within EMU mechanism was indeed troublesome and need full cooperation from now debt-ridden countries to find solution together. However, seeing that it was not possible to find balance between flexible and discipline nature of policies proposed by countries in different situation, countries in deep crisis tried to find another way. They resorted to another macroeconomic policy, fiscal policy as their way out of crisis.

A lot of countries during period of 2007 – 2013 tried to use expansionary fiscal policies, even passing limit of excessive deficit stands at 3%. Even further, some countries such as Spain and Greece refuse to adjust their fiscal budget and maintain their expansionary fiscal even when the deficit is over 3% level which in result increase their debt level. Those countries believed that fiscal management is the only way out of crisis since monetary policy was definitely out of picture. This also result in free rider problem where countries believed that Germany, France, ECB, and other bigger countries will always have the interest to maintain Euro value, thus ensuring ECB was not empty and providing bailout in emergency.

In Spain, problem of fiscal deficit only come to surface after crisis hit. Before crisis, Spain almost seen no problem at all within their economy even though the signs should be clear. Spain financial crisis was full of huge debt from construction sector, exactly the same reason that make the US financial sector collapse from huge mortgage debt. The problem in Spain was even deeper as debt not only coming from consumer, but also from growing number of developer.

All of those problem resulted from EMU lack of mechanism to deal with crisis and especially controlling domestic financial institutions and how a country manage their economy. Thus, European countries left with a huge burden to recover their economy and increasing debt before it was too late. This research will try to find out how EMU actually failed in providing sound crisis management and only left Spain economy with little choice but to find other way to recover their economy.

1.2 Identification of Problem

1.2.1 Description of Problem

Monetary Union supposed to be macroeconomic strategy to avoid crisis in regional economic integration. However, the reality says something on the opposite as monetary union become the main reason for European crisis that persisted until today. The problem lies in incomplete economic tools that ECB or EU owned currently. Indeed ECB able to manage monetary policies that should be followed by all Eurozone member states. However, fiscal policies remained within nation's authority and nobody else could dictate it. This situation resulted in ECB inability to holistically manage European economy and can only sit and watch as crisis getting worse in some part of Europe, especially countries with excessive fiscal deficit.

In early years, it was already hard enough to maintain fiscal discipline of every member states even Germany. And after crisis hit, it was even harder to control. Decision making within ECB was made to accommodate diverse interest and ECB have to create convergence of policies to ensure it will be beneficial for all. However, ECB also to some extent have to listen to more powerful countries interest to keep maintaining price stability which translates into restricting amount of money available in market instead of consumption. Thus, fiscal policy being exploited by countries affected deeply by crisis such as Spain in order to fill in the gap left by monetary policy of ECB. This, resulted in lack of coordination between monetary and fiscal policies and cannot produce desired results.

European crisis proven to produce a huge loss for European countries as Europe economic growth during crisis was on the negative. It was predicted that economic growth in 2006 – 2008 projected to be stable in region of 2%.[14] In reality, it was lowest recorded number for Eurozone since its implementation in 1999 with only around 1% recorded during end of 2006 until end of 2008. Eurozone economic growth even reached negative in 2009, something unthinkable since discussion to implement single currency system. Even though it showed slight progress of recovery in later years, it still far below expected growth supposed to be reached by

[14] European Commission, *European Economy 5/2016: Economic Forecast (Autumn 2006)*, (Brussels: Directorate-General for Economic and Financial Affairs, 2006), 4

implementing single currency coupled with monetary union in already single market system. This become a bad record in history of European integration that supposed to create prosperity to all member states, not unequal growth.

All of this problem, further worsened by inability of ECB to manage or at least apply some degree of control over fiscal policy of each countries, even when economic restructuring plan has been voiced out. Countries unwillingness to comply with plan to implement austerity only worsened condition of Europe economy. All of these problems, supposed to be predictable and preventable with implementation of monetary union. However, as can be seen, monetary union cannot prevent or solve the crisis.

1.2.2 Scope of the Research

This research will seek to find explanation of why EMU unable to solve European crisis, and instead prolong the crisis during period of 2007 – 2013. This crisis will focus on looking at case study of Spain, especially analysing implications of EMU toward Spain domestic economy. Focus of research will be Spain domestic economy structure and problem lies behind what looked like a sound system and how Spain macroeconomic management affect the duration of crisis. The reason this research use timeframe of 2007 – 2013 because year of 2007 – 2008 was the initial years when the crisis started. Years of 2009 – 2012 marked the worse time of the crisis when Europe economy was hurt deeply in every areas, only to be slightly recovered in 2013 with extraordinary measures. Some factors that will be the main parameter in this research is Growth Domestic Product (GDP), GDP growth, GDP per capita, debt level, fiscal structure, and unemployment level of Spain. Those factors will be assessed based on its situation before crisis, and during the actual years of crisis. Policies made as a response to crisis will become variable that changes those factors and then assessed whether policies response and coordination with monetary policies made by ECB successful or fall short in solving the crisis.

1.2.3 Formulation of the Problem

Why is the implementation of EMU combined with domestic policies of Spain failed to solve ongoing crisis and instead worsen the situation?

1.3 Objectives and Significance of the Research

1.3.1 Objectives of the Research

Main objective of the researcher in this research is to analyse connection between regional economic integration of European countries and European crisis. Researcher aimed to take a look why and how economic integration that supposedly create economic growth instead failed to deal with crisis and only prolong the crisis. This research will try to compare theoretical prediction of resilient economy after integration with facts on the field.

Further, researcher wants to see the causality of policies made by ECB and Spain with European crisis in Spain during 2007 – 2013. This research will focus on analysing macroeconomic policies (monetary and fiscal) and crisis that hit

Spain. Further, this research aimed to find how implementation of monetary union without fiscal union create a loophole that become new problem when crisis arise. Along with that, this research will also try to find whether European economic integration brings more benefits or instead harms. Finally, researcher also aimed to resolve classic macroeconomic problem in economic integration of whether economic integration require strict rules or instead flexible rules might have better chance of success.

1.3.2 Significance of the Research

Significance of this research will be divided into two level. First, on theoretical level, this research aimed to bring further development toward theories and concepts being used in this research. Further, researcher aimed to also bring development toward theoretical perspectives and understanding of economic integration model that could be lessons for future economic integration everywhere. Other than to bring development to theoretical world, researcher also hoped that this research will be useful reference for other researchers and future researches on this particular fields. On practical level, researcher aimed to help analyse weakness of monetary union model of Eurozone and find the solution to fix it. Further, researcher hoped that this research could find recommendation that possibly could fix current European crisis.

1.4 Literature Review

Researcher will do literature review to find proofs and supportive arguments that would help strengthening thesis statement in this research. This research will use three literatures as main source of supportive arguments. The literatures are *Crisis in the Eurozone* by John Grahl; *The Formation of New Monetary Policies: Decisions of Central Banks on the Great Recession* by Ana Esther Castro and José Francisco Teixeira; *The Optimality of a Monetary Union without Fiscal Union* by Roel M. W. J. Beetsma and A. Lans Bovenberg.

First literature written by John Grahl state that current problem in Europe is inherited from imperfect decision-making process within EU that remain unsolved.[15] Next, a classic problem of single currency system arises where state have to willingly give up their right to determine monetary policies to make the system works.[16] However, state now become unable to exercise monetary policy as one of macroeconomic policy to get out of crisis.[17] Coupled with open market and competitive nature of single market, there will always be winners and losers even in friendly cooperation.[18]

Second literature by Ana Esther Castro and José Francisco Teixeira discuss about how European economic crisis made countries started to question and tried to intervene decisions made by ECB.[19] Problem mentioned in the literature is that those interventions seemed to have more political motives than economical

[15] John Grahl, *Crisis in Eurozone, Soundings* vol. 47 (2011), 143-148
[16] ibid
[17] ibid
[18] ibid
[19] Ana Esther Castro dan José Francisco Teixeira, The Formation of New Monetary Policies: Decisions of Central Banks on the Great Recession, *Economies* vol. 2 (2014), 109-123

motives.[20] Ana Esther Castro and José Francisco Teixeira argue that intervention to ECB decision was driven by some motivation under the pretence of helping countries in need.[21]

Second literature focused on political aspect of decision making process in ECB compared to first literature that more focused on theoretical aspect of integration and link to projection of economic growth. One thing both literature have in common was both literature criticize Eurozone member countries half baked commitment in implementing regulations made both by ECB or consolidation. Both literature also argue that some degree of flexibility might be the key to get Europe out of crisis.

Third literature by Roel M. W. J. Beetsma and A. Lans Bovenberg discuss how a monetary union would not survive crisis without proper coordination of fiscal and monetary policies.[22] This literature argue that there is a need to coordinate fiscal and monetary policies and use it for different situations.[23] In the case of Europe, this literature discuss how lack of coordination between ECB and state government create a situation where state tried to adjust their fiscal policies without prior coordination with ECB and fall into excessive fiscal deficit.[24]

Third literature again argue that there is a need to coordinate fiscal and monetary policies in a regional economic integration. Further, third literature discuss about willingness to cooperate and compliance to regulation made by ECB

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[20] ibid
[21] ibid
[22] *Journal of Money, Credit, and Banking* (2001) 33, 2, 179
[23] ibid
[24] ibid

as common guidelines in determining actions. However, third literature have a bit of difference with first and second literature on theoretical level where third literature instead argued that there is a need of rigid and binding system in Europe to create a resilient regional economy.

1.5 Theoretical Framework

Gunnar Myrdal (1956) state that economic integration is a situation where some countries attempted to remove any barriers for economic activities within socio-economic context.[25] Main argument of Gunnar Myrdal was that economic integration created should be open to all parties involved in the integration process and should bring benefits to all parties without discrimination.[26] Gunnar Myrdal theory further developed by Bela Balassa by trying to explain that economic integration could be defined in the context of interstate relations where there is attempt made by countries to remove any kinds of discrimination in economic relations such as tariff or quotas.[27] Further in his book, Bela Balassa state that there are seven stages of economic integration: Preferential trading area, Free trade area, Customs union, Common market, Economic union, Economic and monetary union, and Complete economic integration.[28] For the context of 19 members of European Union that become part of Eurozone, it has reached sixth stage where integration has reached advanced level of integration named monetary union where some

[25] Gunnar Myrdal, *An International Economy*, New York, Harper, 1956, p. 11
[26] ibid
[27] Bela Balassa, *Toward the Theory of Economic Integration*, George Allen and Unwin: 1962, 3-6
[28] Balassa, *The Theory of Economic Integration*

countries use same currency with centralized monetary policies but remain the right to have own fiscal policies.

Bela Balassa further argued that economic integration has to be followed by harmonization of policy made and implemented.[29] Harmonization will be detrimental to the success of integration as every monetary, fiscal, and social policy made will have certain degree of implications toward economic interaction.[30] It was necessary to ensure there is coordination of policies to prevent it from become new economic barrier in integration.[31] Harmonization especially become important as Eurozone has reached level of monetary union that requires coordination of monetary policies and fiscal policies to ensure stability of Euro value exchange in market.[32] When we take a look at real examples in Europe, exclusive right to manage fiscal policy retained by state government resulted in disharmony of monetary policies taken by ECB and fiscal policies taken by individual state government.

Bela Balassa theory on integration and especially seven stages of integration was what inspired 19 European countries to implement monetary union to achieve greater level of economic integration. This decision was taken based on premise that in order to maximize benefits from economic integration, there need to be minimum barriers in economic activities. Thus, difference of currency value deemed as one of the most fundamental barrier that need to be removed to

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[29] ibid
[30] ibid
[31] ibid
[32] Šehović, Damir," Coordination of Monetary and Fiscal Policy in the European Monetary Union," *Management: Journal of Sustainable Business and Management Solutions in Emerging Economies* [Online], Volume 19 Number 73 (31 May 2017)

strengthened integration and reap maximum benefit. With this, difference in exchange value removed and parties of Maastricht treaty can trade with more ease.

Bela Balassa theory of economic integration use the principles of liberal economy written by Adam Smith in his book Wealth of Nations. Adam Smith theory of free market system then become the most popular system within economic liberalism scientist and further inspires more theory including any theory for interstate economic relations. One of those persons was William Dyer Gramp that tried to use economic liberalism as critiques toward mercantilist system by accusing mercantilism can never produce fast and remarkable economic growth due to seclusive and closed nature.[33] All of those liberal economic theories then give birth to idea of economic integration with a complete set of recommended regulations to make it work.

Even though economic integration seemed requires a lot of complex mechanism, transfer of authority, and tight control over fiscal balance, some economist argued otherwise. John Maynard Keynes tried to argued that fiscal deficit does not always mean negative spending, as Keynes argued that could also be translated as productive spending done by government.[34] Keynes actually agreed that the end goal of fiscal policy should always be maintaining positive balance and pursuing growth.[35] However, Keynes also argued that in certain situation that require ore spending, a period of fiscal deficit was actually necessary to stimulate

[33] William Dyer Grampp, *Economic Liberalism vol. 2 The Classical View*. 11/16/2017, (New York: Random House, 1965), http://oll.libertyfund.org/titles/2131
[34] Roy J. Rotheim, *New Keynesian Economics/Post Keynesian Alternative*, London: Routledge (1998), 33-34
[35] ibid

or recover economy.[36] This would mean that there would be scenario where fiscal deficit need to be considered sound policy especially in crisis and government are left without monetary policy as an option. And some European country citizens seemed to agree with Keynes as they believed that EMU made their government unable to utilize monetary policies thus forcing government of Southern European states to take risky Keynesian fiscal deficit model as alternative.[37]

To understand more of fiscal and monetary policy and analyse the implications of each policy to another, firstly we have to understand what monetary union is. Monetary union defined by International Monetary Funds (IMF) as agreement among members of that union (countries or other jurisdictions) to share a common currency, and a single monetary and foreign exchange policy.[38] This would mean one group of countries will use one currency and have one monetary policy to rule over it just like single currency system implemented by Eurozone or Dollar union of the US.

Function of monetary policy inside of one country is for government to manipulate supply of money and credit within market.[39] In practice, this would mainly affect interest rate to incentivize people to either spend or save their money. Problem in Europe was, countries unable to manipulate supply one money or incentivize people to spend with monetary policy. Thus, option left for countries

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[36] ibid
[37] Marcus Miller dan Robert Skidelsky, "How Keynes would solve the eurozone crisis," Financial Times, diakses pada 14 Oktober 2017, https://www.ft.com/content/55d094cc-9e74-11e1-a24e-00144feabdc0
[38] Samuele Rosa, *IMF Committee on Balance of Payments Statistics Currency Union Technical Expert Group (CUTEG),* Issues Paper 1 CUTEG (2004)
[39] "Monetary Policy," Encyclopaedia Britannica, diakses pada 14 Oktober 2017, https://www.britannica.com/topic/monetary-policy

now is to utilize fiscal policy and tried to promote consumption with it or to directly provide credit using government spending.

Now to understand further of the main topic which is crisis, we have to take a look at Henryk Grossman theory of crisis. Henryk Grossman tried to develop Karl Marx Theory of "tendency of the rate of profit to fall," what called pinnacle of Karl Marx theory of economic crisis. In Henryk Grossman version, he tried to simplify the theory and said that crisis happened mainly when a certain amount of goods cannot be sold in certain amount of time the mechanism allowed.[40] That would mean capital unable to be turned to profit.

Theory of crisis can be implemented within European crisis context. However, to understand that, we need to first understand Hyman P. Minsky theory of financial instability. Minsky argued that current economic system worked based on principles of using current money to gain future money.[41] In that sense, people are investing capital to gain profit in the future. However, as Grossman argued, there could be some times where goods unable to be sold in certain amount of time, meaning future money could be loss and cannot cover present money. This is what create crisis right now in Europe as property being unsold. Further, Minsky argued that speculative investment could be the cause of greater crisis as when people faces period of prosperity, behaviour of business become too reckless and taking a lot of debt without considering sudden fall in prices or aggregate demand.[42] This is what

[40] Henryk Grossman, "The Theory of Economic Crisis," Bulletin International de l'Académie Polonaise des Sciences et des Lettres, Classe de Philologie, Classe d'Histoire et de Philosophie, I Partie, Les Années, Kraków (1922), 285-290
[41] Minsky, Hyman P, "The Financial Instability Hypothesis," Levy Economics Institute Working Paper No. 74 (1992), 6–8.
[42] Minsky, Hyman P. Ph.D., "Op-Ed Piece" (1974), Hyman P. Minsky Archive, 275, http://digitalcommons.bard.edu/hm_archive/275

create debt crisis as Minsky mentioned and in the context of state, not household, it become sovereign debt crisis.

Minsky works did not stop at explaining crisis. In some of his works, he tried to criticize current market system. He believed that current market has gone out of control and government can do nothing about it. He become enemy of Chicago School thinker that glorify deregulation of financial system. Minsky argued that in present, government cannot do anything in regards to crisis as government can only slow it down without full control over market.

In conclusion, discord of fiscal and monetary policy which remain unresolved until today left a big loophole inside EMU and even prolonged crisis. From the perspective of country in crisis, fiscal deficit is the only logically sound policy to recover their national economy. However, from perspective of EU, integration requires more discipline fiscal. Then we come to one conclusion that European economic integration need a lot more complex mechanism and willingness by countries to give up portion of their authority to make it work.

1.6 Methodology of the Research

1.6.1 Research Method

This research will use qualitative method according to John C. Creswell. According to John C. Creswell, qualitative method is a method that will analyse a phenomenon with constructive philosophical thinking and connect it with context of realities in current world using theoretical perspectives.[43] Qualitative method focus on analysing data using theoretical perspective starting from philosophical assumption and then translated into descriptive analysis.[44] This method must in the end analyse from the point of view of impacted actor.

This research will focus on descriptive analysis where researcher will try to describe relevant cases and connect it with the main topic of research. Researcher will try to find answer to the research question stated in previous part. At the same time, researcher will try to find description from relevant and similar cases and use theoretical perspectives outlaid in theoretical framework to find the connection between EMU and prolonged crisis in Spain.

1.6.2 Method of Data Collection

This research will use primary and secondary data gathered from documents and other relevant sources. Primary data will consist of statistical data relevant to the topic of research. Primary data will be gathered from official documents released by relevant parties. Primary data will include reports released by ECB, official report of Spain government and Banco de Espana, and documents from banks or other organizations. Secondary data used is literature produce by researchers before this research was made. Literature that will be studied is books, thesis, journals, and papers made by other researchers. Researcher will then process the data in the hope that it can complete previous researches.

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[43] John W. Creswell, "Designing a Qualitative Study", dalam Qualitative inquiry and research design: Choosing among five approaches (2nd ed.), (California: Thousand Oaks, 2007), hal 38
[44] ibid

1.7 Systematics of Research

In this research, I will assess first what aspects and variables inside monetary union will have direct or indirect implications toward a country economy. after that, this research will describe what happened in Spain until it finally became economic crisis. After that, I will explain the correlation of aspects and variables mentioned before in causing and prolonging the crisis.

Chapter I will discuss about background of what cause European crisis, theories and concepts that will be used to analyse, and systematics of the research.

Chapter II will discuss about origin of crisis in details and impacts of the crisis. This chapter will aim to prove that EMU is indeed responsible partially for crisis in Europe and especially Spain. Chapter II will analyse common economic policies inside Eurozone and its connection to economic crisis.

Chapter III will discuss Spain economic structure that looked promising and healthy but vulnerable to crisis. This chapter will aim to prove how Spain economic structure is vulnerable to crisis and unsustainable for long term. Later part of this chapter will describe Spain condition before and during the crisis, including some domestic responses linked to economic structure toward crisis.

Chapter IV will discuss how EMU has changed Spain banking system for worse and creating somehow too liberal economy. This chapter will also discuss Spain lack of policy coordination with ECB monetary policy which in turn left Spain economy vulnerable to unexpected situation and failed to recover.

Chapter V will be the conclusion of this research. Chapter V will assess what have been described and analysed in previous chapter and try to conclude it all. This chapter will be purely a product of researcher personal thought after assessing all data and theory involved in previous chapter.